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EDITORIAL OPINION

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Federal Preemption Is the Latest Key to Democratizing Investment

We have witnessed a profound transformation of the capital markets in America over the past three decades. From a landscape comprised primarily of institutional and wealthy investors to one where the typical American household enjoys broad access and the financial benefits of low cost and diversified investments. The Federal Reserve Bank of Dallas, once seeking to understand what drove this democratization, attributed it in part to rapid decline in the cost of mutual funds, which itself resulted in no small part from a crucial decision by Congress in 1996 to provide for federal preemption of state securities regulation over these needed products. Today, policymakers and the investing public sit at a similar crossroads. Fortunately, the path to promoting investor protection and prosperity should be the one more travelled.

The past several months have seen issuers and regulators, at both the federal and state level, raise serious concerns with sweeping changes to Real Estate Investment Trust (REIT) regulations proposed by the North American Securities Administrators Association. Included in those changes are restrictive investment concentration limits for public companies not listed on a nationally registered or third-party exchange.

State administrators have tried for decades to carve out a workable merit review process for these types of public companies. The result of that ill-conceived and quixotic endeavor has been more confusion and less transparency and diminished access for investors.

The debate over how to approach this issue has now reached a fever pitch. The Wall Street Journal observing the dialogue noted in a recent Editorial Board Opinion piece, the inherent contradiction in suggesting that one can protect investors while restricting the use of a needed investment diversification option. It also highlighted the anti-Main Street effect of limiting some retail investors dependent upon accredited status access to lucrative investment strategies proven to deliver positive results. The WSJ editorial board suggested that NASAA pull back from this effort. Clearly, ***asking*** NASAA to stand down isn't going to produce results.

However, there is a best course of action and a clear goal for an investor-friendly resolution. Identifying the substance and source of the problem are key.

NASAA's latest proposal is reminiscent of state activity which resulted in federal intervention during the Clinton administration. Passed in 1996 in response to state-level regulatory confusion, the National Markets Improvements Act (NSMIA) modernized the then cobbled together regulatory system and exempted almost all public fund issuers from state registration. The proliferation of conflicting regulations, at the time, forced (predominantly mutual fund) companies to conform with not only US Securities and Exchange Commission (SEC) rules but many differing requirements which were instituted state by state. To quote former SEC Chairman J. Sinclair Armstrong, the overlapping regulatory framework was…

> *"full of complexities, surprises, unsuspected liabilities for transactions normal and usual -in short, a crazy-quilt of state regulations no longer significant or meaningful in purpose, and usually stultifying in effect, or just plain useless."*

The passage of NSMIA was Congress' clear repudiation of state regulators who sought to supersede an already highly regulated and compliant industry.

However, like all legislation, NSMIA was written at a point in time and informed by the financial landscape at that moment. It omitted a subsection of other federally registered and publicly offered issuers the market for which was nascent. To wit, non-traded REITs (NTRs) were not prevalent at the time, nor did they look anything like the investor-friendly NTRs which dominate today's market.

The question for us is not the value of another state adopted disclosure or the utility of adding a more restrictive concentration limit, but whether the states should be tasked with doing this at all. Is it sensible to have a 52-state regulatory framework, on top of an SEC framework which stunts investors' ability to invest in the third largest asset class (commercial real estate) in the world, while raising the costs to do so?

It is incumbent on all of us to work together to advance a definitive and constructive solution: Federal preemption.

History has proven the wisdom of this policymaking approach. Following NSMIA's passage, federally registered issuers including, investment companies (e.g., mutual funds, closed-end fund, and unit investment trusts) as well as exchange-traded securities, which were previously subject to state regulations, were freed from the unnecessary burden of overlapping and contradictory legal regimes. Regulatory uniformity ensued which simplified and modernized the subscription process for retail investors. Almost overnight, American households gained and benefited from their newfound access to investment companies. This laid the groundwork for the democratization of investing in the markets for all, not just the rich (sometimes referred to as "Accredited"). With broader investment access came lower fees and costs as competition and the industry's scale grew—it was a virtuous cycle. Mutual Funds and ETFs would not be household names without NSMIA's intervention. The financial benefit and security that resulted from this to middle class household wealth is so large as to be difficult to calculate. Where would we be today without NSMIA?

The pleasant reality is that federal preemption for NTRs and other similarly publicly registered funds only amounts to adoption of a minor amendment to NSMIA. To be specific—federal legislators can add the following language into Section 18 (b) of Exchange Act of 1934 and expand the definition of a covered security:

> **(5) EXEMPTION IN CONNECTION WITH CERTAIN FEDERALLY REGISTERED OFFERINGS** A Security is a covered security if such security is an equity security which is issued by a company that is registered under section 12 of the SECURITIES EXCHANGE ACT of 1934. [15 U.S.C. 78I]

This amendment would allow for Federal Pre-Emption of Blue-Sky Laws for Federally Registered Companies consistent with congressional intent under NSMIA, passed in 1996. This would include Real Estate Investment Trust ("NTRs") and non-traded Business Development Companies ("NTBDCs") as examples of public companies who file 10-Ks and 10-Qs and are subject to the same SEC review, disclosures, and consistency of reporting as all publicly listed companies.

The modernization or the inclusion of Investment Companies that either didn't exist or were nascent in 1996 and are today subject to the same reviews at the SEC (there were no NTBDCs in 1996 and NTRs raised a total of $92 million when NSMIA was proposed) is commonsense. Leaving it to the discretion of 52 individual states to conduct a separate review and create their own merit standards is inefficient and not in the interest of the investing public. So much so that history informs us that even a Democratic President and a Republican House and Senate can agree when regulations need to be updated, so the absurd is not perpetuated.

We believe NASAA and the states are at their best when protecting the investors from fraud and the needed review of private securities offerings. However, individual states are ill suited and duplicative to a task that is already undertaken by the SEC with its $2.7 billion budget and highly skilled staff in reviewing of publicly registered offerings. All investors should benefit from regulatory modernization that improves protections and lowers costs. Let us also not repeat a mistake of adding to the wealth gap by drawing distinctions between wealthy and others. Everyone deserves the opportunity to invest and diversify in a prudently administered and regulated market. To say otherwise is not protection, it is paternalism. ■

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