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FINRA
Senior Vice President and Corporate Secretary
1735 K Street, NW
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The Securities and Exchange Commission
Division of Enforcement
Office of Market Intelligence
100 F. Street NE
Washington, DC 20549

Re: 1031 Investments in Delaware Statutory Trusts
Notice to Member 05-18 (March 2005) (the "Notice to Member")

Ladies and Gentlemen:

We are a law firm based in New York City, whose practice focuses on real estate and securities related arbitrations. We exclusively represent claimants in FINRA arbitrations and our firm is an active member in the Public Investors Arbitration Bar Association, or PIABA. Our firm recently filed over a dozen individual cases involving 1031 investments in Delaware Statutory Trusts, which are a relatively new investment vehicle.

We are writing to you with respect to the above-referenced Notice to Member, which concerns the sale of private placements of tenants-in-common interests. Specifically, we are writing to urge you to either modify the existing Notice to Member or release a new notice to member, which focuses on the unique risks associated with Delaware Statutory Trusts ("DSTs"). Because they allow for easier bank financing, DSTs are now more frequently used in connection with 1031 exchanges and contain unique and material risks, which are not addressed by any FINRA materials.

As you are aware, Section 1031 of the IRS code allows tax payers to defer capital gains tax upon the disposition of investment property, provided that the tax payer purchase a "like kind" property within certain prescribed time periods. In March 2005, FINRA released the Notice to Member in response to IRS Revenue Ruling 2002-22 ("Rev. 2002-22"), which addressed the

conditions under which the IRS would allow a tax payer to exchange tenant-in-common interests to satisfy the requirements of a "like kind" exchange. Rev. 2002-22 lead to member firms marketing and selling interests in tenants-in-common through private placements.

In 2004, the IRS issued Rev. Ruling 2004-86 ("Rev. 2004-86"), which addressed the conditions under which the IRS would allow a taxpayer to invest in a Delaware statutory trust ("DST"), which in turn owns the real estate, to accomplish the same tax deferral under IRS Section 1031. Rev. 2004-86 contains seven guidelines and prohibitions regarding the operation of a DST, which are known as the "seven deadly sins."

No Control

When investors invest in a tenant-in-common investment, they each own an undivided fee interest in the underlying real estate. As a result, each investor has some level of control with respect to the management of the underlying property. They also have reasonable legal recourse if the property is mismanaged or if they want to force a sale through a partition action.

Pursuant to Rev. 2004-86, in order for a DST to qualify as "like-kind" property, investors have to give complete control of the property to a third-party trustee. As a result, ***investors have no control over the property.*** Moreover, the DST trust documents generally limit the trustee's liability to a gross negligence standard, which is difficult to prove in most cases. This is a material risk, which is unique to investments in DSTs, and is often misunderstood by investors who are surprised to learn that trustees are not mere property managers. In fact, in one case we are involved with the trustee mismanaged a property, which resulted in a foreclosure. The investors were unable to recover in a court action against the trustee because a court found that the actions, although potentially negligent, did not rise to the level of gross negligence.

Complex Structure in an Illiquid Investment

Rev. 2004-86 also prohibits the trustee from entering into new leases or renegotiating current leases. This prohibition creates an added layer of complexity because it requires the DST to enter into a ground lease for the property with a "master tenant," who in turn, enters into many smaller leases with tenants so as not to run afoul of the Rev. 2004-86.

This master tenant is almost always an affiliate of the real estate company that acts as trustee. When investors are pitched DST investments they are told that the master lease structure is secure and analogous to an investment with a long term reputable ground tenant. This is not only false, but it is incredibly misleading. The reality is that the DST tenant is not just undercapitalized, it is merely a shell used merely as a pass-through.

This complex structure also enables the collection of fees at every level reducing the profitability of the investment. The trustee receives a fee, as does the master tenant and the management company – all of which are often affiliates of the same company. The possibility to churn and generate fees at multiple levels simply does not exist with an ordinary tenant-in-common investment because there are not multiple and complex layers of parties.

Lastly, these investments are completely illiquid. There is no secondary market for beneficial interests in DSTs. Assuming such a market even existed, the sale of a DST interest would likely trigger capital gains tax.

Excessive Fees

In one case we filed recently, the initial upfront fees associated with the investment actually ***exceeded the income tax deferral***. In fact, in this case the fee to the FINRA member alone equaled 10% of the total amount of the investment. This investment literally made no logical sense as the investor would have been better suited paying the capital gains tax and investing in a less risky investment. Unfortunately, this is not an uncommon occurrence as we notice that DST investment generally have higher upfront fees than traditional TIC investments.

In addition to the fees paid to the FINRA member at a closing, we have noticed various fees paid to the real estate investment company (i.e. the trustee) at the closing for the real estate. These fees include payments of a real estate brokerage commission and payments of a commission to arrange the underlying financing.

Foreclosure Prone

Possibly the most unusual of the "seven deadly sins" is the requirement that the DST cannot be recapitalized. According to Rev 2004-86, if investors want to recapitalize a DST they must convert it to a limited liability company, which would destroy the tax savings. In fact, in a recent case that our law firm filed, investors faced a difficult choice – on the one hand they could save their investment from foreclosure by converting and recapitalizing the DST, but on the other they would face the prospect of an added tax burden.

Another fatal feature of the DST is that Rev 2004-86 prohibits the trustee from renegotiate the terms of existing loans as well as borrowing new funds. This essentially eliminates the possibility of a work-out if the underlying property is in danger of foreclosure. Once again, this risk is entirely unique to DSTs.

Why is this important now?

It is imperative that FINRA take action immediately. The real estate market is enjoying an unprecedented high and investors are realizing large profits. As a result, 1031 transactions are becoming more and more prevalent. Unfortunately, as we saw during the last cycle, many of these investments are laden with fees and based on overblown financial projections. As a result, many of them are simply destined to fail.

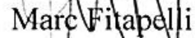
We are also noticing that member firms are pitching DST investments by giving investors marketing materials for tenant-in-common investments – effectively treating the risks as equal. This is not only wrong, but it is irresponsible as there are heightened risks associated with DST investments. It is imperative that member firms are not only educated regarding these risks, but mandated to provide heightened oversight. FINRA or the SEC should issue separate suitability guideless, but there are none. This is a problem.

Conclusion

Over the last several months our firm has filed over a dozen individual arbitrations on behalf of 1031 investors throughout the country who have suffered devastating losses through Delaware Statutory Trusts. Many of these investors were elderly and most had no idea how risky and complex these instruments can be. Sadly, many of these customers would never have invested in these investments had they been aware of the serious risks associated with DST investments.

We appreciate your time and consideration. We will make our office available to FINRA or the SEC to assist in this endeavor in any way that it deems appropriate.

Best regards,



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