Ohio

SECURITIES BULLETIN

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OHIO SECURITIES BULLETIN

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SUMMARY OF CHANGES TO THE RULES OF THE DIVISION OF SECURITIES

On June 8, 2015, pursuant to the statutory requirement that all agencies review their rules every five years, the Division of Securities (the "Division") has re-filed all 27 of its rules with the Joint Committee on Agency Rule Review, proposing to make some amendments and rescind one rule. The following is only a summary of the changes to the existing rules. Reference to the rule itself is suggested if a thorough understanding is desired. Rules may be found at http://www.com.ohio.gov/ProposedRules.aspx. The public hearing on the rules will be held on July 9 with the anticipated effective date of August 23, 2015.

PROPOSED RESCISSION:

Ohio Administrative Code ("OAC") 1301:6-1-03, Public Notice of Promulgation of Rule. The rule in its present form duplicates the existing statutory requirements and is therefore unnecessary.

PROPOSED AMENDMENTS:

OAC 1301:6-3-01 (L) contained a citation to the '33 Securities Act which needed to be corrected.

OAC 1301:6-3-02 is being revised to delete the names of specific national exchanges and substitute a reference to the Securities Act of 1933 to determine the exchange exemption.

OAC 1301:6-3-03(G) will omit the reference to RC 1707.03(X) because the consent to service is no longer required as part of the filing for section (X). OAC 1301:6-3-14.1 will require notice filers to submit a form ADV, Part 2A and will also make three corrections – one to Form ADV, one to change references from NASD to FINRA and the last to correct a citation to OAC 1301:6-3-15.1.

OAC 1301:6-3-15(B) contains a change to substitute designated principals identified on the federal form BD for those listed in the former rule to provide uniformity with the federal requirements.

OAC 1301:6-3-15.1 contains a number of changes relating to Investment Advisers. In section (A)(16) the definition of "qualified client" has been revised to mirror the federal definition, as amended by Dodd-Frank. In section (B) the language has been changed to make consistent with the new ADV instructions by relabeling parts I and II to parts 1 and 2. In that same section, the filing of Amendments to the form ADV is made consistent with federal requirements. In section (E)(1)(d) the term "cash reconciliations" has been revised to "bank reconciliations." In sections (E)(!)(k) and (p), language is inserted to clarify that internet and social media advertising records must be maintained with other advertising. Section (E)(7) has been amended to require electronic records to be maintained for the same period that the same paper records would have to be maintained. Section

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SUMMARY OF CHANGES TO THE RULES OF THE DIVISION OF SECURITIES (CONTINUED)

(Continued from page 1)

(G) was changed to clarify that the brochure should be in the format of new Part 2 only and to make corrective changes. Section (H) was revised to expressly require all advisory contracts to be signed and dated by both the client and the IA. Section (K) now provides that the time an application may remain pending without action is 180 days.

OAC 1301:6-3-16 relating to salespersons' licenses has been updated. Section (D) creates a limit of 180 days as the time a salesperson's application may remain pending without action. Section (E) expands the rule to allow a salesperson to be affiliated with two dealers.

OAC 1301:6-3-16.1, dealing with investment adviser representative's license, is proposed to be amended in section (G) to create a limit of 180 days an application may remain pending without action by the applicant.

OAC 1301:6-3-39.1, relating to retroactive exemptions, qualifications or registrations, has been proposed to be changed in section (F) to omit consent to service of process, in keeping with the change the Division recommended to the statute, and to add language to allow credit for any previously paid fee.

OAC 1301:6-3-44 relates to Investment Advisers and Investment Adviser Representatives. Section (A) is updated to include social media sites in the restrictions to false advertising. Section (C) revised the solicitor rule to include state securities violations as a disqualifying event. Section (E) adds a specific prohibition against any IA or IAR from breaching their fiduciary duty to their client.

OAC 1301:6-3-48 deals with record retention by the Division. It is proposed that the rule be revised to allow the Division to receive and maintain electronic records in the same manner as paper records.

ADMINISTRATIVE ACTIONS

Division Order No. 15-006
Eric T. House, CRD No. 1984306

On April 20, 2015, the Ohio Division of Securities (the "Division") issued Division Order Number 15-006, a Cease and Desist Order against Eric T. House, based on findings that he sold unregistered investment contracts to three of his investment advisory clients for an aggregate amount of $850,000, in exchange for sales commissions of more than $30,000. The unregistered investment contracts were issued by French Manor Properties, LLC through Brenda Ashcraft. (See Criminal Actions.) The Division further found that House had engaged in fraudulent, manipulative or deceptive practices by selling the investment contracts without disclosing his remuneration and by making false representations on his Form ADV filings in 2011, 2012 and 2013. In 2013, the Division revoked the Ohio licenses of House and his firm, Valhalla Investment Advisory, Inc. CRD No. 111534, in Division Order Number 13-035, entered with consent. An administrative hearing was not requested by House.

Division Order No. 15-007
Edward I. Campbell and Rosewood Consulting, LLC

On May 5, 2015, the Division issued a Notice of Opportunity for Hearing and a Notice of Intent to Issue Cease and Desist Order in Division Order Number 15-007, against Edward I. Campbell and his company, Rosewood Consulting, LLC. The Notice alleges that Campbell solicited and sold Chinese Reorganization Gold Loan Bonds and related investment contracts to two Ohio investors without proper licensure and registration from the Division. The Notice further alleges that Campbell and Rosewood sold the securities through fraudulent and misleading statements on their website and LinkedIn pages, including allegedly false information about Campbell's background, quick and substantial returns on investment and guaranteed principal values.

UPCOMING CRIMINAL TRIALS

July 7, 2015	State v. Bernard Minneyfield	14CR006460	Franklin County
July 21, 2015	State v. Steven P. Moore	14CR110-0455	Delaware County
September 22, 2015	U.S. v. Geoffrey Nehrenz	1:15CR017	U.S. Dist. N. Ohio

CRIMINAL CASES

Case No. 1:13-CR-00093
U.S. District Court for the Southern District of Ohio U.S. v. Brenda Ashcraft

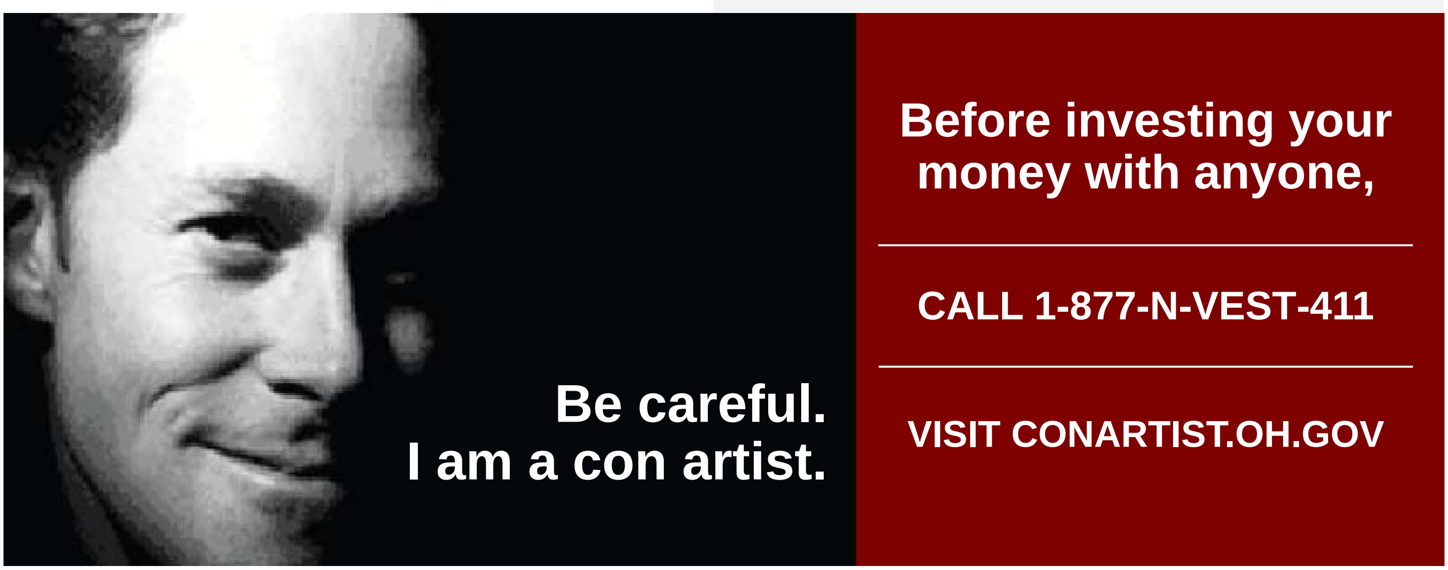
On April 15, 2015, Ms. Ashcraft pleaded guilty to wire fraud, securities fraud, money laundering and obstruction of justice in case number 1:13-cr-00093 in the U.S. District Court for the Southern District of Ohio for her actions related to the sale of investment contracts, REITs, issued by her company, French Manor Properties, LLC. Ashcraft was arrested on April 14, 2015 after failing to appear for the first day of her scheduled criminal trial in this case. The sentencing hearing will be scheduled after the presentence investigation report is received by the court.

Case No. B1304 320
Court of Common Pleas, Hamilton County, Ohio
State of Ohio v. Peter A. Beck, et al.

Following a criminal referral by the Division and a criminal trial, Peter A. Beck was convicted on 13 criminal counts, including 3 counts of theft, 3 securities violations and 7 counts of perjury based on false statements he made under oath during a Division investigative hearing. Peter A. Beck, John Fussner and Janet Combs were all indicted in a superseding indictment filed February 13, 2014, which included allegations that the defendants defrauded investors out of millions of dollars and then funneled investor funds to various accounts through Christopher Technologies, LLC, TML Consulting and other related businesses. Instead of being used to fund technology and future development, investor funds were used to pay prior expenses and liabilities that were not disclosed to investors prior to investing in Christopher Technologies, LLC. Investor funds were also funneled through a local church where Combs was the pastor. Both Fussner and Combs pleaded guilty to reduced charges prior to the start of the trial and agreed to testify against Beck. Vernon "Chip" DeMois pleaded no contest to a bill of information for a charge of the unlicensed sale of securities his actions as the CEO of TML Consulting LLC. The sentencing hearing is scheduled for August 20, 2015.

Case No. CR-14-584064-A
Court of Common Pleas, Cuyahoga County, Ohio
State of Ohio v. Peter Wilson

Following a criminal referral by the Ohio Division of Securities and an indictment, Peter Wilson of Rocky River, Ohio pleaded guilty to one count of securities fraud and one count of aggravated theft in the Cuyahoga County Common Pleas Court. The conviction stems from misrepresentations Wilson made to Ohio investors that their money would be used to purchase an ownership interest in a spirituous liquor company. Instead, Wilson used the investors’ money to fund tuition at a private university and for his own personal spending. In 2005, prior to the indictment in this case, Wilson was permanently enjoined from trading in securities, with limited exception, by Judge Patricia Gaughan of the U. S. District Court, Northern District of Ohio, after a complaint was filed by the Unites States Securities and Exchange Commission alleging securities fraud and other violations. Sentencing is scheduled for July 7, 2015.



COMMENTS FROM COMMISSIONER, ANDREA SEIDT

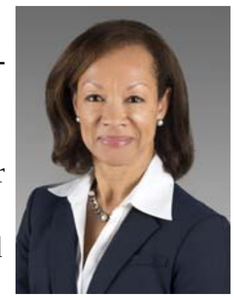
Summer greetings, friends and colleagues. It is hard to believe that we are already half-way through 2015, but what a productive year it has been so far for all of us here at the Department of Commerce's Division of Securities. I am pleased to start this quarter's issue with an introduction to our new agency Director, Jacqueline Williams. Director Williams is an accomplished business woman and policy leader focused on economic development and providing fast, common-sense service to Ohio's regulated industries. Members of the Division's Advisory Committees will have the opportunity to meet with Director Williams at a late-summer meeting the Division is planning this year as a prelude to the annual Fall Conference. Subscribers interested in joining an Advisory Committee can contact me for details.

I just recently returned from Washington, D.C. for the first ever Capital Formation Roundtable hosted by the North American Securities Administrators Association (NASAA). Members of NASAA's Capital Formation Committee met with scholars, investor advocates, and industry leaders representing the startup, crowdfunding, and small business communities to discuss ways state regulators can better facilitate robust but responsible capital formation. If you have a suggestion for modernizing or easing, where appropriate, state blue sky regulatory requirements, please share it. We are always looking for ways to improve Ohio's regime and I would be happy to pass along information regarding other state requirements or multi-state matters to NASAA's Capital Formation Committee or Corporation Finance Section.

The articles in this *OSB* provide a glimpse into some of the Division's other recent activities, which include the near end of the five-year rule review process, convictions in a few high-profile Enforcement cases, as well as helpful tips for practitioners and industry professionals in resolving common licensing questions and concerns. We also present our second installment of the *Ohio Securities Exchange*, offering views and commentary by outside contributors that are sure to spur debate on current topics and trends occurring in the securities world today. Individuals or entities interested in submitting an article in a future edition should contact the *OSB*'s Editor-In-Chief, Enforcement Attorney Kyle Evans, for more information.

I hope you find the *Ohio Securities Bulletin* and *Ohio Securities Exchange* useful and interesting resources for your practice and trust you will not hesitate to contact me or Division staff if you have any questions about the content or other matters of interest or concern. Have a great summer and hope to see you all at this year's Ohio Securities Conference in October.

OHIO DEPARTMENT OF COMMERCE DIRECTOR, JACQUELINE T. WILLIAMS



Prior to her appointment as Director, Williams served as Chief of the Minority Business Development Division in the Ohio Development Services Agency. In that role, she was responsible for leading the state's efforts to develop, grow and sustain minority, women and disadvantaged business enterprises. She previously was Executive Director of the Ohio Liquor Control Commission.

Williams has also served as the Director of College Savings with the New America Foundation in Washington, D.C. In that capacity, she worked with policymakers, opinion leaders and consumers to establish a national college savings agenda.

Prior to her time in Washington, Williams served for 10 years as Executive Director of the Ohio Tuition Trust Authority, where she repositioned the enterprise to grow assets in CollegeAdvantage, the state's 529 college savings plan, from $440 million to $6.5 billion and increased plan participation from 85,000 to 760,000. During her tenure, CollegeAdvantage was recognized by SavingforCollege.com and Morningstar as a Top 5 national college savings plan. Williams served two terms as Chair of the College Savings Plans Network and under her leadership, the network achieved tax free distribution for 529 plans. Williams has also served as Chief of Consumer Services at the Ohio Consumers Counsel and Chief Administrative Officer with the Ohio Bureau of Workers Compensation, where she oversaw marketing, human resources, training and communications.

A to Z with L & E

VARIABLE ANNUITY SALES

Some readers may not be familiar with the interplay between federal and state (insurance and securities) regulations when selling variable annuity contracts. While the Ohio Division of Securities (the "Division") cannot speak to the specific licensing requirements of other regulating authorities, we hope our coverage of the topic here encourages variable annuity sellers to conduct their own "licensing due diligence" before moving forward with a sale.

The U.S. Supreme Court in *SEC v. Variable Life Insurance Co. ("VALIC")*, determined that under federal securities laws, variable annuities carry with them sufficient risk characteristics such that they are securities (either as "investment contracts" or "certificates of interest" or the "participation in a profit sharing agreement").[1] As such, variable products and those who sell them are subject to federal securities regulations.

VALIC notwithstanding, a majority of states have excluded the annuities themselves from coverage under their state's securities laws.[2] Ohio is among that majority, as set forth in R.C. 3911.011(D), which states, in part: "Chapter 1707: of the Revised Code [the Ohio Securities Act] does not apply to any policy, annuity, or other contract providing fixed, variable, or fixed and variable benefits or contractual payments, that is issued by any company, partnership, or association authorized to transact the business of life insurance in this state."

Under Ohio insurance law, in order to sell variable annuity products in Ohio, agents must be licensed with a variable products qualification.[3] One of the requirements for a variable annuity line of authority is registration with FINRA as a registered representative, after having passed at least one of the following exams: the S6, S7, S63, S66, or any other FINRA examination approved by the superintendent.[4]

An individual (and/or their firm) properly licensed both at the federal level and with the Ohio Department of Insurance, may also be required to be licensed with the Division before advising or recommending the sale or purchase of a security in order to effectuate the annuity transaction. One such scenario which could trigger this licensing requirement is where the agent advises the client to sell certain securities holdings and apply the proceeds of those sales to fund the purchase of a variable annuity. Licensure with the Division as either an Investment Adviser (IA) or Investment Adviser Representative (IAR) may be required in this context, to the extent that the sale of the variable annuity is connected to or with "advising others … as to the value of securities or as to the advisability of investing in, purchasing, or *selling* securities."[5] As described in detail by the article "Do I Need a License?" (Ohio Securities Bulletin, Issue 2014:2, pp. 7-9), there are three core requirements which generally classify one as an IA under Ohio law: (1) the receipt of some economic benefit, even when that benefit is not provided directly by the recipient; (2) when the individual is "engaged in the business" of providing investment advice; and (3) when the advice pertains to securities.[6]

If you have not already considered whether IA or IAR licensure is required in connection with your variable annuity sales practices, we strongly encourage you to explore these requirements further. As always, the Division's Licensing staff is available to provide additional guidance about this topic.

A TO Z
WITH L & E

This section of the Bulletin, the Licensing and Examination Section of the Division ("L & E"), discusses timely and important topics impacting our licensees. The goal is to cover a wide-range of issues – from "A to Z" – that are of greatest interest to you!

We welcome your suggestions for future topics.

Ohio Division of Securities

Licensing & Examination

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[1] *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 71-72 (1959) (A variable annuity, said the Court, "places all the investment risks on the annuitant, none on the company. The holder gets only a *pro rata* share of what the portfolio of equity interest reflects -- which may be a lot, a little, or nothing.").
[2] 1-2 Blue Sky Regulation § 2.08.
[3] *See* R.C. §§ 3905.02, 3905.05, and 3905.06.
[4] *See* R.C. § 3905.06(A)(1)(e).
[5] *See* R.C. § 1707.01(X) (emphasis added).
[6] Ohio Securities Bulletin, Issue 2014:2.

Q&A

General Semantics *(def): the language used to achieve a desired effect on an audience especially through the use of words with novel or dual meanings (Merriam Webster)*

Every week the Ohio Division of Securities (the "Division") receives a multitude of phone calls and emails that ask about the examination requirements in Ohio. The Division has found that many of the Registered Representatives (RRs) and Investment Adviser Representatives (IARs) are given "words" by their firm compliance officers that do not translate as anything meaningful to the Division, and this leaves many firms and their licensees confused. Here is a start to explaining Ohio's minimum qualification requirements as it pertains to both RRs and IAR working with Ohio investors.

Q. Does Ohio "require" the Series 63 to be a licensed IAR? The Series 65? The Series 66?

A. No, we do not "require" the 63, 65, or 66 specifically, but rather, accept a passing score on any one of these tests (along with several other examinations) as a minimum competency requirement for licensure in Ohio. Ohio Administrative Code Section 1301:6-3-16.1 lays out the examination or professional designation requirements for meeting the minimu competency standards for Ohio IAR licensure.

Q. My Series 65 (or any examination for that matter) is about to "lapse" or "expire." Will the Division grant a waiver for these examinations in order for me to be a licensed IAR in Ohio?

A. The Ohio Administrative Code does not use the words "lapse" or "expire." Ohio does not require that in order for a test score to be valid, the test must have been taken and passed within the last two years. The Ohio Administrative Code provides for validation of all passing test scores no matter when they were taken. Thus, Ohio does not consider a test to "lapse" or "expire."

Q. My last firm did not register me as an IAR, only a RR. Did Ohio "hold" my S65? Will the Division allow me to "use" my "lapsed" test to become a licensed IAR again?

A. Ohio does not "sponsor" or "hold" a license or test score. In order to be a licensed IAR in Ohio, one must be employed by or affiliated with a licensed Investment Adviser firm. Once the employment relationship severs, the IAR license terminates by law.[1] Upon reapplication with a new Investment Adviser firm, the Division will review the application to verify the candidate has achieved a passing score on one of the requisite examinations.

Keep in mind that each state has its own minimum competency determination, and as such, the examination requirements and validation rules in other states may not be the same as they are in Ohio. Similarly, FINRA has its own requirements when it comes to the validation of test scores for an applicant seeking to become a licensed RR with a FINRA-registered Broker Dealer. Applicants seeking licenses across multiple jurisdictions should contact each regulator for guidance on their specific rules. We hope that this helps cut the confusion about this terminology, but whenever in doubt, please call the Division's Licensing section at (614)644-7381.

[1]R.C. § 1707.161(C).

LICENSING SPOTLIGHT

Pam Edgerton-Saunders is a 27-year veteran of the Division. Pam has held various roles at the Division, especially as it grew and took on the licensure of Ohio Investment Advisers and their Representatives.

Pam's experience in administration and licensing has served the Division well, as she is able to communicate effectively with the public on a number of important issues.

One of Pam's important roles is to help Ohioan's "Check before they Invest!" As part of the Division's outreach endeavors, we stress the importance of checking out the individual and company you are planning to invest with, and confirm that they are properly licensed.

Pam is always available by email or telephone to look up individuals and verify licensure. Before joining the Division, Pam worked for the law firm of Bricker & Eckler, LLP.

Away from the office, Pam is a Board member of the Metropolitan Youth Foundation, an organization that helps youth in the community prepare for college, including preparing for college entrance exams.

The Division is very fortunate to have Pam as a part of its Licensing Team!

Ohio

SECURITIES EXCHANGE

MAJOR INVESTOR LOSSES DUE TO CONFLICTED ADVICE: BROKERAGE INDUSTRY ADVERTISING CREATES THE ILLUSION OF A FIDUCIARY DUTY

BY PETER J. MOUGEY, CHRISTINE LAZARO, AND JOSEPH C. PEIFFER

OHIO SECURITIES EXCHANGE

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OHIO SECURITIES EXCHANGE

The Ohio Securities Exchange provides a platform where views and opinions relating to the securities industry can be shared from sources outside the Division.

The Division encourages members of the securities community to submit articles pertaining to securities law and regulation in the state of Ohio.

If you are interested in submitting an article, please contact the Editor-In-Chief,

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MISLEADING ADS FUEL CONFUSION, UNDERSCORE NEED FOR FIDUCIARY STANDARD

Currently, there is no national standard requiring brokerage firms to put investors' interests in preserving their nest eggs over brokerage firms' interests in making money from those investors' accounts. According to a recent study, every year that goes by without such a rule costs American investors another $17 billion.[1] Dodd- Frank, passed five years ago, mandated that the Securities & Exchange Commission (the "SEC") study this issue. During the course of the last five years without a SEC rule, inaction on the issue has cost investors nearly $80 billion.[2]

The problem continues to grow worse as more and more Americans lose their defined benefit plans and, instead, roll their life savings into IRAs,[3] which they must invest for their future. A critical component of the problem is the brokerage industry's marketing efforts to convince investors they absolutely require the assistance of brokers to protect their retirement savings.

Firms routinely advertise themselves as giving personalized, ongoing, non-conflicted advice that puts the customer first. Brokerage firms have also taken the position publicly with the regulators that such a duty should exist. But, when called to account for their actions behind closed-doors, these same brokerage firms litigate like they have no such duty. This highlights the need for a national, strong fiduciary duty that holds firms to the standard they advertise to the public and articulate to the regulators.

THE CURRENT LANDSCAPE: INVESTMENT ADVISER AND BROKER DUTIES

Investment advice is provided to investors by two different types of financial advisers: Investment Advisers and Brokers. Each is subject to different regulatory regimes, although there is some overlap in those who enforce the regulations. Investment Advisers are subject to the Investment Advisers Act of 1940 (the "Advisers Act") and the rules promulgated thereunder as well as state statutes and regulations. The SEC and the state securities regulators enforce those statutes and regulations. Brokers are governed by the Securities Exchange Act of 1934 (the "Exchange Act") and the rules promulgated thereunder as well as by state statutes and regulations. In addition, Brokers are regulated by the Financial Industry Regulatory Authority ("FINRA"), a self-regulatory organization and are subject to the rules promulgated by FINRA.[4]

Investment Advisers must adhere to a fiduciary duty standard, which is derived from judicial interpretations of the Advisers Act. The fiduciary duty is generally defined by case law to include the duty of loyalty and care, and the obligation to always put the client's interests before and above the Investment Adviser's own interests when the Adviser interacts with a client. Brokers, instead of a fiduciary standard, must adhere to a suitability standard which is premised on a FINRA rule that requires a Broker to have a reasonable basis for believing a recommendation of a security or an investment strategy is "suitable" for a client, based on the client's investment profile.

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[1]*See* "The Effects of Conflicted Investment Advice on Retirement Savings," February 2015, available at https://www.whitehouse.gov/sites/default/files/docs/cea_coi_report_final.pdf.
[2]*Id.*, $17 billion times 4.6 years since the passage of Dodd-Frank equals $79.22 billion.
[3]*Id.* at 5. Beginning in the 1970s and continuing through the end of 2013, the number of Americans covered by a traditional pension plan was cut in half while the number of Americans depending on 401(k)s and IRAs more than doubled.
[4]Both brokers and investment advisers are subject to the various states' common law regarding the imposition of fiduciary duty. The patchwork of inconsistent state laws on the subject only serves to highlight the critical need for a national standard.

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Although both Investment Advisers and Brokers are regulated extensively, the differences in these regulatory regimes lead to different results for investors. Investors generally are not aware of these differences or their legal implications. Many investors are also confused by the different standards of care that apply to Investment Advisers and Brokers, and many do not even know with which type of investment professional with whom they are doing business. Investors believe their financial adviser, whether they are a “broker” or an “investment adviser,” is acting in their best interest. That confusion has been a source of concern for regulators and Congress. Section 913 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) required the SEC to conduct a study to evaluate:

- The effectiveness of existing legal or regulatory standards of care (imposed by the Commission, a national securities association, and other federal or state authorities) for providing personalized investment advice and recommendations about securities to retail customers; and
- Whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for providing personalized investment advice about securities to retail customers that should be addressed by rule or statute.[5]

PROPOSED CHANGES

The Staff of the SEC issued its report to Congress following the study it conducted pursuant to section 913 of Dodd-Frank. The Staff made the following recommendation:

The Commission should engage in rulemaking to implement the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. Specifically, the Staff recommends that the uniform fiduciary standard of conduct established by the Commission should provide that:

> the standard of conduct for all brokers, dealers, and investment advisers, when providing personalized investment advice about securities to retail customers (and such other customers as the Commission may by rule provide), shall be to act in the best interests of the customer without regard to the financial or other interests of the broker, dealer, or investment adviser providing the advice.[6]

The Staff interpreted this uniform fiduciary standard to encompass the duties of loyalty and care as interpreted and developed under the Advisers Act Sections 206(1) and 206(2).[7]

Between 2011 and 2013, the SEC did not issue any rules in furtherance of the Staff’s recommendations. Instead, in March 2013, two years after the Staff recommendation, the SEC sought further data and other information, noting it had not yet decided whether to commence rulemaking.[8]

SEC COMMISSIONER PERSPECTIVES

The SEC should commence rulemaking immediately, clarifying the existence and extent of the fiduciary duty and thereby holding brokerage firms to the standards of conduct they

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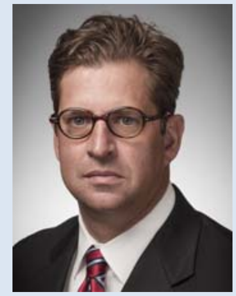

PETER MOUGEY is a shareholder with Levin, Papantonio, Thomas, Mitchell, Rafferty & Proctor and is head of the Securities & Business Litigation Department.

Mr. Mougey concentrates his practice in the areas of financial services and securities litigation, whistleblower or qui tam litigation, as well as complex business litigation.

Over the last five years, Mr. Mougey has represented approximately 50 state, municipal, and institutional investors in financial services litigation and arbitration. In addition, he has represented more than two thousand securities fraud victims in state and federal court and securities arbitrations across the country.

Peter Mougey is recognized as one of Florida’s top 100 trial lawyers, a Florida Super Lawyer in securities litigation, Florida Trends Legal Elite, and the former President PIABA.

Mr. Mougey received his Bachelor of Science in Business Administration, majoring in Finance, from Creighton University. He earned a Master of Business Administration from the University of Portland and graduated from Samford University's Cumberland School of Law.

[5] *See* “Study on Investment Advisers and Broker-Dealers,” Executive Summary, p. i, January 2011, available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf.
[6] *Id.* at 109-110.
[7] *Id.* at 111.
[8] *See* “Duties of Brokers, Dealers, and Investment Advisers,” SEC Release No. 34069013, p. 9, available at http://www.sec.gov/rules/other/2013/34-69013.pdf.

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advertise to the public. Commissioners White and Aguilar have both expressed support for rulemaking that would stop brokerage firms from marketing like they have a duty to put investors first and litigating like no such duty exists.[9] Commissioner Stein has not clearly articulated her stance on a uniform fiduciary rule, but has expressed support for aligning the interests of brokers and investors, which underlies a part of a uniform fiduciary rule.[10] Commissioners Gallagher and Piwowar have both stated that they believe more study is necessary.[11]

THE DEPARTMENT OF LABOR ACTION

The United States Department of Labor ("DOL") has examined the role Brokers and Investment Advisers play in the management of retirement accounts. The DOL proposed a rule under ERISA broadly defining the circumstances under which a person is considered to be a ''fiduciary'' by reason of giving investment advice to an employee benefit plan or a plan's participants.[12] The DOL encountered fierce industry opposition from the very brokerage firms that advertise their personalized service, received extensive comments on the rule proposal, and withdrew the proposal in order to conduct further analysis.[13]

The DOL cited to a study by the White House Council of Economic Advisers to explain the harms faced by investors as a result of conflicted investment advice:

> Based on extensive review of independent research, the White House Council of Economic Advisers (CEA) has concluded that conflicted advice causes affected savers to earn returns that are roughly 1 percentage point lower each year (for example, a 5 percent return absent conflicts would become a 6 percent return). As a result, a retiree who receives conflicted advice when rolling over a 401(k) balance to an IRA at retirement will lose an estimated 12 percent of the value of his or her savings if drawn down over 30 years. If a retiree receiving conflicted advice takes withdrawals at the rate possible absent conflicted advice, his or her savings would run out more than 5 years earlier. Since conflicted advice affects an estimated $1.7 trillion of IRA assets, the aggregate annual cost of conflicted advice is about $17 billion each year.[14]

The DOL has submitted the rule proposal to the Office of Management and Budget's Office of Information

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CHRISTINE LAZARO is an Associate Professor of Clinical Legal Education and the Director of the Securities Arbitration Clinic at St. John's University School of Law. She joined St. John's in 2007 as a Supervising Attorney for the Clinic. The students in the Clinic represent investors in arbitration claims against brokerage firms and brokers on a pro bono basis. Professor Lazaro also teaches Broker-Dealer Regulation at St. John's, and is a faculty advisor for the Moot Court Honor Society and the Corporate and Securities Law Society. Professor Lazaro is also currently Of Counsel to the Law Offices of Brent A. Burns, LLC, where she consults on securities arbitration matters.

Professor Lazaro holds a B.A. from New York University and a J.D. from Fordham Law School. After graduating from law school and prior to joining St. John's, she was an associate at Davidson & Grannum, LLP, representing broker-dealers and individual brokers in disputes with clients in both arbitration and mediation, and handling employment law cases and debt collection cases. She also advised broker-dealers regarding investment contracts they had with various municipalities and government entities.

Professor Lazaro is a member of the Public Investors Arbitration Bar Association (PIABA), is the Chairperson of the Legislation Committee and a member of the SRO Committee. She also serves on the New York State Bar Association's Securities Litigation and Arbitration Committee. She speaks and writes regularly on the topics of securities arbitration and the duties of brokers and brokerage firms.

[9]Chairman White has recently expressed her view on the subject. She recently stated that the SEC should "implement a uniform fiduciary duty for broker-dealers and investment advisers where the standard is to act in the best interest of the investor." http://www.bloomberg.com/news/articles/2015-03-17/sec-will-develop-fiduciary-duty-rule-for-brokers-white-says

[10]Commissioner Stein explained her position as follows: When interests are aligned, there are fewer incentives to play games, and better results for ordinary investors, who can make straight-forward, smart decisions… On the market participant side, we have professional standards and rules to ensure that investment advisers' and broker-dealers' interests are appropriately aligned – or at least, not misaligned – with the investors they serve… Are our rules in all of these areas perfect? No. Is there a lot to be done and improved? Absolutely. For example, the Commission is in the midst of considering how to better align the interests of broker-dealers with the investors they serve. It's an important area, and I'm looking forward to seeing progress made.
Remarks Before the Consumer Federation of America's 27th Annual Financial Services Conference, December 4, 2014, available at http://www.sec.gov/News/Speech/Detail/Speech/1370543593434.

[11]See Remarks at the 2014 SRO Outreach Conference, September 16, 2014, available at http://www.sec.gov/News/Speech/Detail/Speech/1370542969623#.VO5lkPnF8Yk; Remarks at the National Association of Plan Advisors D.C. Fly-In Forum, September 30, 2014, available at http://www.sec.gov/News/Speech/Detail/Speech/1370543077131.

[12]See "Definition of the Term ''Fiduciary''," 29 CFR Part 2510, available at http://www.gpo.gov/fdsys/granule/CFR-2010-title29-vol9/CFR-2010-title29-vol9-sec2510-3-21.

[13]See Department of Labor, "FAQs: Conflicts of Interest Rulemaking," available at http://www.dol.gov/featured/ProtectYourSavings/faqs.htm.

[14]*Id. See also* "The Effects of Conflicted Investment Advice on Retirement Savings," February 2015, available at http://www.whitehouse.gov/sites/default/files/docs/cea_coi_report_final.pdf.

(Continued from page 9)

and Regulatory Affairs ("OIRA") for a standard interagency review, after which it will publish a "Notice of Proposed Rulemaking" ("NPRM").

JOE PEIFFER is the managing partner at Peiffer Rosca Wolf Abdullah Carr & Kane.

He has represented over 500 investors in FINRA arbitration, has spoken and written extensively at national conventions about FINRA arbitration, retirement advice and class actions.

He co-authored a treatise published by Thompson West titled "Litigating Business and Commercial Torts."

He currently serves on the FINRA Arbitration Task Force and as President of PIABA, a nation-wide bar association of attorneys who represent individuals and institutions in claims against brokers, brokerage firms and investment banks.

Brokerage Firms Advertise Like They Offer Ongoing Personalized Service That Puts the Investor First, But Deny Any Such Duty When Called To Account For Their Actions

There is a striking difference between the positions brokerage firms take when soliciting customers and those they take when those customers arbitrate claims against the same firms. Set forth below are various firms' proclamations to the public set forth in advertisements contrasted with those firms' arguments set forth to FINRA arbitrators. On one hand, the firms boast that they offer un-conflicted, trustworthy advice while, on the other hand, those same firms argue they are little more than salesmen with a single duty: to execute trades in customers' accounts.

FIRM A Tells The Public That the Client Comes First

"Until my client knows she comes first. Until I understand what drives her. And what slows her down. Until I know what makes her leap out of bed in the morning. And what keeps her awake at night. Until she understands that I'm always thinking about her investment. (Even if she isn't.) Not at the office. But at the opera. At a barbecue. In a traffic jam. Until her ambitions feel like my ambitions. Until then. We will not rest. FIRM A." (Emphasis in advertisement.)

FIRM A Tells Regulators The Client Does Not Come First

FIRM A, like many other firms, ignores the representations in its advertising when it is forced to defend its actions. "[A] broker does not owe a fiduciary duty to his customer in a nondiscretionary account."

Firm B Tells The Public That It Provides a Personalized Plan

"Having an intimate knowledge of blue chips and small caps is important. But even more important is an intimate knowledge of you and your goals. Get connected to a Firm B Financial Adviser and get a more personalized plan for achieving success." In an investor arbitration, Firm B says it will only have a fiduciary duty when the service goes beyond the plan and includes Firm B taking over the trading in an account on a discretionary basis. "There is no fiduciary duty where, as here, the client maintains a non-discretionary brokerage account."

Firm C Tells The Public That It Maintains the "Highest Standard of Integrity"

"We are committed to maintaining the highest standards of integrity and professionalism in our relationship with you, our client. We endeavor to know and understand your financial situation and provide you with only the highest quality information and services to help you reach your goals."[15]

Firm C Tells Arbitrators That the "Highest Standard of Integrity" Does Not Include a Duty to Put Investors First

While "highest standard of integrity" certainly sounds like a representation that a clients' interests will be put first, Firm C says it does not owe a fiduciary duty to clients. "Respondents deny that they owed fiduciary duties to Claimants."

Firm D Tells The Public That It Puts Investors "Needs Front and Center"

(Continued on page 11)

[15]*See* http://www.kevinyaley.com/!CustomPage.cfm?PageID=1&disclaimer= accept.

(Continued from page 10)

"It's time for a financial strategy that puts your needs and priorities front and center.

"Our organization has all the tools and technology and ease of use that you would want. But ultimately, the real measure is when you sit down with your adviser and build that trusting relationship… and at any time you know exactly where you stand… when you think about progress towards what it is you want to accomplish with your… finances and with your money.

"Our entire company's purpose is to help you achieve the best life for yourself, and for your family. And this purpose, to making life better extends even further to our communities and beyond."

Firm D Tells Arbitrators That It Has No Duty to Put Investors "Front and Center"

Despite marketing that clients' interest would be "front and center" and a desire to "build a trusting relationship" as well as publicly supporting the imposition of a fiduciary duty, Firm D has refused to acknowledge it owes a fiduciary duty in arbitration when it breaches that duty to investors. "The Second Circuit ruled that in a non-discretionary securities account, there is no ongoing duty of reasonable care that requires a brokerage firm to give advice or monitor information beyond the limited transaction-by-transaction duties that are implicated in executing its customer's instructions." "Respondents did not stand in a fiduciary relationship with Claimants." [16]

Firm E Tells The Public That Investors "Feel that Your Best Interests are the Top Priority"

"Are we working toward common goals? A healthy relationship with your Financial Adviser should make you feel that your best interests are the top priority, no matter what is happening in the market and no matter the size of your portfolio."

Firm E Tells Arbitrators To Forget About Feelings, The Firm Is Not Required to Consider Investors' Interest First

Ignoring that it markets itself as making investors feel their "best interests are the top priority" and that Firm E has even publicly supported the need for a uniform fiduciary duty, in private arbitrations, Firm E has refused to acknowledge owing a fiduciary duty. In an investor arbitration, Firm E argued "The law establishes that a broker does not owe a fiduciary duty to a customer with respect to a non-discretionary account."

Why Wouldn't Investors Want A Uniform Fiduciary Rule?

In the above advertisements, brokerage firms consistently acknowledge that investors want, expect and need for brokerage firms to put their interests first. However, when the reality of the imposition of a fiduciary duty is evaluated, brokerage firms have changed their story and often argued that such a duty would actually harm investors. If some representatives of the brokerage industry are to be believed, the imposition of a national fiduciary duty would result in higher costs for investors and a barrier to low-income investors' access to brokerage advice. For example, the National Association of Plan Advisors ("NAPA"), a securities industry advocacy group, claims that a "conflict of interest" rule is really a "no advice" rule. In other words, according to NAPA, prohibiting conflicts of interests would "block Americans from working with the financial advisers and investment providers they trust simply because they offer different financial products – like annuities and mutual funds – with different fees."[17] NAPA continues: "This rule could even restrict who can help you with your 401(k) rollover." The situation would be particularly dire, according to a 2011 study prepared by Oliver Wyman Inc. in response to the DOL's first attempt to propose a uniform fiduciary standard.[18]

According to the abstract of the report, IRAs are widely held by small investors, who overwhelmingly favor brokerage relationships over advisory ones, and the proposed rule would prohibit 7.2 million current IRAs from receiving investment advice thanks to account minimums.[19] Further, the study claims that costs for brokerage IRA customers would increase between 75% and 195%.[20] Actual data, as opposed to the rhetoric and hyperbole, demonstrates that the imposition of a fiduciary duty upon brokers has no meaningful impact on cost to investors or access to investment advice. In fact, differences in state broker-dealer common law standards of care have been tested to determine whether a relatively stricter fiduciary standard of care affects the ability to provide services to customers, and it was found that there is no statistical

(Continued on page 16)

[16] *Id.*
[17] "White House Rule Could Block 401(k) Participants from Advice," available at http://asppanews.org/2015/02/23/white-house-rule-could-block-401k-participants-from-advice/.
[18] The report was submitted to DOL by Davis & Harman LLP on April 12, 2011, on behalf of twelve financial services firms that offer services to retail investors. The cover letter and report can be found at http://www.dol.gov/ebsa/pdf/WymanStudy041211.pdf.
[19] *Id.* at 2.
[21] *Id.*

CONCENTRATION LIMITS FOR DIRECT PARTICIPATION PROGRAMS ARE A GOOD IDEA, WHICH IS WHY THEY ALREADY EXIST

By Investment Program Association

KEVIN HOGAN is the President & CEO of The Investment Program Association. The Investment Program Association (IPA) supports individual investor access to a variety of asset classes not correlated to the traded markets and historically available only to institutional investors. These include public non-listed REITs (NL REITs), business development companies (BDCs), energy and equipment leasing programs, and private equity offerings.

For 30 years the IPA has championed the growth and improvement of such products, which have increased in popularity with financial professionals and investors alike. The mission of the IPA is advocating direct investments through education.

In the last issue of Ohio Securities Bulletin, I discussed the positive outcomes that are possible when industries and regulators work together to protect investors. The Investment Program Association (IPA) has demonstrated its belief in this approach over the past two years, working with the North American Securities Administrators Association's (NASAA) Direct Participation Program Project (DPP) Group – led by Ohio's Mark Heuerman – to revise the Non-Listed Real Estate Investment Trust (REIT) Guidelines. But while we remain committed to the process, we hope that NASAA is willing to let the collective wisdom of the Financial Industry Regulatory Authority (FINRA) and hundreds of independent broker dealers regulate how investors invest in DPP products.

Currently NASAA is considering focusing its guideline revisions on one primary issue: proposing a concentration limit of 10% of an individual investor's total assets in DPP products, including non-listed REITs and non-listed Business Development Companies (BDC), oil and gas and equipment leasing programs. Unfortunately an arbitrary concentration limit percentage doesn't offer "one-size-fits-all" investor protection.

The IPA understands that illiquid investment programs are not suitable for every investor. But it's an advisor's ultimate job to determine their client's suitability with respect to individual client holdings. That said, illiquidity is part of a non-listed REIT's product design and can minimize the swings in short-term valuations associated with market volatility. The financial advisor is best positioned to determine whether and how much illiquidity is right for their client based on investment objectives and goals. It is hard to understand how that percentage should/can be determined as a fixed amount.

FINRA clearly understands the importance of suitability. A broker-dealer's obligation to make a suitability determination arises from FINRA Rule 2310(b), which provides that a FINRA member may not participate in a public offering of non-listed REIT securities unless the REIT has established suitability standards, and that in recommending a transaction in a non-listed REIT security, the member must have reasonable grounds to believe that the security is suitable for the investor. Further, FINRA Rule 2111 states that a FINRA member must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security is suitable for the customer, based on the information obtained through the reasonable diligence of the member to ascertain the customer's investment profile. Pursuant to FINRA Rule 2111(a), this investment profile includes "the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation." As the industry regulator, it is apparent that FINRA places this responsibility squarely within the confines of the financial advisor/client relationship, where we agree it should remain.

The IPA has a strong track record of working with regulators to shape effective rules regulation. Our goal is to protect investors. It is our hope that this open exchange of ideas will ultimately ensure investor protection while encouraging capital formation. Coordination and uniformity among the various state and federal statutes moves us further in that direction.

We know that NASAA's revision of the Non-Listed REIT Guidelines is well intentioned. But we don't believe an arbitrary concentration limit of 10% of an investor's net worth will enhance investor protection.

ASSET ALLOCATION WITH NON-TRADED REITS

By Brian Henderson

Non-traded Real Estate Investment Trusts (REITs) are one type of Direct Participation Plan (DPP) and are marketed primarily to clients of retail brokerages. Investments in non-traded REITs have been large, totaling more than $116 billion over the last 25 years.[1] Like their publicly traded counter-parts, non-traded REITs pool investor assets for the purpose of acquiring a portfolio of commercial real estate properties, securities collateralized by real estate, or lease agreements. The majority of non-traded REITs are registered with the SEC, enabling their sale to unsophisticated investors.

What role should non-traded REITs play in an investment portfolio? Due to their high fees, conflicts of interest, ineffective governance mechanisms for protecting shareholder interests, and illiquidity, non-traded REITs should not be included in any investment portfolio. To support this conclusion, I first review the standard asset allocation framework used in portfolio management. This process considers the investment characteristics of non-traded REITS, as well as those of the other available investment opportunities. After describing the approach, I discuss the investment characteristics of non-traded REITs, highlighting the impact of the high fees, conflicts of interest, and illiquidity that make them unattractive investments.

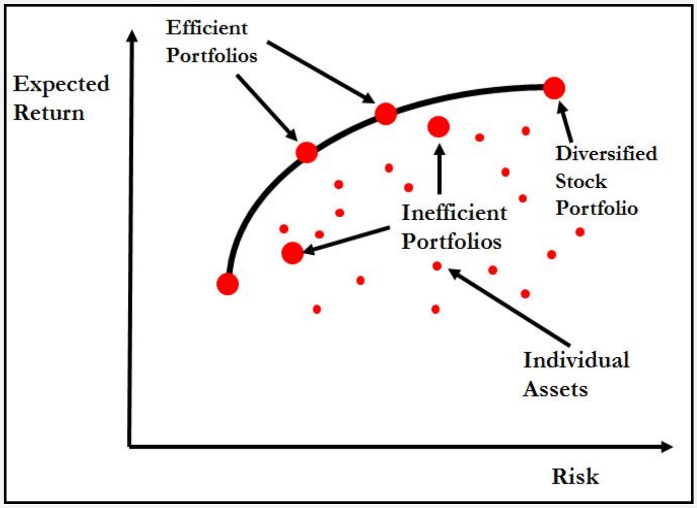
The Portfolio Construction Process

Portfolio construction is the process through which investors allocate capital across investment assets. In this process, an investor analyzes the characteristics of investment assets to construct a portfolio optimally diversified investment exposures across asset classes to maximize the expected return for a given level of risk. The process takes into account the investor's objectives and risk-tolerance and should be broad so as to consider all accessible asset classes. Investment assets are ownership claims (in the form of equity or debt) on firms that produce goods and/or services with real assets such as raw materials, land, and equipment. Investment assets are generally classified into asset classes based on their defining characteristics. For example, equity holders are entitled to the firm's residual income, enjoy limited liability, and have the right to vote on the election of directors and other corporate decisions.

Asset Allocation is the most important step in the portfolio construction process and involves the determination of the optimal combination of investment assets given an investor's objectives. A portfolio having 60% exposure to global stocks and 40% to bonds is an example of a simple asset allocation. Traditional approaches to asset allocation begin with a set of basic assumptions about the expected returns, risk, and correlations across investment assets.

The set of assets available to an investor is referred to as the investment opportunity set. Figure 1 illustrates a sample investment opportunity set. The small dots indicate individual risky assets and the larger dots indicate diversified portfolios. The solid line arching across the top of the investment opportunity set represents the "efficient frontier." The diversified portfolios that lie on the efficient frontier offer investors the highest expected return for a given level of risk. Any portfolio lying below the efficient frontier is sub-optimal as its expected return is less than the efficient portfolio with the same risk.

Figure 1: Investment Opportunity Set and the Efficient Frontier



Typically, asset allocation is accomplished through software that uses optimization tools to determine the optimal portfolio allocations that maximize expected portfolio returns. The optimization includes a number of constraints, allowing the investor to specify a maximum risk level (risk constraint) and maximum or minimum weights for each allocation. At a minimum, the optimization procedures require estimates of expected returns, variance, and correlation for all asset classes considered in the analysis. Typically those estimates come from historical returns to the asset classes considered, although historical returns are known to be noisy proxies for future returns. The optimization procedure favors asset classes that have higher expected returns and those that exhibit lower correlations with other major asset classes. The latter fact results from the cancellation of risk that takes place when forming portfolios, and is frequently referred to as the benefit of diversification.

Figure 2 illustrates the risk-reduction that takes place through diversification. The two red dots represent two portfolios: one portfolio contains high-risk and high-

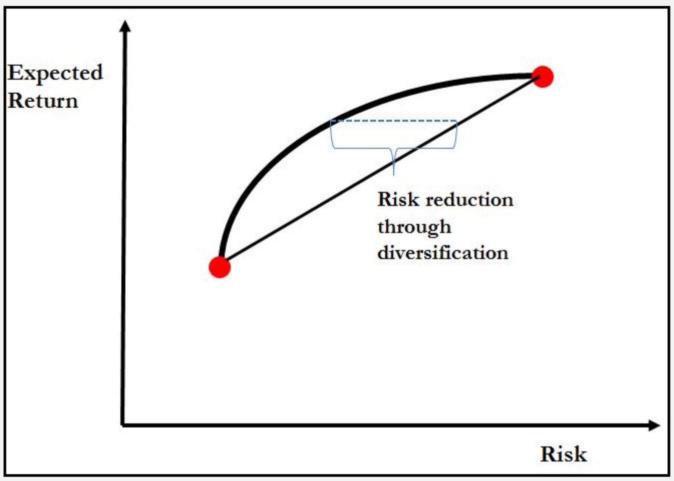
(Continued on page 14)

[1] B. Henderson, J. Mallet & C. McCann, *An Empirical Analysis of Non-Traded REITs* (Securities Litigation & Consulting Group, Working Paper, 2015).

(Continued from page 13)

expected return assets such as stocks, the other portfolio contains lower-risk and lower expected return assets such as short-term investment-grade bonds. The straight line connecting the two dots represents all the possible combinations of the two portfolios under the assumption that returns to the two portfolios are perfectly positively correlated (i.e. there is no benefit of diversification). The arched line represents the actual portfolio properties of the combinations after accounting for the portion of risk that will cancel out through diversification. The arched line is preferable to the straight line since for a given level of expected return (horizontal line), the corresponding risk level is less. The horizontal distance between the two lines represents the reduction in risk accomplished through diversification.

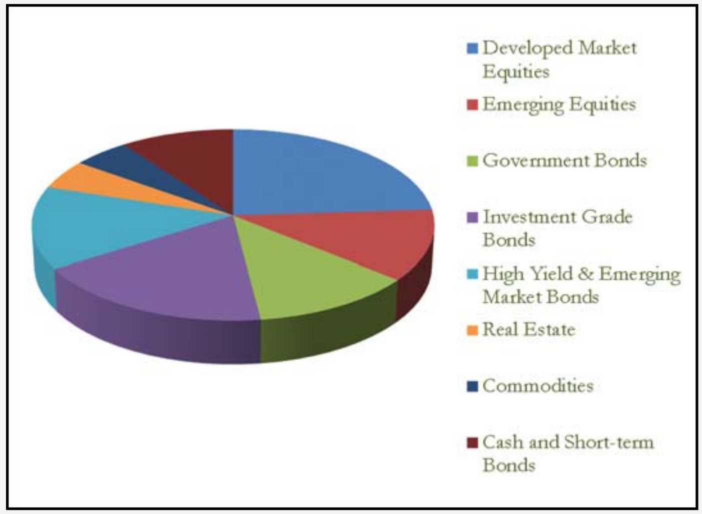
Figure 2: Risk Reduction through Diversification



While Figure 2 illustrates the portfolio properties when diversifying across two assets, or asset classes, in practice investment professionals consider a wide range of investment assets. Optimization procedures are known to favor (concentrate portfolios in) assets having high historical returns and exhibiting low correlations with other major asset classes. For example, in recent years, investors have increasingly included commodity-linked investments in their investment portfolios since, despite their low historical returns and sizeable volatility, they have historically exhibited low correlations with major asset classes. [2]

For illustration purposes, Figure 3 provides a sample asset allocation for an investor with moderate risk-tolerance. The asset allocation includes 8 separate asset classes and is balanced across higher risk/return assets such as developed and emerging market equities and emerging market bonds, but also balances those exposures with sizeable allocations to less risky assets such as investment grade and government bonds.

Figure 3: Sample Asset Allocation Incorporating Traded REITs



INCORPORATING NON-TRADED REITS IN THE PORTFOLIO CONSTRUCTION PROCESS

Relative to publicly registered and traded REITs, the defining characteristics of non-traded REITs are: high up-front fees, conflicts of interest among affiliated parties, corporate structures that prevent effective governance, and a dearth of secondary market liquidity. Non-traded REIT investors pay up-front fees which average 13.2% and dramatically reduce the capital available to purchase portfolio holdings.[3] The majority of those fees are directed to compensating the selling brokers. Note that very few broker-sold mutual funds charge more than a 5% sales load and on average are less than 1%.[4] Also, registered, traded REITs can be purchased in the secondary market at minimal commissions for investors seeking real estate exposure. Conflicts of interest permeate non-traded REITs and include portfolio managers affiliated with the sponsor, portfolio transactions conducted with related parties, and governance structures that ensure absolute power and discretion to affiliated parties.

As mentioned above, the portfolio optimization procedures used by investment professionals require estimates of expected returns, risk, and correlations across the investment assets considered. Practitioners typically use historical data to obtain those estimates. Since non-traded REITs do not have secondary market trading, the standard

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[2] Thomas M. Idzorek, Strategic Asset Allocation and Commodities, Inc., 2006.
[3] *An Empirical Analysis of Non-Traded REITs* (Working Paper, 2015).
[4] 2015 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry, Investment Company Institute (55th ed. 2015).

(Continued from page 14)

approach that uses returns-based estimates of expected returns, risk, and correlations among asset classes is not possible. A feasible approach to including non-traded REITs in a portfolio optimization framework uses traded real estate exposures, such as publicly traded REITs, with reasonable adjustments, to proxy for the investment characteristics of non-traded REITs.

The risk and return characteristics of an investment ultimately reflect those of the underlying assets. For example, consider a REIT that is all-equity financed (no debt) and owns Manhattan office buildings. The risk and return to the REIT equity investors mirrors those of the assets – in this case, Manhattan office buildings. It is important to note that whether or not the REIT's equity trades in a secondary market in no way ameliorates any portion of the actual risk of investing in these properties. In fact, financial economists have well established that investors view illiquidity as an additional source of risk. Thus, an otherwise identical non-traded REIT is riskier than an exchange traded REIT due to its illiquidity. This means investors would pay less for the non-traded REIT shares in a secondary market to compensate for the illiquidity risk. Although this example considers a REIT entirely financed by equity, the risk and return to REIT equity investors increases proportionally to the degree of debt financing that is used in the capital structure. Many non-traded REITs use borrowed funds to maintain large distribution levels, further increasing risk to non-traded REIT investors.

Advocates of non-traded REITs often claim that the dearth of secondary market trading is a benefit of the non-traded REIT product design. This gross conceptual error stems from the illusion of stability that is created by non-traded REITs' ability to self-report valuations (net asset values) that are not based on market prices, but may be based on historical costs or appraised values. As described above, the risk of a REIT investment stems from the risk of the portfolio holdings and the financing structure. Additionally, non-traded REIT investors endure years of illiquidity, after which the funds realize liquidity events such as public listings, mergers, or liquidations. Prior to a liquidity event, non-traded REIT liquidity is limited by the sponsors to a fraction of distribution proceeds reinvested by other investors, and may be curtailed in the sponsor's discretion. Thus, their very limited liquidity augments non-traded REIT risk, in stark contrast to claims otherwise.

Advocates of non-traded REITs also advance the claim that the lack of secondary market liquidity is advantageous since publicly traded REIT market prices may deviate from their fair values. This view is based on the belief that reported net asset values are more accurate measures of fair value than market prices. In fact, research shows that REIT net asset values, which are largely based on appraisals, are slow to incorporate value-relevant information, and that REIT secondary market traded prices incorporate that information faster.[5] This is further evidence that the absence of secondary market trading provides absolutely no economic benefit to non-traded REIT investors, but instead increases their riskiness.

Using traded REITs as a reference point, non-traded REIT returns are significantly reduced due to their high up-front

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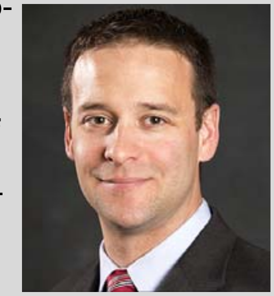

BRIAN HENDERSON is an Associate Professor of Finance at The George Washington University in Washington D. C. He earned his PhD in Finance at the University of Illinois at Urbana-Champaign. His teaching experience includes courses in investment analysis and portfolio management, derivative securities, fixed income portfolio management, and corporate finance. He is also a Chartered Financial Analyst.

Additionally, Brian is Principal at Securities Litigation and Consulting Group where he is a testifying expert in securities matters. He has consulted with a number of investment managers in roles that have included tactical asset management, quantitative investment research, and development of content on quantitative modeling tools and investment algorithms. He has also conducted due diligence work and been on the investment committee at a tactical ETF portfolio manager. Prior to his graduate studies, he worked as an analyst in the Asset-Backed Securities Practice at PricewaterhouseCooper LLP, where de developed payment models of complex, non-agency mortgage-backed securities.

Dr. Henderson has published extensively in peer-reviewed journals and professional books, including the *Journal of Finance Economics, Review of Financial Studies, Journal of Corporate Finance, Journal of Banking and Finance, Journal of Portfolio Management, Journal of Investment Management*, and *Journal of Fixed Income*. He has contributed chapters to highly visible practitioner handbooks, including *The Handbook of Fixed Income Securities* and *The professional Risk Manager's Handbook.*

[5] S. Michael Giliberto, *Measuring Real Estate Returns: The Hedged REIT Index* 94-99, in 19 The Journal of Portfolio Management No. 3 (1993). See also *Joseph Gyourko & Donald B. Keim, What Does the Stock Market Tell Us About Real Estate Returns?* 457-485, in 20 Journal of the American Real Estate and Urban Economics Association No. 3 (1992).

[6] *An Empirical Analysis of Non-Traded REITs* (Working Paper, 2015).

ASSET ALLOCATION WITH NON-TRADED REITS (CONTINUED)

(Continued from page 15)

fees. Additionally, operating income is reduced by the high fees and expenses paid to affiliates, further reducing expected returns. Based on my research, non-traded REITs have returns that are 4 to 5% per year less on average than traded REITs because of the high upfront fees and inefficient ongoing costs.[6] The economic magnitude of these return differences are large: our research finds non-traded REIT investors accumulate $50 billion less wealth than had they invested in a REIT index fund.

Further, non-traded REITs' illiquidity increases their riskiness relative to liquid, diversified, publicly traded REITs. Although they do not trade, non-traded REITs do not provide economically different investment exposures compared to traded REITs and therefore do not offer additional diversification benefits through their correlation structure.

After considering their salient features, no standard portfolio construction methodology that accounts properly for their fees, expenses, and illiquidity, would include non-traded REITS in an investment portfolio. When real estate investment exposures do belong in a diversified portfolio, an investor should use traded, not non-traded REITs.

MAJOR INVESTOR LOSSES DUE TO CONFLICTED ADVICE (CONTINUED)

(Continued from page 11)

difference in the brokers' ability to provide services to higher or lower wealth clients, or their ability to provide a broad range of products including those that provide commissioned compensation. There was also no difference in the ability to provide tailored advice. And, perhaps most cuttingly for the industry's argument – there was no difference in the cost of compliance.

Given that the imposition of a uniform fiduciary rule neither affects access to investment advice nor increases costs, it is clear that the rule stands to benefit investors in a meaningful way by prohibiting conflicted investment advice.

CONCLUSION

Billions each year slip through the fingers of American investors because of the conflicted investment advice they receive. The SEC and DOL must take action to force brokerage firms to live up to the standard that they market to investors rather than the one brokerage firms argue when they have wronged those same investors. Brokerage firms advertise that they put customers' interests first, offer personalized advice and do all of this on an ongoing basis. In other words, they advertise that they are a fiduciary such as a doctor or lawyer. But, when a dispute arises with investors, brokerage firms consistently argue they have the duties of a used car salesman. SEC and DOL action for a strong, national fiduciary standard is the only way to protect investors' hard-earned retirement savings by holding firms to the image they themselves present.

TO VIEW THE FULL ARTICLE WITH EXHIBITS - CLICK BELOW:

https://piaba.org/system/files/pdfs/PIABA%20Conflicted%20Advice%20Report.pdf

OCTOBER 2, 2015

REGISTRATION BEGINS AT 8:30, CONFERENCE SET TO END 4:30

5.5 HOURS OF CLE

2015 OHIO SECURITIES CONFERENCE

RENAISSANCE COLUMBUS

50 N. 3RD ST.
COLUMBUS, OH 43215

TOPICS:

ELDER & DIMINISHED CAPACITY INITIATIVES

Bringing awareness of financial fraud in this population to the forefront with a discussion by:

- **PAUL GREENWOOD,** Deputy District Attorney, Office of the San Diego District Attorney, Head of Elder Abuse Prosecution Unit
- **GEORGIA J. ANETZBERGER,** Adjunct Assistant Professor in the Department of Medicine at Case Western Reserve University, specializing in elder abuse and related interventions
- **CHRISTOPHER MAJESKI,** Compliance Executive with Bank of America/Merrill Lynch

VIRTUAL CURRENCY

A discussion about regulation of Bitcoin and other virtual currency by:

- **ERIC C. CHAFFEE,** Professor of Law, The University of Toledo College of Law
- **J. SCOTT COLESANTI,** Professor of Law, Maurice A. Deane School of Law, Hofstra University
- **WILLIAM J. LUTHER,** Assistant Professor of Economics, Kenyon College

ADVISORY COMMITTEE MEETINGS

(During lunch hour)

NATIONAL CROWDFUNDING DISCUSSION

- **THOMAS E. GEYER,** Member with Bailey Cavalieri LLC
- **PAUL ROSE,** Professor of Law, The Ohio State University, Moritz College of Law

ANATOMY OF A CASE: STATE VS. PETER BECK

- **HARVEY MCCLESKEY,** Deputy Attorney Inspector Ohio Division of Securities,
- **DANIEL KASARIS, JESSE B. KRAMIG, LEO FERNANDEZ,** and **RICHARD WARD** of the Ohio Attorney General's office.

DIVISION OF SECURITIES UPDATES

- **MARK HEUERMAN,** Registration Chief Counsel
- **JANICE HITZEMAN,** Attorney Inspector
- **ANNE FOLLOWELL,** Licensing Chief

Registration opens late July. Check the Division's website http://www.com.ohio.gov/secu *for updates. For questions, contact Kelly Igoe at* kelly.igoe@com.state.oh.us.