A Review of Certain Securities Regulations Related to Alternative Investments 2009-2012

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The most recent economic recession, which occurred from late 2007 to early 2009, was largely driven by an over-expansion of the housing market. This "bubble", combined with other economic factors, led to the S&P 500 dropping nearly 57% from its peak on October 9, 2007 to its bottom on March 9, 2009. As of the writing of this paper the S&P 500 has never returned to its pre-recession peak. (Google Finance)

During this market downturn, most investors experienced a loss of market value in their investments. Investors expressed outrage at these losses in several different ways. Some sought to bring legal action against their financial representatives, advisors, or fund companies. The Financial Industry Regulatory Authority (FINRA) reports that the number of arbitration filings increased by over 40% from 2008 to 2009. (FINRA Dispute Resolution Statistics) Other investors sought to limit losses by changing their investment strategy. Other investors sought to put pressure on regulators in order to bring about change in the financial industry; specifically with the regulation of Alternative Investments.

Alternative investments are usually defined as being an investment other than the three traditional asset classes: stocks, bonds, and cash. They tend to be complex and illiquid. These products are typically subject to limited regulation. Examples of alternative products include variable annuities, hedge funds, derivatives, managed futures, and commodities. There has been an ongoing question of whether such products are suitable for average investors. Some such products are limited to institutional or accredited investors.

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As a result of pressure from investors and legislators, financial regulators have instituted a number of new regulations which attempt to protect investors. This paper will look at: 1) the update to FINRA's "Know Your Customer" regulations which took effect July 9,2012; 2) regulatory guidance related to leveraged and inverse exchange trade funds (ETFs); and 3) legal action taken by individuals, FINRA and the SEC related to Real Estate Investment Trust (REIT) products.

In January of 2011, FINRA released Regulatory Notice 11-02 "Know Your Customer and Suitability". This SEC approved regulation was originally intended to come into effect on October 7, 2011; however, the effective date was later moved back to July 9, 2012. The Regulatory Notice states: "The know-your-customer and suitability obligations are critical to ensuring investor protection and promoting fair dealing with customers and ethical sales practices." This regulation requires firms to obtain and review the "essential facts" concerning each customer. The firm is required to use these facts when determining which products are suitable for any given customer. Further the rule requires financial representatives to document the initial strategy recommendation and any changes to strategy which are recommended to their clients.

These new requirements are not limited to clients seeking to invest in alternative products; however, it is apparent by the guidance provided that one of the areas FINRA is intending to address is the unsuitable recommendation of alternative investments. The regulators intend to ensure that only suitable products are recommended to clients. The Regulatory Notice does not

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prohibit non-accredited investors from using alternative investments; but it does require that the representative obtain “essential facts” prior to making a recommendation. There continues to be no explicit definition of what constitutes a “reasonable” or “suitable” recommendation.

Another alternative investment which has sparked recent regulatory concern is the leveraged or inverse ETF. Leveraged and inverse ETFs differ from standard ETFs in their use derivatives. A standard ETF is a closed-end fund which purchases a variety of assets; in general, the value of the ETF will change based upon the value of the underlying assets. One of the most used ETFs tracks the changes of the S&P 500 Index.

A leveraged or inverse ETF also attempts to track the changes in a given index; however, the return of a leveraged ETF will be a multiple of the daily return of the underlying index, and the return of an inverse ETF will be the opposite or a multiple of the opposite of the daily return of the underlying index. As an example a 2x leveraged ETF which tracks the S&P 500 will give twice the daily return of the S&P 500; so, if the S&P 500 has daily returns of 1%, -3%, and 2%, the leveraged ETF will have daily returns of 2%, -6%, and 4%.

Leveraged ETFs had first been introduced in 2006 (Yates) and in 2009 many financial representatives and advisors were still unfamiliar with how the products worked. The exaggerated swings of the leveraged products lead to greater volatility, greater risk, and more potential for gain or loss. The leveraged or inverse ETF is considered an alternative investment because it uses specialized derivatives in order to achieve its gain or loss objective.

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In June of 2009, FINRA released Regulatory Notice 09-31 titled “Non-Traditional ETFs”. In this notice FINRA reminded its representatives that products must be suitable their clients. FINRA made it clear that it did not consider leverage or inverse ETFs appropriate for retail clients if the ETF was held for longer than one day.

On August 18, 2009, the SEC published a bulletin titled “Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors”. In this bulletin the SEC made it clear that it did not consider leveraged ETFs appropriate for a buy-and-hold strategy. The SEC wrote:

> While there may be trading and hedging strategies that justify holding these investments longer than a day, buy-and-hold investors with an intermediate or long-term time horizon should carefully consider whether these ETFs are appropriate for their portfolio…because leveraged and inverse ETFs reset each day, their performance can quickly diverge from the performance of the underlying index or benchmark. In other words, it is possible that you could suffer significant losses even if the long-term performance of the index showed a gain.

It was unusual for either FINRA or the SEC to provide this level of specific guidance for such a specific class of investments. It would appear that this action on the part of the regulators was a direct result of the volatility experienced in the market place, specifically from October 2008 to March 2009, and public outcry at a widely misunderstood investment vehicle.

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Another alternative investment product class which has received particular scrutiny since the recession of 2008-09, is the Real Estate Investment Trust (REIT). A REIT, in general, owns and operates income producing properties. Individual investors can earn a share of the profits from owning property without the responsibility of personally caring for the property. (SEC Investor Bulletin) Due to the nature of a REIT, that the bulk of assets are tied up in real estate, a company may limit when shares of REIT can be sold. Some REITs are traded on a secondary market, but most are non-traded REITs. Because of these two factors, there can significant liquidity risk if a non-traded REIT enters a period of in which it will not allow redemptions.

REITs were severely impacted by the over-expansion of the housing market. Between 2008 and 2010 most REITs began to limit their redemptions and many REITs lost a significant portion of their value. This has caused a number of suits to be filed alleging misrepresentation and a breach of fiduciary duty. (Kelly) FINRA also pursued financial representatives who solicited investors to purchase REITs through deceptive marketing and without fully investigating suitability. (FINRA News Release) Also, the SEC has pursued REIT companies for alleged improprieties. (Karmin)

There is no question that most, if not all, REITs lost value during the market downturn. It is yet to be proven if this lost value was due to natural market forces, unsuitable sales by financial advisors, or illegal activity by the REIT company. However, the SEC has made it very clear in their Investor Bulletin that REIT investors must be aware of the lack of liquidity, issues with share value transparency, up front fees, distribution arrangements, and potential conflicts of interest.

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Since 2008, all levels of securities regulators have been working to assure the public that financial representatives and advisors are acting appropriately. Congress, the SEC, FINRA, and state regulators have paid particular attention to alternative products. It has been made clear by the regulators that some products are not suitable for some people. The regulators have also made it clear that they will punish those representatives, advisors, and companies who prey on unsophisticated investors, or who otherwise act improperly.

In general, the regulators have not provided specific guidelines as to how suitability should be determined. The most specific guideline reviewed in the information above is the explicit statement that leveraged ETFs are not suitable for retail customers to hold for longer than one day. Unfortunately, this pronouncement affects only a niche market. The large markets, such as the REIT market, continue to receive only vague guidance as to the manner in which suitability is to be determined. While the guidance is vague, it is clear that all levels of securities regulators will actively pursue punishment for representatives, advisors, and firms whom are believed to have acted improperly. Securities regulations, particularly with regard to alternative products, should continue to be a complex field in the future.

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