Advocating Direct Investments
Through Education

Investment Program Association

Regulation of Alternative Investments

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Overview

Broker-dealers and financial advisors seeking to help clients diversify their investment portfolios by purchasing certain alternative investments must ensure that the product issuers have complied with the relevant regulations. They must also make certain that the offering memorandums or other disclosures are adequate, and that the investment is suitable for the clients to whom they're being recommended. In some cases, this includes confirming that the clients are accredited or sophisticated investors, and, in others, that they have adequate financial resources, given the illiquidity and other risks of the investment.

This responsibility is complicated, first by the number and scope of regulations and rules that apply, at both the federal and state levels, and second by the fact that the regulations are regularly updated and new guidance is issued, both proactively as new investment products evolve and reactively as issues involving transparency, suitability, and fraud arise or in response to laws passed by the US Congress or state legislatures.

Using the White Paper

This white paper begins with a condensed summary of the major federal and state securities laws that govern the registration and marketing of alternative investment products to provide the context for discussing the regulations that apply specifically to these five types of investment:

- Non-traded real estate investment trusts (REITs)
- Non-traded business development companies (BDCs)
- Regulation D private placements
- Non-Regulation D private placements
- Limited partnerships

You may wish to refresh your knowledge of securities regulation by reviewing the overall document or prefer to turn your attention to the specific type or types of investment that you may recommend or are considering recommending to clients.

Background

To deal with the abuses perceived to have triggered the stock market crash of 1929, the US Congress enacted four major pieces of legislation that continue to serve as the foundation of US securities law: The Securities Act of 1933, The Securities Act of 1934, The Investment Advisers Act of 1940, and the Investment Company Act of 1940. All four Acts have been amended and expanded over the years to close loopholes, eliminate fraud, encompass new products, and incorporate new methods of disseminating, reporting, and storing information.

Well before the market crashed, state securities laws, described generically as Blue Sky laws though they varied from jurisdiction to jurisdiction, were being developed to regulate registration and review of securities offered for sale in their jurisdictions. The laws set corporate governance standards and investor suitability requirements and required examination and registration of broker-dealers, registered investment advisors, and financial advisors on a state-by-state basis. Here, too, fraud prevention was a primary focus.

The National Securities Markets Improvement Act (NSMIA) of 1996 addressed and reorganized the often redundant and sometimes conflicting state and federal securities laws. Specifically, NSMIA preempted state requirements for registration and review of securities that the legislation identified as covered securities:

- Securities listed or authorized for listing on a national securities exchange or securities from the same issuer that are senior to the listed security
- Securities, such as mutual funds, issued by a registered investment company
- Securities sold exclusively to qualified purchasers whose characteristics are defined by the Securities and Exchange Commission (SEC)
- Securities offerings exempt from registration under Rule 506 of Regulation D (Reg D) of the Securities Act of 1933

The states can no longer require registration of or collect filing fees for covered securities. However, the states retain the right to require the registration of non-covered securities, all broker-dealers doing business in the state, and registered investment advisors with assets under management (AUM) of less than $100 million. Additionally, the states have the authority to investigate and prosecute fraud, deceit, or unlawful conduct by any issuer, broker-dealer, or advisor within the state.

Securities that are neither covered nor exempt from registration are subject to dual federal-state regulation. This category includes non-traded real estate investment trusts (REITs) and non-traded business development companies (BDCs). Securities exempt from federal regulation except those made to qualified investors or exempt under Rule 506 are subject to state registration, review, and regulation. In at least some states, securities exempt under Rule 505 of Reg D are also considered exempt.

Federal Securities Law

Federal securities law is a disclosure-based system that requires securities issuers, broker-dealers, investment companies, and certain investment advisors to register with the SEC and provide all material information both with the registration application and on an on-going basis after the registration is approved. The registration must be granted before issuers may offer their securities for sale, broker-dealers can act on a client's behalf, investment companies may operate, or financial advisors may be paid for their counsel.

The underlying precept of federal securities regulation is that investor protection is paramount, and that access to extensive and verifiable information about potential investments enables investors to make informed decisions and avoid being victimized by fraudulent issuers, broker-dealers, or financial advisors. All required filings are available to the public online through the SEC's electronic data gathering, analysis, and retrieval system, better known as EDGAR.

The organizations and individuals subject to federal regulation, in addition to operating companies, registered investment companies, and registered investment advisors, include the Financial Industry Regulatory Authority (FINRA) and other self-regulatory organizations (SROs), broker-dealers, and the registered representatives who work for them.

The Securities Act of 1933

The Securities Act of 1933, referred to as the Act, mandates that operating companies seeking to issue securities in the primary market must successfully register those securities with the SEC before they may be offered for sale in the United States. The Act details the registration process and the registration fee required and establishes the consequences of providing incomplete or inaccurate information. Among the materials required at registration is the prospectus, which must be regularly updated with any new material information to keep it current.

The Act gives the SEC the authority to:

- Determine the information that an issuer, underwriter, or dealer of a proposed offering must provide
- Identify the form the information must take, which may vary based on a number of factors including the business in which the company is engaged
- Examine the applications
- Issue comment letters
- Authorize stop orders suspending a registration
- Enter cease-and-desist orders
- Impose penalties where warranted
- Bring civil or criminal cases

Under the Act, certain securities are exempt from SEC registration and regulation. Some, including those issued by banks, municipal, state or federal government, and certain nonprofit organizations, are described as statutory exemptions. Securities offered solely intrastate are similarly exempt. Additionally, some securities that do not involve a public offering are exempt provided they meet certain conditions, such as offering size, sales to accredited investors, and the delivery of information to prospective investors. Some of these exemptions are authorized under Reg D and others are granted outside of Reg D.

Until the Jumpstart Our Business Startups (JOBS) Act of 2012, Reg D exempt securities were prohibited from advertising their offerings or otherwise soliciting investors. Those restrictions have now been lifted for exemptions under Rule 506(c), though these securities now must be sold exclusively to accredited investors. An additional exemption applies to small companies seeking to raise up to $1 million from investors through crowdsourcing. However, an audited financial statement is required at the point a company has raised $500,000 through such an offering.

The Securities Exchange Act of 1934

The Securities Exchange Act of 1934, referred to as the Exchange Act, regulates securities transactions in the secondary market. It grants the SEC power to register, regulate, and oversee the:

- National securities exchanges on which these transactions occur
- Broker-dealers, transfer agents, and clearing firms that facilitate the transactions
- Industry self-regulatory organizations (SROs), including FINRA

Before a security can be traded on a national exchange, the security must be registered under the Exchange Act, as must non-traded public securities that are not exempt from registration, including non-traded REITs and non-traded BDCs. The Exchange Act provides explicit information about what must be included in the application for registration, with repeated emphasis on investor protection.

Listed and unlisted publicly registered companies that are identified as reporting companies must make periodic mandatory reports, including the annual 10-K and quarterly 10-Q, plus the 8-K, which is required whenever there is a material change that affects the company. This requirement applies to all publicly traded companies that meet the Exchange Act's definition of a reporting company—having more than 2,000 accredited or 500 unaccredited beneficial owners and at least $10 million in assets.

The required filings must include detailed information on the company's officers and directors, the business in which the company is engaged, audited financial statements, and a section of management discussion and analysis. Taken together, these details are designed to provide investors with comprehensive information they can use to make informed buy and sell decisions. Under the Exchange Act, the SEC can enforce compliance with mandatory and accurate reporting because it has the power to act against companies that don't comply.

Under the Exchange Act, broker-dealers must register with the SEC if the firm executes securities transactions and receives commission income based on those sales or purchases. This regulation applies to broker-dealers who sell private placements (including those that qualify for a Reg D exemption and those that do not). To register, a broker-dealer must file Form BD, become a member of FINRA or other SRO and the Securities Investor Protection Corporation (SIPC), and comply with applicable state registration requirements. A broker-dealer must also ensure that its registered representatives have met the applicable qualification requirements and supervise their compliance with securities laws.

The Exchange Act is explicit both about what constitutes fraud—whether through misstatements or misleading omission of material facts—and the liability to which such actions expose the broker-dealers, advisors, or issuers who commit it.

The sections of the Exchange Act that are particularly relevant include:

- Section 10, which addresses fraud, deceit, and manipulation
- Section 15, which details the registration and regulation of broker-dealers
- Regulation FD, which covers disclosure requirements
- Regulation S-P, which requires the privacy of consumer financial information

Like the registration filings required under the Securities Act, those required by the Exchange Act are available for review on EDGAR.

The Investment Company Act of 1940

The Investment Company Act of 1940 requires investment companies that invest, reinvest, and trade securities and offer their own securities to the public to register with the SEC. These companies include open-end investment companies, better known as mutual funds, closed-end investment companies, exchange traded funds (ETFs), and unit investment trusts (UITs).

Section 3(c)(1) of the Act provides for exemptions from the registration requirement. Among the factors that support an exemption are having fewer than 100 investors, all of whom are accredited, or having only qualified purchasers. Individual investors are accredited when they have assets of $1 million excluding the value of their primary home or an annual income of $200,000 (or $300,000 if married). They are qualified purchasers if they have $5 million in investment assets, minus any amounts borrowed to finance the purchase of those assets and excluding the value of personally held real estate, jewelry, art, and other collectibles.

The goal of the Investment Company Act, as it is with the Acts of 1933 and 1934, is to protect investors by providing the information they need to make informed decisions. However, the disclosure requirements and anti-fraud provisions are more extensive for the companies covered under this Act than they are for operating companies. Among the regulations that apply to registered investment companies are those affecting:

- Capital structure
- The make-up of a company's board of directors, the majority of whom must be independent
- Custody arrangements for the company's assets
- Methodology for the valuation of shares (net asset value)
- Transparency, or financial disclosure
- Regular updates to their prospectuses for companies making continuous offerings
- Records and recordkeeping
- Fees and other charges
- Use of leverage
- Role of investment advisors

In addition, the Act requires an investment company to have a compliance policy and a chief compliance officer, a code of ethics, indemnification arrangements, and a fidelity bond.

According to the SEC, the Investment Company Act is designed to minimize potential conflicts of interest that could arise and focuses on the required disclosure of information. What the Act does not do is allow the SEC to supervise an investment company's investment decisions or evaluate the merits of its investments.

The Investment Company Act was amended in 1980 by the Small Business Incentive Act to add investment companies that could elect to be business development companies (BDCs). BDCs are required to invest in eligible portfolio companies. Since 2006 those portfolio companies have been defined as small domestic operating companies, which are either privately held or publicly held but not listed on an exchange. BDCs are exempt from certain provisions of the Act, such as the use of leverage, that apply to other regulated companies.

The Investment Advisers Act of 1940

The Investment Advisers Act of 1940, which was amended in 1998 and 2010, authorizes the SEC to regulate advisors' activities and requires the registration of companies and individuals who are paid for providing investment advice if they have at least $100 million AUM or advise a registered investment company.

Advisors with less than $100 million AUM must register with the state or states where they provide their services, except advisors working in Nevada and New York, who must register with the SEC.

The Small Business Incentive Act of 1980, which amended the Advisers Act as well as the Investment Company Act, requires investment advisors to BDCs to register with the SEC but allows them, in some circumstances, to receive performance fees of up to 20% linked to increases in portfolio value. That is an exception to the Act's general prohibition against such fees. For more information, including the texts of these Acts, see the SEC website (www.sec.gov).

FINRA

As the primary self-regulatory organization of the broker-dealer community, FINRA makes and enforces rules that govern the firms and individuals that are FINRA members. It has the power to bring disciplinary actions, impose fines, and refer violations to the SEC for further action. FINRA also files regulatory notices that address broker-dealer compliance with its existing rules. Among these notices is one focused on communications about non-traded REITs (RN 13-18) and updated forms for filing private placement of securities (RN 13-26).

FINRA focuses particular attention on investor protection, enforcing rules that mandate:

- Due diligence of investment products
- Investor access to full disclosure for every product before purchase
- Fair and balanced communication about securities products

- Determination of suitability of a particular product for a specific investor

Each year, FINRA highlights its regulatory and examination priorities, often directing specific attention at one or more alternative investments, including non-traded BDCs, non-traded REITs, and private placement securities. Among the issues about which FINRA has expressed concern are those related to investment valuation, illiquidity, clarity on risk-versus-return profile, availability of independent financial information, and complex fee structures.

The FINRA rules that are particularly relevant to broker-dealers who sell any of these alternative investments include but are not limited to:

- 2020 – Use of Manipulative, Deceptive, or Other Fraudulent Devices
- 2090 – Know Your Customer
- 2111 – Suitability
- 2210 – Communication With the Public
- 2310 – Direct Participation Programs
- 2340 – Customer Account Statements
- 5110 – Corporate Financing Rule – Underwriting Terms and Arrangements
- 5123 – Private Placement of Securities

Rule 2111 places responsibility for determining that a securities transaction is suitable for a customer directly on the shoulders of the member or associated person recommending the transaction. The rule includes three obligations, two of which apply to recommending an individual investment. The first is having a reasonable basis to believe the investment is suitable for at least some investors. The second is that the investment is suitable for the specific investor in question, which in the case of non-traded and exempt securities may be determined by net worth, liquidity needs, risk tolerance, and investment objectives among other profile characteristics.

Rule 2210, which addresses communications between broker-dealers and their clients or prospective clients, covers a number of topics for which broker-dealers have direct responsibility:

- Filing requirements and review procedures for retail communications prior to first use
- Content standards for retail communications, with an emphasis on fair and balanced coverage of material facts
- Standards for members' public appearances and the public appearances of the firms' associated persons

Rule 2310 deals directly with Direct Participation Programs (DPPs), which it defines as programs with flow-through tax consequences, such as a limited partnership, but that is not in a category that is specifically excluded from the provisions of the rule. Examples of excluded categories include employer-sponsored retirement plans and Subchapter S corporations. The requirements of the rule that would apply to at least some DPPs touch on issues of suitability, disclosure, organization and offering expenses, valuation for customer account statements, and participation in roll-ups. The rule also forbids non-cash compensation unless it falls within the guidelines explicitly specified.

Rule 2340 states that broker-dealers whose customers hold DPP or REIT securities in their accounts may provide a per share estimated value for those securities if the estimated value has been developed from data that is no more than 18 months old. In addition, there must be a brief description of the source of the estimated value and the methodology by which it was developed. However, the rule stipulates that no per share value should be provided if the broker-dealer is able to demonstrate that the information is inaccurate or no longer valid.

Further, the rule specifies that if no estimated value is provided, there must be a disclosure pointing out that the security is illiquid, its purchase price is not its value, and, if it is the case, that an accurate valuation is not available. Also required is a disclosure that the securities are generally illiquid and that investors may not realize the estimated value if they seek to liquidate their holdings.

Rule 5110 addresses the terms under which a member or associated person may participate in a public offering of securities. It explains the filing requirements that apply to the offering, the documents that must be filed, and the information that must be provided. Included among the offerings that must be filed with FINRA are those of DPPs, REITs, and certain securities with Reg D exemptions, among others.

Rule 5123 governs private placements, which are defined as non-public sales of securities. FINRA requires a member involved in this type of transaction to submit marketing materials, and a copy of the private placement memorandum or other offering document within 15 days of the date of the first sale or provide notification that no offering documents were used. The private placements that are exempt from the rule are detailed, including but not limited to those made exclusively to accredited, qualified, or institutional investors.

For more information on these Rules, Regulatory Notices, and related topics, see the FINRA website (www.finra.org).

State Securities Regulation

While there can be major differences among states in the way securities regulations are written and enforced, a majority of states and the District of Columbia model their legislation on the Uniform Securities Act of 1956 (updated 1985) or the Uniform Securities Act of 2002 (updated 2005), which reflect the federal changes included in NSMIA.

State securities regulations are designed to protect investors from fraudulent or deceptive sale of securities and to punish the perpetrators of fraud while at the same time fostering an active financial environment within the state.

To prevent fraud, state securities regulators require registration of:

- Securities to be sold within their borders, except covered and certain federally exempt securities (although a filing notice may be required)
- Broker-dealers who do business in the state and their agents
- Investment advisors with less than $100 million in AUM who do business in the state and their representatives

State antifraud provisions apply to all securities, including covered securities, all securities transactions except those that are explicitly exempt from regulation, and all broker-dealers or financial advisors who may be involved.

Securities registration may be handled in one of two ways, either by coordination or by qualification. In the former, registration at the state level occurs at the same time it becomes effective at the federal level, while in the latter a separate, extensive application is required by a state's regulator and becomes effective when the regulator accepts it.

A coalition of state regulators, working in conjunction with the North American Securities Administrators Association (NASAA), the umbrella organization of state securities regulators, has focused on making state securities regulation less cumbersome in several ways. These include:

- Coordinating filing requirements for federally registered but non-covered securities
- Developing a uniform registration statement for private placement securities that are exempt from federal registration
- Aligning their review processes
- Developing a more consistent approach for offerings made exclusively to accredited investors

What has not changed is that issuers must register their securities in each state where those securities will be offered for sale, though in many cases they can do so with a single application.

A number of states, working with NASAA, have created Coordinated Equity Review (CER) programs. The CR-Equity program is for multi-state initial public offerings (IPOs) of securities that are registered under the Securities Act of 1933. The CR-SCOR program is for offerings that are exempt from federal registration under Regulation A or Rule 504 of Regulation D in two or more states within a geographic area. The CR-DPP program is for issuers whose products must provide disclosures required in NASAA Guidelines for direct participation programs, including those for interests in limited partnerships and the securities of oil and gas programs, equipment leasing programs, REITs, and products, such as BDCs, that fall under the Omnibus Guidelines. This DPP program is not open to blind pool offerings or offerings of securities exempt from SEC registration under Regulation A of the Securities Act of 1933.

Using a consolidated review, issuers file a single application and are assured of response within a fixed period. Issuers using the CR-DPP process, for example, are told it will take a minimum of 60 days. Two participating states lead the review of each application, one handling the merit review and the other handling the disclosure review. When the lead states approve the offering, all the participating states approve it simultaneously, although states can opt out of the process. For various reasons, consolidated review is rarely elected, and most offerings must be cleared separately through all jurisdictions.

Similarly, broker-dealers can file a uniform registration application rather than one in each state where the firm operates. Additionally, in most states, their agents can qualify for licensing by successfully passing Series 63 or Series 66 exams, which FINRA administers for NASAA. Other requirements may also apply. In addition, most states utilize the Central Registration Depository (CRD), a centralized, online licensing and registration system for broker-dealers and their agents that was developed jointly by NASAA and NASD (now FINRA) and that FINRA maintains. CRD information is supplied by the firms, the representatives, and by state regulators, although states may have additional information that isn't included in the CRD database.

Registration of investment advisors is likewise streamlined by multistate use of the SEC's Form ADV and its Investment Adviser Public Disclosure (IAPD) program, which the SEC developed jointly with NASAA. However, states differ in their use of the IAPD and may impose other registration requirements. IARs must pass a FINRA Series 65 or 66 exam (in conjunction with passing a Series 7 exam) to register. Holding certain credentials may qualify an applicant for licensing in lieu of passing Series 65. These designations include Certified Financial Planner (CFP), Chartered Financial Consultant (ChFC), Personal Financial Specialist (PFS), and Chartered Financial Analyst (CFA).

In most cases marketing and other client communications must be filed with a state's regulator, and states may apply different standards in reviewing these materials. States may also set different net worth and income criteria to establish the suitability of certain investment products for individual investors.

In short, every broker-dealer and financial advisory firm must be responsible for knowing and abiding by the securities regulations and registration requirements of each of the states where it wishes to operate. NASAA surveys consistently identify compliance with suitability standards as one of the most frequent broker-dealer compliance violations.

Major Investment Categories

Broker-dealers and financial advisors who recommend one or more of the alternative investments that are the subject of this paper need to be aware of the specific regulations that apply specifically to these products.

Non-Traded REITs

Real estate investment trusts (REITs) were created by the REIT Act of 1960 and designated as uniquely treated investment vehicles. A REIT is defined in its current form in Subchapter M of the Internal Revenue Code (IRC) as a corporation, trust, or association that is managed by a board of directors or trustees. It must meet annual ownership, asset, income, and distribution tests to maintain its special status and qualify for an exemption from federal corporate income taxes on taxable earnings and profits distributed to its shareholders.

All public REITs, including those not listed on a national securities exchange or publicly traded, must register with the SEC under the provisions of the Securities Act of 1933. As reporting companies, non-traded REITs must file regularly updated 10-K, 10-Q, and 8-K reports under the provisions of the Exchange Act of 1934 as well as current proxy statements. REITs are not required to register under the Investment Company Act of 1940 despite resembling investment companies in some ways. Likewise, their professional advisors are not required to register under the Advisers Act of 1940.

Non-traded REITs are not covered investments because they are not listed on an exchange, so they must also register in each state where they are offered for sale. In the states that participate in a NASAA Coordinated Equity Review Program, a non-traded REIT's sponsor can file a single application that will become effective when the SEC registration is effective. In the remaining states, individual applications are required though those registrations may also be coordinated with the SEC registration.

All non-traded REIT offerings must be made by prospectus. Both federal and state regulators are explicit about the information that a non-traded REIT sponsor must provide both initially and in regular updates. Among the requirements are a statement of investment policy, including the types and geographic locations of real estate it plans to purchase, a description of its method for financing acquisitions, and information about the properties it owns.

Specific disclosure rules apply exclusively to REITs. Guidelines were initially issued as Guide 5 in 1976 for real estate limited partnerships and made relevant to REITs in 1991. The Division of Corporate Finance, the SEC division that oversees REIT registration, released a substantially expanded document for non-traded REITs in July 2013. In brief, *Disclosure Guidance: Topic No. 6* requires a regularly updated prospectus throughout the continuous offering period, reporting significant acquisitions as they occur. The Disclosure G guidance specifies the format that should be used as well as the content that should be provided, including:

- Reporting of prior performance, including the documentation required
- Sources of distributions, both paid or declared
- Redemption history of the current program
- Valuations, calculated either quarterly or annually
- Quarterly consolidation of required supplements to reduce bulk but not substance

The text of the SEC Disclosure Guidance can be found at http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic6.htm.

Further, REIT marketing materials must be filed with FINRA and the SEC prior to first use. The information in any marketing material must not only provide a fair and balanced discussion of risk and potential return but be consistent with the information included in the REIT's prospectus.

NASAA's policy statement on REIT registration, amended in May 2007, includes but is not limited to requirements affecting the:

- Role and responsibilities of the trustees, the majority of whom must be independent, and who have a fiduciary relationship to the REIT and its shareholders
- Suitability of shareholders

- Fees, compensation, and expenses
- Investment restrictions
- Prospectus and required annual reports
- Sales materials

The text of the NASAA statement can be found at http://www.nasaa.org/wp-content/uploads/2011/07/g-REITS.pdf.

Broker-dealers and financial advisors must be aware of the suitability requirements articulated by FINRA, NASAA, and individual states before recommending a non-traded REIT. These include, but aren't limited to, net worth and income levels. Broker-dealers and advisors further have responsibility for determining and affirming the suitability of any sale to a particular shareholder. This judgment must be based on a number of factors including whether the shareholder can bear the economic risk of the investment and understands the lack of liquidity, restrictions on transferability, and potential tax consequences that are involved.

Regulation of these products and enforcement of applicable rules continue to evolve. In March 2013, FINRA proposed amendments to Rules 2310 and 2340 that address the per share estimated valuations of securities of non-traded REIT and DPP real estate investment programs that are included in customer account statements. While member firms would not be required to provide a per share estimated value, a firm could choose to provide such a valuation provided that:

- The estimate has been arrived at in a way designed to ensure it is reliable
- The firm has no reason to believe the estimate is unreliable

The proposal suggests three acceptable methods for arriving at a reasonable estimated value, including an outside valuation by an independent valuation service every three years and a periodic valuation using a method described in the program's prospectus.

In May 2013, FINRA filed regulatory notice 13-18 dealing with the content of communications provided to the public about DPPs that invest in real estate and non-traded REITs. The notice references Rule 2210, which requires broker-dealer communications not to be misleading, specifically in regard to the risks of investing in these products or the sources of the distributions the programs pay.

Among other things, the filing requires that:

- Broker-dealer communications with prospective clients be consistent with the current prospectus
- The discussion of risks is comparable to the discussion of potential benefits
- Presentations of distribution rates must specify that the payments aren't guaranteed, that they may consist of return of principal or borrowings, the period over which distributions might come from such sources, and how such distributions affect potential investment return
- If borrowed funds were used to pay distributions, the broker-dealer must make clear that the distribution rate may not be sustainable
- An annualized distribution rate can't be included in communications unless the program has paid the rate for at least two consecutive quarters
- Claims of price stability must be clarified by explaining that the value of the underlying assets may fluctuate
- Descriptions of redemption features must reveal the restrictions and limitations that apply, including the fact that the redemption program could be ended
- Discussions of liquidity events must clarify that the dates at which these events may occur are not guaranteed

In September 2013, FINRA issued regulatory notice 13-31 highlighting effective practices for complying with suitability rules under Rule 2111 and supervising the compliance. While firms are encouraged to adopt these practices, FINRA warns that doing so does not ensure effective compliance or provide a safe harbor. FINRA's Suitability reference page, at http://www.finra.org/industry/issues/suitability/ is a valuable reference and provides a number of useful links.

Non-Traded BDCs

The Small Business Investment Incentive Act of 1980 authorized the creation of business development companies (BDCs) as a special type of closed-end investment company. A BDC can elect to be treated as a regulated investment company (RIC) under Subchapter M of the IRC, which means it is not subject to federal corporate income tax on taxable earnings and profits distributed to its shareholders. To qualify as an RIC, a BDC must meet annual income, asset diversification, and distribution tests.

Public BDCs, whether or not they are listed on a national securities exchange, are regulated under the provisions of the Investment Company Act of 1940. The information a BDC must provide includes:

- A description of the offering's objectives and its investment methodology
- The types of companies and securities in which it plans to invest
- The leverage it plans to use, and the risks to which leverage exposes investors
- Its fees and other expenses and how they will affect return
- The amount it seeks to raise, and how it plans to spend the money

If a BDC is externally managed, as most are, the external advisor must register under the provisions of the Investment Advisor Act of 1940.

A BDC must also register with the SEC as an operating company under the Securities Act of 1933 unless it qualifies for a Regulation E exemption and as a class of securities under the Securities Exchange Act of 1934. As a reporting company it must file regularly updated 10-K, 10-Q, and 8-K reports and required proxy materials.

Further, provisions of the Investment Company Act of 1940 require, among other things, that:

- A majority of a BDC's board of directors be independent
- A BDC's portfolio assets be valued quarterly based on a good-faith estimate of fair market value if no actual market value is available

- A chief compliance officer be named to prevent violations of securities law and ensure compliance with fiduciary duties, among other duties
- A qualifying custodian be appointed to hold the BDC's investment assets
- The board determine the fair value of each investment in its portfolio for quarterly reports filed with the SEC

Although they are regulated as investment companies, non-traded BDCs don't qualify as covered securities and so are subject to state registration. NASAA has not developed specific guidelines for non-traded BDCs as it has for non-traded REITs and certain private placements. As a result, BDC sponsors must follow NASAA's generic Omnibus Guidelines and file registration applications in individual states rather than using a uniform document in states participating in the Coordinated Equity Review Program. However, when a BDC offering in a state must be made by prospectus, the Omnibus Guidelines provide that the prospectus can be the same as one that has met SEC requirements under the Securities Act of 1933.

What is consistent about offering non-traded BDCs in different states is that broker-dealers and financial advisors must ensure that prospective investors meet a state's suitability standards before selling shares in a non-traded BDC. In general, that means the investor must:

- Have income and liquid net worth adequate to cover his or her liquidity needs during the projected term of the investment
- Be able to bear the related investment risks including illiquidity and possible loss of principal
- Own a diversified portfolio of investment assets, at least part of which could be liquidated to meet unanticipated cash needs
- Have adequate cash reserves

Broker-dealers recommending BDCs are subject to the suitability requirements articulated by FINRA in Rule 2111 and the communications content standards of Rule 2210, including the filing requirement for all new communications. The required disclosures include a discussion of fees, their impact on return, and specific risks, including lack of liquidity, the use of leverage, the possibility that the investment objective may not be met, and the prospect of losing money in a redemption.

Rule 2210 also requires that any claims made about the BDC be consistent with the information in the prospectus and that discussion of distributions must make it clear that they are not guaranteed, may be paid from investment principal or borrowings, and may not be sustainable.

Private Placements Exempt Under Regulation D

Rather than selling a new security through a public offering, an issuer may be able to raise money from investors through a private placement. To do this legally, the security must qualify for an exemption from the mandate that all securities be registered with the SEC before they can be offered for sale. The majority of these exemptions are granted under Regulation D of the Securities Act of 1933. Reg D is often said to provide a "safe harbor" exemption.

When a Reg D exemption is granted, issuers do not need to register the security before offering it for sale but must file a Form D with the SEC within 15 days of the first sale. This document includes the names and addresses of the executives and promoters of the offering. Exemption also means that the issuer does not have to file regularly updated 10-K, 10-Q, or 8-K reports, which are otherwise required by the Securities Exchange Act of 1934.

In addition, issuers who sell their own securities are not required to register or be regulated as broker-dealers. Their employees who sell the securities are also exempt from registration and regulation if they don't earn commissions directly linked to the sales, don't work for a broker-dealer, and follow the other provisions of Rule 3a4-1 of the Act.

However, if the issuer uses a registered broker-dealer to market its exempt securities, the broker-dealer and its associated persons must adhere to the registration requirements of the Securities Exchange Act of 1934 and the SRO of which it is a member. Further, any broker-dealer recommending a Reg D security to its clients is required under FINRA rules to investigate the offering to confirm it meets suitability requirements and that all material facts are not only adequately disclosed but provide a basis for evaluating the offering.

Registration exemptions mean, in effect, that there is no federal regulatory oversight of Reg D offerings provided the issuers and their employees comply with the requirements of the particular rule (504, 505, or 506) under which the exemption is granted. However, using a private placement memorandum or similar document, the issuers must disclose the same level of material information to potential non-accredited investors that is required in the prospectus of a registered offering. That information includes, among other things:

- Details about the issuer
- How the company will be managed
- The industry of which it will be a part
- What its product or service is and how it will be marketed
- The projected sales and revenue
- The risks of investing

Issuers can, on the other hand, determine how much and what kind of information to provide to accredited investors. The only obligation from which they are not exempt at the federal level is compliance with the anti-fraud provisions of the Exchange Act.

Issuers of securities exempt under Reg D may also be exempt from state registration and regulation if they comply with Sections 501, 502, and 503 of the regulation. However, states may require that the offering be filed before it can be sold. The date on which that filing must occur varies from state to state.

Under Rule 504, an issuer can raise up to $1 million of capital within 12 months from an unlimited number of investors whether accredited or not. The offer can't be advertised and no public solicitation is permitted. The securities may be unrestricted if the issuer meets specific requirements linked to state securities regulation. In some cases, the issuer may be required to use an escrow account to hold the capital it raises.

Under Rule 505, an issuer can raise up to $5 million within 12 months from a combination of accredited investors and up to a maximum of 35 who are not accredited. In this case, too, no advertising or solicitation is permitted, and investors receive restricted securities that they must hold for a least a year before selling. Non-accredited investors must be given the same type of information about the offering that they would have received if it were registered. Issuers must also provide audited financial statements unless they can prove doing so would require unusual effort or expense. In that case, they can provide an audited balance sheet.

Most Reg D exemptions, however, are granted under Rule 506, which was materially altered in 2013 to add new provisions, while at the same time preserving the existing provisions for those issuers who choose to follow them.

Issuers can still raise an unlimited amount of capital, as had been the case, and investors still receive restricted securities. However, the ban against advertising and solicitation to market the issue has been lifted, if the issuer chooses to advertise or solicit its offering, and a ban on the participation of bad actors in the offering has been added for those opting to use the new provisions.

Under the new provisions, sales may now be made only to accredited investors, and issuers must take reasonable steps to verify that potential investors meet the criteria to be accredited. Issuers can decide what documentation to provide to potential investors provided they don't violate anti-fraud restrictions against false or misleading information. They must also provide either audited financial statements or an audited balance sheet under the same terms that apply under Rule 505.

All securities exempt under Rule 506 are defined in NSMIA as covered securities and so are exempt from state registration and regulation though filing of the offering may be required. In some states, securities exempt under Rule 505 are not required to register. On the other hand, all securities exempt under Rule 504 must register with the states in which they make an offering.

States investigate and prosecute fraud, including fraud in the sale of exempt securities, and broker-dealers and financial advisors are held to state suitability requirements. NASAA has been outspoken in expressing its concerns about lifting the ban on advertising and solicitation of Rule 506 offerings, arguing that private placements are already the most frequent source of enforcement cases by state securities regulators and these new rules increase the potential for fraud.

Special suitability rules for private placements may apply at the federal or state level, or both, including a requirement that a broker-dealer or financial advisor know the purchaser of a private placement personally. Further, less sophisticated investors may be required to have the advice of a purchaser representative, who is a knowledgeable person, independent of the issuer, and capable of evaluating the merits and risks of an investment.

Broker-dealers must be aware that all communications about private placements, under whatever regulation that exemption is granted, must be consistent with the content standards of FINRA Rule 2210, with particular attention to the illiquidity of an investment, its fees and expenses, and the specific risks applicable to the type of investment it is. Broker-dealers should also be in compliance with FINRA Regulatory Notice 10-22, which addresses their obligation to conduct due diligence on all Reg D offerings.

Other Exempt Private Placements

In addition to the exemption available under Regulation D of the Securities Act of 1933, small businesses may use certain other exemptions that relieve them of the obligation to register a security with the SEC and meet the reporting requirements of the Exchange Act of 1934. The details of these exemptions and the relief they provide vary in a number of ways. What remains consistent is the obligation of broker-dealers and financial advisors to:

- Conduct due diligence
- Recommend only suitable investments to their clients
- Provide relevant offering documents
- Ensure that all of their client communications present investment information in a fair and balanced way

There is a valuable overview from the staff of the SEC Division of Corporate Finance explaining what small businesses need to know about complying with federal law as they raise capital in both public offerings and private placements at http://www.sec.gov/info/smallbus/qasbsec.htm that may be good background reading. It points out, among other things, that in general public offerings of private placements are not allowed and that anti-fraud provisions always apply.

Regulation A (Reg A) of the Securities Act authorizes exemptions from SEC registration for small securities offerings that raise no more than $5 million in 12 months. Issuers must file an offering statement and provide an offering circular that includes the same material information required in a prospectus.

This exemption may be attractive because the securities aren't restricted, investors don't have to be accredited, financial statements don't need to be audited, no reporting under the Exchange Act is required, and the issuers are able to "test the waters," or advertise their proposed offering to assess investor interest before filing an offering statement with the SEC. However, no capital can actually be raised until after the actual filing.

The JOBS Act of 2012 mandates a new exemption from registration, similar to Reg A in some respects, including a "testing the waters" provision that will cover offerings of up to $50 million. Issuers must file an offering statement and audited annual financial reports. The other terms and conditions have not yet been formulated.

Regulation E (Reg E) of the Securities Act provides exemption from registration under the Act for small business investment companies registered under the Investment Company Act of 1940 and closed-end investment companies that have chosen to be regulated as business development companies (BDCs), provided the company is not excluded from qualifying based on previous regulatory problems. The exemption allows a company to raise up to $5 million within 12 months if it files notice of the first sale at least 10 days before it occurs. If the offering seeks to raise more than $100,000, the company must provide each investor with a current offering circular before a sale is finalized. Limited advertising of a Reg E offering circular is permitted.

Section 3 of the Securities Act provides an exemption for intrastate offerings when the money that is raised will be used to fund local business operations. The issuer must be organized in the state where the offering is made and do a substantial amount of business there, as well as offer and sell the securities exclusively to state residents. There are no limits on the amount of money that can be raised or the number of purchasers. However, these offerings must be registered in the state where they are offered.

Section 4(a)(2) of the Securities Act provides private placement exemptions for securities offered exclusively to sophisticated investors, who must either be able to evaluate the risks and merits of the investment or be able to bear the investment's economic risk. Elsewhere, sophisticated investors are defined as having a minimum net worth of $2.5 million and an annual income of $250,000. Under this exemption, potential investors must be given an offering memorandum that provides the same level of information normally included in a prospectus for a registered offering. They must also agree not to resell or distribute the securities they purchase.

Section 4(a)(5) of the Act exempts offerings and sales to accredited investors when the total offering price is less than $5 million. The exemption does not require that any particular information about the offering be provided to prospective investors.

Broker-dealers should note that FINRA Rule 5123 requires member firms to file a private placement memorandum and marketing materials for any security it recommends to clients within 15 days or indicate that no such document was used. The rule also requires broker-dealers to have reasonable grounds for believing that all material facts have been adequately disclosed and those facts provide an adequate basis for evaluating an offering.

Private placements restricted to accredited investors that are granted federal exemptions from registration, such as under Rule 506 of Reg D or under Section 4(2) of the Securities Act, are also exempt from state registration. However, private placements under Reg D Rule 504, Reg A, and Section 3(a)(11) of the Act must be registered with each of the states in which they will be offered for sale.

To help facilitate these registration requirements, NASAA and the American Bar Association (ABA) have developed Form U-7 as part of a Small Company Offering Registration (SCOR) program. It serves as a uniform disclosure document for Rule 504 and Regulation A offerings in all states that accept SCOR. To qualify, issuers must be in compliance with NASAA's Statement of Policy, which among other things specifically excludes companies engaged in petroleum exploration and production, mining, or other extractive industries. In addition, any person, including anyone affiliated with the issuer, who receives a commission for selling shares in the offering must be registered or licensed.

All private placement offerings sold to residents of a state are always subject to that state's anti-fraud laws whether or not the offering is exempt from registration.

Limited Partnerships

A limited partnership involves one or more general partners and one or more limited partners. The limited partners are passive investors in the partnership, and, while they risk the loss of their capital, they have no liability for the partnerships' debts. The general partners, on the other hand, manage all aspects of the partnership and are fully liable for its debts and other obligations.

A limited partnership is created when it registers with the Secretary of State in the state where it is formed. The Uniform Limited Partnership Act, which has been adopted in its 1976, 1985, or 2001 versions by 49 states and the District of Columbia, sets organizational guidelines and defines the rights and liabilities of both limited and general partners.

A limited partnership must be registered with the SEC under the Securities Act of 1933 and the Securities Exchange Act of 1934 if it:

- Meets the definition of "investment contract" because it sells securities to investors
- Does not qualify for an exemption from regulation as a private placement

A limited partnership may file for SEC registration as a smaller reporting company. In that case, it must comply with two specific regulations of the Securities Act: Regulation S-X, which includes the SEC requirements for financial statements, and Regulation S-K, which covers non-financial disclosure requirements. In Subpart 1200 of Regulation S-K, the Commission provides industry-specific disclosure requirements for oil and gas operations to follow in preparing their registration statements and annual reports. As in other cases, the goal is to provide a level of information that will allow potential investors to make informed decisions.

Individual states may regulate a limited partnership as a security even if it is exempt from registration at the federal level unless it is sold exclusively to accredited or sophisticated investors. As a security, the partnership must register with and be regulated by those states' securities laws.

NASAA has issued a Statement of Policy, last updated in 2012, on oil and gas program registration, setting out the disclosure standards that are required for qualification of limited partnership offerings as well as for general partnerships and working interest programs. The policy requires, among other things:

- Extensive background information on the sponsor
- Explicit standards for sales literature and presentations, which may not materially modify the information in the prospectus
- Suitability of participants, including income and net worth standards for various types of programs
- Signed subscription agreements from each participant
- Details of fees, compensation, and expenses
- A prospectus that was filed with the SEC, or if no such filing was made, a document that would comply with SEC disclosure requirements

In addition, the broker-dealers and financial advisors who recommend investments in a limited partnership are subject to registration and regulation at the federal and state levels, although employees of the partnership who sell these investments do not have to be registered or licensed. Broker-dealers, financial advisors, and their respective employees are responsible for:

- An independent due diligence report, including confirmation of compliance with registration or exemption rules
- A review of financial data
- An evaluation of fees and distribution of proceeds
- An investigation of managers' backgrounds and track records
- The timely delivery of the prospectus
- Evidence that the investment is suitable for the particular investor, particularly in light of the financial risks and lack of liquidity
- Fair and balanced communications materials with no false or misleading information or material omissions
- Compliance with anti-fraud provisions

The SEC, NASAA, and FINRA have all issued investor alerts on limited partnerships, and the sale of gas and oil partnerships in particular. All these regulators highlight the same basic red flags, many of which involve the way the investment is sold. The list includes the absence of written documents, including a private placement memorandum and financial reports, claims of unsubstantiated high rates of return, and misleading information about risks and fees.

IRS rules and regulations that affect limited partnership income are not addressed in this paper, though broker-dealers and financial advisors must be aware of the implications of providing inaccurate or misleading information about potential tax advantages associated with these investments.

Summary

The regulations governing alternative investments, while complex and evolving, are consistent in some important ways. For broker-dealers and financial advisors, the emphasis, at federal and state levels, focuses on determining, after thorough due diligence, whether an investment:

- Is appropriate for any investor
- Is appropriate for the particular investor to whom it is being recommended

A complicating factor is that the specific regulations apply to each type of alternative investment. But as the chart that concludes this paper demonstrates, they are similar in some important ways:

- A prospectus or offering circular is required
- Suitability is paramount
- Anti-fraud provisions apply

Regulation of Alternative Investments

	Prospectus/Offering circular required	Suitability rules apply	Anti-fraud provisions apply	Open only to accredited investors	Limits on amounts to be raised	Federal registration required	State(s) registration required
Non-traded REITs	YES	YES	YES	NO	NO	YES	YES
Non-traded BDCs	YES	YES	YES	NO	NO	YES	YES
Private placements (Reg D)	YES[1]	YES	YES	YES[2]	NO[2]	NO	Varies[3]
Private placements (Other than Reg D)	YES	YES	YES	Varies[3]	Varies[3]	NO	Varies[3]
Limited partnerships	YES	YES	YES	Varies[3]	Varies[3]	Varies[3]	Varies[3]

[1] Only if selling to unaccredited investors

[2] Under certain Rule 506 exemptions only

[3] Variation based on rule or section on which exemption, if any, is based

For more details, visit www.ipa.com/research/rulesandreqs

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