OPINION

KNOW THY CLIENT:
NASAA BELIEVES THE TIME-HONORED STANDARD IS NOT GOOD ENOUGH ANYMORE

BY RON BROUNES AND SYDNEY LEBLANC

Since the dawn of the financial services industry, advisors have strived to adhere to one primary standard in performing their daily tasks: Know Thy Client (Know Your Customer—NYSE Rule 405). Using questionnaires and investment policy statements in an effort to understand the investor's long-term goals and risk tolerance levels.

Then they focus on concepts like asset allocation and diversification when structuring client portfolios. They track the market performances of various securities to determine the best-in-breed managers within each asset class. And, if that's not enough, they conduct comprehensive due diligence on securities, managers, and firms before making any recommendations to clients. They grow professionally by taking continuing education courses and by satisfying requirements for such additional designations as CFA (Chartered Financial Analyst) and CFP (Certified Financial Planner). Most importantly, they learn about the new regulations they must follow to ensure product suitability and industry compliance.

It's an exhausting process ---time consuming and nerve-wracking. But above all else, Know Thy Client remains the underlying standard by which all of their tasks and responsibilities are based. Advisors learn about their clients' financial goals and objectives, levels of investment experience, and tolerances for risk. They get to know their clients' families and the changing cash flow needs that come with college education and upcoming retirement. The NASD, and virtually every regulatory body, have structured their requirements with that basic suitability standard in mind. And, at the end of the day, the regulators trust the advisors as industry professionals who better understand the markets, the economy, and the needs of the investor to Know Thy Client and to do the right thing by him or her.

At least until now

The North American Securities Administrators Association (NASAA), in a heightened regulatory environment, is considering significant changes to suitability standards that will have the greatest impact on the direct participation program industry since the enactment of the Tax Reform Act of 1986. says Atlas America, Inc. Senior Vice President, Jack L. Hollander, "While investor protection is surely a worthwhile mission, industry representatives call for a joint effort to address the concerns of the regulators to avoid excessive regulation as well as damaging unintended consequences."

NASAA is an international volunteer organization comprised mainly of state securities officials and maintains a mission of investor protection. Since its establishment in 1919, NASAA has become the voice of the state securities agencies and works to investigate state laws, file enforcement actions, and educate the public about fraud and other potential issues. Last September, NASAA's Direct Participation Programs Policy Project Group proposed several revisions to its guidelines regarding the suitability of Direct Participation Programs (DPP) as investments. These statements pertain to such investments as asset-backed and mortgage-backed securities, traded and non-traded REITs, and other real estate programs, commodity pools, and oil and gas programs. While the initial guidelines had been in the books since 1991, NASAA felt it necessary to review the applications and update those policies for current times. In reality, all guidelines, statements and regs should be reviewed for updates periodically, and 15 years seems to be a more than appropriate timeframe, according to industry insiders. NASAA says that they were completely justified in undertaking such a task. However, it was the results of the NASAA review and the proposed revisions that really raised the ire of the broker-dealer community. In fact, to date, NASAA has received more than 80 comment letters that mainly denounce the revisions (at least, in part) and request additional discussion about these matters.

Other B/D insiders have expressed a more blatant view of the proposal. Some have remarked off the record that the North American Securities Administrators Association (NASAA) actually seems to believe that its members understand more about the needs of the investors than the financial advisors themselves.

So Just What are the Issues in Question?

The proposed revisions contain three main updates to the initial guidelines, and all pertain to the suitability of DPPs for certain investors:

1) Raise the investor's annual income requirement from $45,000 to $70,000 and the net worth requirement from $150,000 to $250,000;
2) Exclude any and all retirement or pension plan accounts from the net worth calculation;
3) Cap the total amount of DPP investment at 10% of the investor's net worth (less retirement assets).

After a quick review of the proposed revisions, most advisors would agree that the intent of the NASAA is clearly in the right place. After all, its members want to make sure that investors meet certain income and net worth requirements before participating in these non-traditional investments. They also are attempting to promote that concept of diversification by ensuring that investors don't place too many of their hard-earned dollars in products that some may believe to be more risky or volatile than more traditional stocks, bonds, and cash equivalents.

However, while many advisors, sponsors, and broker-dealer firms may agree with the overall intent of the revisions, they do not agree with the proposed implementation. In reality, the NASAA is redefining "net worth" by excluding retirement assets, and its new calculation now differs from virtually every other related regulation that advisors must adhere to.

Furthermore, assigning an arbitrary cap to limit investments in certain products may actually serve to reduce diversification rather than promote it or even encourage investors to seek out other non-traditional investments that may be less regulated than DPPs.

While the comment letters almost universally accept the increase in the income and worth requirements, the second and third revisions have encountered major dissention.

What Say You, NASAA?

For its part, the broker-dealer community has reached out to the NASAA in an attempt to have certain concerns addressed about the reasoning behind the proposed changes. Among them are the following:

- What was the genesis of the proposed revisions?
- Have you received significant investor complaints about DPPs or other related investments that prompted a need for these changes?
- Won't the new definition of net worth (without retirement assets) prove to be more confusing to investors and professionals?
- Are you concerned about hindering diversification opportunities by placing arbitrary caps on these investments?
- Do you believe any inconsistencies exist in limiting some investments like REITs, but not non-regulated ones like hedge funds?

To date, NASAA officials have been virtually silent about the underlying reasons for the changes; however, they've indicated that the organization has not received excessive investor complaints about DPPs in general. According to Mike Stevenson, Chair of NASAA Corporation Finance Section, "Three years ago, NASAA undertook a process of updating

Jack L. Hollander, Senior Vice President for Atlas America, Inc.

all policy statements as part of a general review. Many had been in effect for quite some time and special consideration was given to policies that would have been impacted by inflation. On behalf of NASAA, we are looking to update the suitability rules and in the area of the (DPP) guidelines, we are carefully reviewing all the comments. The process is not over yet."

Broker-dealer firms and advisors find little solace in the lip-service they have received thus far from NASAA officials. While broker-dealers and sponsors hope their comment letters prove to be helpful, they merely desire a better opportunity to state their cases and find out more about the thought processes behind these proposals. Mainly, they want to continue to service their clients in the best manner they know how and believe that these changes impose needless restrictions to the detriment of the investor. A ray of hope was shone, however, at a recent Securities Industry and Financial Markets Association (SIFMA) committee meeting that NASAA President Joe Borg attended. He acknowledged the industry's concerns and committed to taking a second look at the proposed revisions to the guidelines. With continued dialogue, the proposal should be decided upon or resolved by mid-April this year.

Too Much Regulation?

The environment is heavily regulated and advisors already adhere to requirements of the NASD, Securities Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), National Futures Association (NFA), and various state Blue Sky laws when trading DPPs, says the Managed Funds Association. "Public commodity pools are subject to extensive regulation, and so differ from other programs subject to various NASAA guidelines," says John G. Gaine, president of the organization in the comment letter to Peter Cassidy, NASAA's Project Group Chair.

They also have disclosure requirements set forth by the Securities Act of 1933 and reporting standards through the Securities Act of 1934. Even the relatively new Sarbanes-Oxley Act has brought an additional layer of compliance to follow. As such, advisors must abide by significant suitability requirements and have a reasonable basis for every investment recommendation.

In its November 27, 2006 comment letter to NASAA's Direct Participation Programs Policy Project Group, the Investment Program Association (IPA) states that the "NASD has already addressed the need for a focused analysis of investor suitability in adopting its [own] Rule 2810."

Rule 2810 states that, (B) in recommending to a participant the purchase, sale, or exchange of an interest in a direct participation program, a member or person associated with a member shall: (i) have reasonable grounds to believe, on the basis of information obtained from the participant concerning his investment objectives, other investments, financial situation and needs, and any other information known by the member or associated person that:

a. the participant is or will be in a financial position appropriate to enable him to realize to a significant extent the benefits described in the prospectus, including the tax benefits where they are a significant aspect of the program;
b. the participant has a fair market net worth sufficient to sustain the risks inherent in the program, including loss of investment and lack of liquidity; and
c. the program is otherwise suitable for the participant

The IPA continued in its letter that, "All DPP investments are sold through NASD member firms. These member firms perform extensive due diligence on DPPs that they offer, and also provide exhaustive training to their representatives on applicable rules and regulations. NASD Rule 2810 guides NASD members' representatives in making investor suitability judgments, based on their personal knowledge of each individual's overall financial situation. The Proposal would eliminate the ability of these professionals to make individually informed judgments and would instead impose upon them and their investor clients an unworkable set of 'black and white' rules." The comment letter also illustrated that, "in contrast to the clarity of the NASD rule, the Proposal to exclude "retirement funds" from the calculation of net worth [see section on "Net Worth Definition" below] is both far too vague to provide any degree of certainty required for compliance, as well as inappropriate and unnecessary."

While the industry is unmistakably one of the most monitored and regulated, at the end of the day, advisors are the ones who must "Know Thy Client" as they help them make crucial financial decisions for today and tomorrow.

Mary-Jean Hanson, Senior Vice President, Ferris Baker Watts.

Net Worth Definition

The broker-dealer community vehemently opposes NASAA's proposal to eliminate retirement plan assets from the net worth calculation. They understand that retirement plans often account for a significant percentage of an individual's worth. Also, the proposal would restrict a great many investors (who are often considered high net worth and accredited by other regulatory standards) from being able to participate in DPPs. The 2004 Survey of Consumer Finances revealed that about 64.3% of the average US family's total assets comprise homes and other non-financial assets that are already excluded from the traditional net worth calculation. And, according to the comment letter from the National Association of Real Estate Investment Trusts (NAREIT), "Of the remaining 35.7% of assets that constitute financial assets, retirement accounts represent nearly one-third of this 35.7%. Thus, the proposal would exclude nearly one-third of the financial assets and nearly 75% of all assets of U.S. families from being taken into account in determining net worth."

Logic should prevail when considering a simple comparison of two potential investors (see chart 1 below). Investor One (high net worth by many standards) has a traditional net worth of $1,000,000, of which $775,000 is held in 401(k)s, IRAs, and other (non-pension) retirement plans. She maxes out her plans each year and takes advantage of the deferral benefits encouraged by the government. Her co-worker, Investor Two, on the other hand chooses not to participate in any retirement plans and instead lives each day to the fullest. Though his compensation is quite comparable to hers, his net worth is only $250,000, much of which is tied up in non-residential personal assets (some of which may be quite illiquid). By NASAA proposed "net worth" standards, the second individual would be considered a "suitable" investor able to participate in DPPs, while the astute saver would not; her newly calculated net worth would total only $225,000 or $25,000 below the proposed requirement.

Among its concerns, NASAA has raised the issue of retirement plans' valuation and the potential need for investors to liquidate such assets should financial needs arise. Such concerns are becoming less justified as fewer companies offer defined benefits (pension) plans these days; today most retirement assets are held in IRAs, 401(k)s, Keoghs, and other defined contribution plans.

In fact, such a proposal would actually stand contrary to the overall concept of effective retirement planning that has been preached to individuals for years. "The government has created numerous vehicles that encourage investors to save for their retirement years by taking advantage of tax-deferral and other benefits of various retirement plans," says Mary-Jean Hanson, Senior Vice President, Ferris Baker Watts. "Many astute investors make maximum contributions to their 401(k) accounts each year; others take advantage of IRAs, Roth IRAs and other plans as they have been advised by the government and their investment professionals. They manage those assets just like they do their non-qualified accounts, and seek to maximize the returns while limiting the risk. Often, that means investing in products like DPPs when such securities are deemed suitable."

(Here again, the "Know Thy Client" standard comes into play.) In effect, NASAA is seeking to penalize these individuals for a job well done by telling them that retirement assets do not count toward their overall net worth.

The Arbitrary 10% Cap

The broker-dealer community also opposes the arbitrary cap that the NASAA is attempting to place on the percentage of assets that a qualified investor can allocate to DPP programs. "We agree that the Project Group's proposal is well-intentioned," says Ferris' Mary-Jean Hanson, and that investors should not 'put all of their eggs in one basket.' In fact, the overwhelming majority of broker/

CHART 1

DESCRIPTION	INVESTOR 1	INVESTOR 2
Traditional Net Worth Calculation	$1,000,000	$250,000
Less: Retirement Assets	$775,000	$0
NASAA Net Worth	$225,000	$250,000
Eligible for DPPs	NO	YES

dealers already have concentration limits in place as a matter of policy. However, we oppose the Project Group's proposal to implement a diversification standard for [these reasons]. Namely, that it is the broker/dealer's responsibility to set concentration limits based on knowing its customers' individual investment objectives and risk tolerance and that a concentration limit potentially precludes the investors' rights to make investment choices that will enable them to achieve their specific investment objectives."

Further, the NASAA may not be considering the tremendous administrative challenges of monitoring this cap guideline. Many investors are serviced by multiple advisors at different broker-dealers. Without full disclosure about all assets held at the various firms, each broker-dealer relies on investors' representations which may or may not be entirely accurate. According to the Managed Funds Association, "We are concerned that clients may find such a requirement overly intrusive, and would be reluctant to provide documentation for all of their financial accounts or copies of account statements to show continual compliance with the investment maximum."

Additionally, many DPPs are structured with the ability to reinvest income directly into the investment. Should investors choose to allocate 10% of their portfolio dollars to a non-traded REIT, for example, they might not be able to take advantage of the reinvestment provision, as they will soon find themselves beyond the allowed 10% cap limit.

Concerns and More Concerns

While the NASAA claims that excessive investor complaints were not the genesis for the proposed revisions, the broker-dealer community remains confused about why DPPs have been targeted in such a manner, particularly when so many regulations already cover suitability. Over the last 25 years, the National Futures Association (NFA), the self-regulatory organization charged with overseeing public commodity pools, has never needed to file an enforcement action against an NFA member relating to the sale of a public commodity pool, and has stated that it cannot recall a single arbitration case filed by a public commodity pool customer. John G. Gaine, president of the Managed Funds Association in their comment letter, says that "The proposed revision purports to solve a problem that doesn't exist."

The proposed change seems to be equating DPPs with private partnership investments that are not subject to federal registration and public reporting. That is simply not the case. In addition to the regulations already in the books, most non-traded REITs, for example, operate through corporate structures with a board of directors providing an additional layer of oversight.

On that note, one potential negative repercussion of the proposed changes would be to "encourage" investors to seek out certain alternative investments that are not subject to such NASAA requirements, but may be deemed "riskier" by some than most DPPs. "Many investors recognize the diversification benefits of owning DPPs, listed REITs or directly-owned commercial real estate as a percentage of their portfolios," says Tony Edwards, Executive Vice President & General Counsel at NAREIT; "For example, studies show that REITs and directly held, income-producing real estate have low correlations with other asset classes like bonds and other stocks. They have distinct risk/reward characteristics, and may perform quite well when other asset classes produce low returns based on certain economic conditions (and vice versa). Furthermore, in many cases, they offer excellent income potential far greater than in other asset classes, and may contribute more certain monthly or quarterly cash flow that often cannot be obtained through other asset classes." Should certain individuals be restricted from investing in such securities, they may seek out income sources from unregistered Reg D private placements like hedge funds or other less-regulated offerings. Many of these alternative products are far less liquid and may not be considered as suitable as non-traded REITs or other DPPs by the advisors who truly 'Know Thy Clients.' Still, they may be incorporated into portfolios to help accomplish an investor's objective (diversification, income, inflation hedge, etc.) because the more regulated DPP is suddenly considered unsuitable.

> “It's an exhausting process---time consuming and nerve-wracking. But above all else, Know Thy Client remains the underlying standard by which all of their tasks and responsibilities are based.”

Leo F. Wells, III, President, Wells Real Estate Investment Trust II, Inc., agrees. "In an effort to diversify their portfolio by acquiring interests in real estate, and to do so without paying a "liquidity premium," investors may turn to the unregistered offerings. Many investors who would not qualify under the proposed NASAA suitability standards would in fact qualify as "accredited investors", and would be able to participate in private offerings. (Investors may count the value of their home, automobiles, home furnishings and retirement assets to meet the $1 million net worth standard for "accredited investor" status.) Given that these offerings are not reviewed by federal or state securities examiners, and that these private issuers are not subject to the NASAA Guidelines, Sarbanes-Oxley, or the reporting requirements of the Securities Exchange Act of 1934, the proposed amendments may actually encourage investment in riskier securities."

Stay Tuned

In short, if the two proposed revisions in question are implemented, numerous potential investors would be unable to participate in DPPs programs and, among other things, take advantage of the diversification benefits. In fact, while many individuals would be penalized, the entire DPP industry would also suffer. "A smaller pool of investors translates into far less capital to commit to REITs, mortgage related products, oil and gas programs, etc. The proposal would significantly shrink the pool of investors eligible to purchase shares in a public unlisted REIT," explains Leo Wells in the firm's comment letter. "We encourage the Project Group to review surveys of consumer finances and estimates from program sponsors to assess the impact of the proposal. Based on data regarding investors in Wells-sponsored real estate investment trusts as well as on our review of consumer finance surveys, we estimate at least a 50% decrease in the pool of potentially eligible investors if the proposed amendments are adopted and a corresponding decrease in the net offering proceeds of unlisted public REITs. These negative consequences might also discourage many of the remaining eligible investors from investing, resulting in an even greater reduction of net offering proceeds, and exacerbating the undesirable consequences of the proposed amendments."

Studies by the IPA confirm Wells' forecast and show that the investor pool of non-traded REITs would shrink by about two-thirds, and an estimated 50% to 80% of the deals would be unable to be funded. Over time, the energy sector and real estate markets would suffer from decreased capital, existing DPP products would become far less liquid, and many investors will be unable to fully diversify their portfolios without looking to other, less- regulated alternative investments. While NASAA is correct in looking out for the investors' best interests, numerous regulations are already intact to promote product suitability. At the end of the day, the advisors have the ultimate responsibility of servicing the needs of their investor clients. When making the most appropriate recommendations to help achieve their financial goals, advisors are already following the strongest standard...

Know Thy Client.