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Prepared Remarks to Investor Advisory Committee
Panel Discussion: Mainstreaming of Alternative Assets to Retail Investors
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Good afternoon. As customary, I note that my views are my own as a Law Professor at the Boyd School of Law. Given the ground already covered, I will share a different view.

I think about today's issue both as an academic and as someone who has represented investors hurt by alternative investments. Here, I pause to stress that the vast "alternative investment" category includes products issued by both reputable firms and by scoundrels.

My skepticism about some complex, costly, and risky alternatives comes from my time running investor clinics. I led investor clinics at Michigan State and at UNLV. We helped investors harmed by substandard advice from financial advisers. Usually, the bad advice came from a financial adviser selling some alternative investment. This is representative experience. A 2021 Report from the North American Securities Administrators Association also confirms that complex, costly, and risky products "products routinely appear in investor complaints and state enforcement actions."[1]

But my experiences are not unique. I serve on the board of the Public Investor Advocate Bar Association, a national organization dedicated to representing investors. The cases PIABA members take often differ from clinic cases only in the scale of the damages. If you lose $20,000 from an unsuitable alternative investment, the small cadre of remaining investor clinics offers your best hope.

Our approach to alternatives will affect the demand for investor representation. If the worst alternatives enter retail portfolios, investors will need help bringing claims.

I. Broker-Sold Alternative Investments

As you think about how to manage mainstreaming alternative investments, I suggest targeting alternatives distributed by brokerages in exchange for transaction-based compensation.

[1] NASAA, Report and Findings of NASAA's Regulation Best Interest Implementation Committee National Examination Initiative Phase II (A) 6 (Nov. 2021), https://www.nasaa.org/wp-content/uploads/2021/11/NASAA-Reg-BI-Phase-II-A-Report-November-2021_FINAL.pdf.

Consider non-traded real estate investment trusts. We saw many cases with these products. Ordinary people do not decide—on their own—to go buy these. Rather, many non-traded REITs were designed to be sold to unsophisticated savers.

In our cases, non-traded REITs usually charged over thirteen percent in upfront fees and costs for the privilege of purchasing them. After that, the REITs' management companies extracted another percentage or two annually. Unsurprisingly, many non-traded REITs significantly underperformed publicly-traded REITs. An analysis from Craig McCann and others found that non-traded REITs "average annual returns [were] 6.3%, compared to 11.6% in [a] traded REIT portfolio"[2]

One financial adviser described what an honest sales pitch would sound like. This is it:

> If you invest $100,000 I will be paid a commission of $7,000. My firm is going to get $1,500—$2,000 in revenue share. My wholesaler, the salesman that works for the investment's sponsor company, will get $1,000. He is a great guy, buys me dinner all of the time and takes me golfing. The sponsor company is going to get around $3,000 to pay for some of the costs they incurred in setting up the investment.

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[2] Brian Henderson et al., *An Empirical Analysis of Non-Traded REITs*, 19 J. WEALTH MGMT. 83 (2016).

So all in on Day 1 there will be around $87,000 left over to actually invest. I bet you are getting excited.[3]

This description still leaves things out. Investors were not told that they should expect this overpriced junk to underperform against public REITs they could buy for free. This doesn't even mention the liquidity problems.

Many of you know this history. As it looks forward, the Committee should distill lessons from past problems with broker-sold alternative investments. Here are things to keep in mind.

1. Retail Investors Will Not Read Traditional Disclosures

First, do not expect retail investors to read traditional disclosures. In every non-traded REIT case I saw, the non-traded REIT itself plainly disclosed that it was a terrible investment. One expressly disclosed that for multiple years the "distributions" it paid investors were just investor capital getting returned.[4] When this happens without disclosure, we call it a Ponzi scheme.

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[3] Joshua M. Brown, *Scenes from an Independent Brokerage Firm*, REFORMED BROKER (May 21, 2014), http://thereformedbroker.com/2014/05/21/scenes-from-an-independent-brokerage-firm/ [https://perma.cc/FW7V-FY2Z] (describing non-traded REITs as "just absolute murderholes for clients—they pay the brokers so much that they cannot possibly work out").

[4] Behringer Harvard Opportunity REIT I, Inc., Form 10-K (Dec. 2009) https://www.sec.gov/Archives/edgar/data/1308711/000104746910002494/a2197457z10-k.htm ("Until we generate sufficient cash flow to fully fund the payment of distributions some or all of our distributions have been paid and may continue to be paid from other sources. To the extent our investments are in development or redevelopment projects or in properties that have significant capital requirements, our ability to make distributions may be negatively impacted, especially during our early periods of operation. As development projects are completed and begin to generate income, we expect to have additional funds available to distribute to investors.

Many retail investors generally do not read offering documents because they rely on their financial adviser to protect their interests. If you want to protect retail investors, you need to think beyond issuer disclosures.

Of course, this does not mean that you should abandon traditional disclosure. Disclosure matters in regulatory responses and for holding people accountable for selling alternatives improperly.

2. Financial Advisers Will Not Faithfully Represent the Offering And Will Not Survive to Pay Damages

Second, financial advisers getting paid to sell a product are not likely to faithfully communicate the true merits and risks of an offering. Their firms will also likely not survive liability.

Earlier, I gave you an honest version of a non-traded REIT sales pitch. This is not what happens when financial advisers *actually* sell these products. When our clients came to us, none of them ever understood the offering cost, fees, and commissions at the time they agreed to the transaction. None of them understood that they could get access to better performing publicly-traded REITs simply by buying them on the open market.

For tax purposes, of the amounts distributed by us in 2009 and 2008, 100% represented a return of capital.").

Now you may not worry about the sales pitches involved in distributing the products on the theory that investors harmed by broker-sold alternatives can recover losses in FINRA arbitration.

I would encourage the Committee not to rely on ex-post liability because the worst alternatives will be sold by the worst brokerage firms. Often, these uninsured firms close when liability arrives, leaving investors without options.

3. How Account Statements "Value" Alternative Investments Matters

The third lesson you should distill is that account statement values matter. When non-traded REITs emerged, they were often sold at $10 per share. As no shares traded, account statements used the sales price to value the investment.

Yet what were these shares worth? One non-traded REIT put it this way in a risk factor, stating:

> Our board of directors arbitrarily determined the price of the shares . . ., and such price bears no relationship to our book or asset values, or to any other established criteria for valuing outstanding shares. Because the offering price was not based upon any independent valuation, the offering price may not be indicative of the proceeds that you would receive upon liquidation.[5]

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[5] Behringer Harvard Opportunity REIT I, Inc., Form 10-K (Mar. 31, 2009), https://www.sec.gov/Archives/edgar/data/1308711/000110465909021799/a09-1665_110k.htm#Item1a_RiskFactors__081717.

Obviously, you don't create 13% in economic value by burning 13% in costs and commissions. There was no clear value. Non-traded REIT management didn't even calculate their NAV until 18 months after an offering. Yet retail investors saw $10/share on their statements and thought their investments were worth that much.

Values somewhat tethered to reality showed up much later when after 18 months, some new value appeared on account statements. This let financial advisers ply their trade without retail investors realizing how much they had paid. If the market rose, increased share value camouflaged losses to commissions, fees, and conflicts. If share value decreased, financial advisers blamed market conditions.

In 2016, a new FINRA rule changed how brokerage firms had to value non-traded REITs on account statements.[6] After the new rule, brokerage firms that sold non-traded REITs for $10 a share suddenly had to display a value that accounted for the fees and commissions. It changed market practice. One broker with Cetera Financial Group even told a reporter that he would no longer sell the products

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[6] *See* FIN. INDUS. REGULATORY AUTH., REGULATORY NOTICE 15-02: DPP AND UNLISTED REIT SECURITIES (Jan. 2015), https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-02.pdf [https://perma.cc/Y74R-AW9U] (explaining the new valuation methods to go into effect in April of 2016);

because he did not "want to have any clients ever saying, 'Oh, yeah, by the way, how come this is $88,000 instead of $100,000?'"[7]

The Committee should pay close attention to how brokerage firms communicate alternative asset valuations to retail investors. If efficient markets do not value alternative investments, account statements need to reflect the uncertainty.

II. Dangers With Communicating Uncertain Valuations

And there are many ways to play games with valuing alternatives. What should a retail investor see on their account statement when a mutual fund holds illiquid shares in startups and other private companies?

As Jeff Schwartz has recognized, "there is a significant incentive for funds to massage the reported valuations" of alternatives because higher values let you collect higher fees and court more investors.[8]

Value here may be unknowable. Mutual funds have a long history of assigning different values when they own the same private investments. Take the

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[7] Ann Marsh, *Commissions Exposed, Adviser Stops Selling Nontraded REITs*, FIN. PLAN. (June 8, 2016), http://www.financial-planning.com/news/commissions-exposed-adviser-stops-selling-nontraded-reits [https://perma.cc/DSW4-9RVQ] (quoting Colin Mackenzie, financial advisor, Cetera Financial Group).

[8] Jeff Schwartz, Should Mutual Funds Invest in Startups? A Case Study of Fidelity Magellan Fund's Investments in Unicorns (and Other Startups) and the Regulatory Implications, 95 N.C. L. REV. 1341, 1371 (2017).

way funds valued investments in Uber before it went public.[9] In June of 2015 BlackRock valued its stake at $40.02 a share. Hartford Financial Services Group Inc. pegged its stake at $35.67. Fidelity Investments claimed its shares were worth $33.32. Who was right? Who knows? They're probably all wrong.

Consider Uber again. Once, Uber had a private market valuation of around $76 billion. In 2019, months after the IPO, the public market cap sat at $49 billion.[10] The untested private market valuation did not hold up.

Retail investors should receive statements that reflect the true uncertainty with alternatives' value. When it came to valuing Uber's shares, stated values fell in a range. Yet ordinary retail investors receive account statements with clear numbers that hide the range of uncertainty around alternative asset valuation. Instead of communicating a false clarity, account statements should communicate the true cloud of uncertainty to retail investors.

Valuation remains a problem even when functioning markets provide liquidity and an illusion of value. Take cryptocurrencies as an example. Many digital assets have existing market values. But should retail account statements reflect only those values? Consider the caution it might inspire if account

[9] Kirsten Grind, Mutual Funds Flail at Valuing Hot Startups Like Uber, Wall St. J. (Oct. 29, 2015), https://www.wsj.com/articles/mutual-funds-flail-at-valuing-hot-startups-like-uber-1446174018.
[10] Annie Palmer, CNBC (Oct. 1, 2019), https://www.cnbc.com/2019/10/01/uber-closes-at-record-low-worth-less-than-50-billion.html.

statements listed liquidation value alongside market value for alternative investments like Dogecoin. Last week, Dogecoin reached 44 cents a coin. If you owned all the Dogecoin in the world, you would not have anything of value other than the ability to sell the useless digital asset to someone else. Dogecoin isn't like copper, silver, or gold because the real economy does not use Dogecoin to produce goods.

Ultimately, alternative investments have more uncertainty in their valuations and retail investors need to have that uncertainty communicated to them in a way they actually hear. Burying it in lengthy disclosure documents ensures that retail investors will not alert to the issue. They will order their lives secure in a false belief that their alternative assets are actually worth their stated values.

Putting valuation uncertainty directly on account statements would meaningfully inform retail investors. If retail investors are sophisticated enough to be **sold** alternative assets, they are sophisticated enough to be **told** the truth about uncertain valuations.