# ***Public Non-Listed REITs Roundtable Meeting***

*Wednesday, April 1st*
*9:45am – 11am*
*JW Marriot Desert Ridge Resort & Spa*
*Phoenix, AZ*

**Discussion Leads:**
Peter Fass, Partner, Proskauer Rose LLP
Sharon Kroupa, Partner, Venable LLP
Kevin Shields, Chairman & CEO, Griffin Capital Essential Asset REIT, Inc.

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**AGENDA**

**REITWISE ROUNDTABLE: PUBLIC NON-LISTED REITS**

Wednesday, April 1, 2015
9:45 am – 11:00 am

Discussion Leaders:

Peter Fass, Partner, Proskauer Rose LLP
Sharon Kroupa, Partner, Venable LLP
Kevin Shields, Chairman & CEO, Griffin Capital Corporation

**I. FINRA RN §15-02**

A. How will industry comply?
B. What will industry do about share class design?
C. What is likely impact on capital flows into PNLRs?

**II. Liquidity Events**

A. What have we learned?
   1. stand-alone listing with and without tender offer
   2. sale
   3. merger
B. Process and director duties; is a special committee necessary?

**III. Department of Labor Re-proposal to Expand Fiduciary Obligations of Advisors under ERISA**

A. What is industry saying about potential impact?
B. What is the impact of the recent White House statements?
C. What are the industry's best arguments against this proposal?

**IV. Becoming a PNLR**

A. Is the cost of entry too high?

**V. Moving From PNLR to Publicly Traded Space**

A. How and when should the company's charter be amended? What is an acceptable governance structure if listing?

**VI. North American Securities Administrators Association Proposed Revisions to Guidelines for REIT Offerings**

A. Effect of a 10% of net worth concentration limit

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April 14, 2014

Hon. Mary Jo White, Chair
Hon. Luis A. Aguilar, Commissioner
Hon. Daniel M. Gallagher, Commissioner
Hon. Kara M. Stein, Commissioner
Hon. Michael S. Piwowar, Commissioner
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Section 913 Fiduciary Rulemaking – Evidence of Investor Harm

Dear Chair White and Commissioners:

We were encouraged to hear that Chair White expects the Securities and Exchange Commission (SEC or Commission) to make a threshold decision regarding whether the Commission will move forward with a rulemaking, pursuant to Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), by the end of the year. As you know, Section 913 authorized the SEC to adopt a rule to require all professionals who provide personalized investment advice to retail customers to do so under a fiduciary standard of care that is no less stringent than the existing standard under the Investment Advisers Act of 1940 (Advisers Act). The undersigned organizations continue to advocate for such a rulemaking and to urge the SEC to move forward expeditiously with a rulemaking consistent with Section 913.

When the SEC issued a Request for Information (RFI) last year seeking data related to the cost and benefits of extending a fiduciary rule to broker-dealers, each signatory of this letter submitted a response. Through those responses, the undersigned organizations provided data and stated support for extending the fiduciary standard of care as the necessary step to better protect investors. Though we will not repeat all of those arguments here, we strongly believe that in order to be meaningful and consistent with Section 913, a uniform fiduciary rule must include more than the current suitability standard supplemented by additional disclosure requirements.

Despite the broad support for rulemaking, some have questioned whether there is evidence of harm to investors that would justify the adoption of a uniform fiduciary standard. After all, they assert, the suitability standard that applies to broker-dealer recommendations affords investors significant protections. For example, it requires brokers to make recommendations that are generally appropriate for their customer based on knowledge of their customer's financial situation. Designed with a sales relationship in mind, however, the suitability standard *does not* impose the same clear obligation that exists under a fiduciary standard, which requires the adviser to put the customer's interest first. Moreover, the suitability standard does not impose an obligation on brokers to appropriately manage conflicts of interest in order to ensure that they do not influence recommendations. These are among the standards that distinguish a suitability relationship from a fiduciary relationship.

While the harm to investors of this two-tiered regulatory scheme may be difficult to quantify, it is nonetheless real and, we believe, pervasive. It directly affects the ability of many middle-income Americans to accumulate funds adequate for their retirement needs and other long-term financial goals. Evidence of the harm to investors from the lack of a uniform fiduciary standard comes in a variety of forms, including observations of industry practices, academic studies, and basic market analysis. First and foremost, however, evidence of this harm is found in the difference between recommendations that satisfy a suitability standard and those that are designed to serve the best interests of the investor. Second, evidence of investor harm is found in the adverse effect that unchecked conflicts of interest have on recommendations. And finally, evidence of harm is found in the effects of a market where investment products compete to be sold rather than bought.

By aggregating a number of examples that appear in the public record, this letter details the harm to investors under a suitability standard that a fiduciary standard consistent with Section 913 of the Dodd-Frank Act would help to ameliorate. Such a rulemaking should ensure that all those who provide personalized investment advice to retail clients have an affirmative fiduciary obligation to act in their clients' best interest and to minimize and appropriately manage conflicts of interest that could impede their ability to do so. In addition, we further explain why disclosure alone or disclosure combined with investor education does not offer an adequate solution. Finally, we provide additional evidence to counter assertions that imposition of a fiduciary standard would itself harm investors by limiting their access to affordable investment services.

**Investor Harm as a Result of Investment Recommendations That Are Suitable But Not in the Investor's Best Interest**

When examining the range of investment options that brokers and investment advisers might recommend to retail investors – i.e., a particular class of mutual funds or variable annuities – the vast differences in the features of these investment products becomes readily apparent. For example, otherwise similar products may impose different fees on the investor, or achieve comparable investment results with significant differences in volatility, or provide different guarantees, or, in the case of variable annuities, offer the investor a greater or lesser degree of choice among underlying investment options that are of varying quality.

Although all of the options within a particular category may be deemed suitable for a particular investor, these differences in features can profoundly impact costs, risks and overall performance. Investors are harmed when they are encouraged to pay excessive fees, receive substandard performance, or are exposed to unnecessary risks because a broker recommended an investment that, while suitable, was inferior to other available options. This harm could be remedied, or at least ameliorated, by requiring brokers to provide services under a fiduciary standard.

The suitability standard allows for the sale of high-cost investments that erode investors' long-term gains

The most readily observable impact of investor harm resulting from the lack of a uniform fiduciary standard arises out of the significantly different costs imposed by otherwise similar investments. Consumer Federation of America (CFA) addressed this issue in a comment letter responding to the Commission's RFI.[1] CFA examined Morningstar data for S&P 500 index funds to determine the impact of costs on otherwise similar investments. CFA chose this type of fund to analyze because it offers a clear example that any increase in investor fees comes directly out of investment performance without offering any added benefits to compensate for those increased costs. Based on its examination of the Morningstar data, CFA found evidence of thriving cost competition among direct-marketed funds, with investor assets heavily concentrated in a handful of very low-cost options. In contrast, administrative costs for broker-sold S&P 500 index funds held outside of retirement plans were often significantly higher than those of direct-sold funds, even after the cost of compensating the broker was excluded. Moreover, in several cases cited by CFA, customers of major brokerage firms paid sales loads of as much as 5.25 percent in order to purchase an S&P 500 index fund that has an expense ratio roughly ten times or even twenty times as high as the expense ratio of the lowest-cost direct-marketed fund. Far from adding value, the recommendation of a broker, in this case at least, merely added to the already excessive cost.

There is nothing inherently more expensive about operating a broker-sold S&P 500 index fund than a direct-marketed fund (other than the cost of compensating the broker, which CFA subtracted from the administrative fee for the purposes of its analysis). The logical conclusion, therefore, is that the higher fees in broker-sold funds reflect a market where competition is based primarily on factors other than cost. Given the singular role that reducing costs plays in determining performance in index funds, there is every reason to believe that this lack of cost competition has the same impact on the sale of other types of investment products that can be sold on the basis of features other than cost alone. As noted by Dr. Michael Finke in the Investment Management Consultants Association (IMCA) comment letter,[2] this lack of cost competition among broker-sold funds, as is permitted under the suitability standard, may help to explain why broker-recommended mutual funds significantly underperform direct-sold funds more commonly recommended by investment advisers operating under a fiduciary standard.

Excess fees paid by investors who invest based on the recommendation of a broker can have a significant impact on the long-term savings of investors. As the Commission warned in a

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[1] See letter from Barbara Roper, Director of Investor Protection, Consumer Federation of America, to the SEC in response to the request for comments on the "Duties of Brokers, Dealers, and Investment Advisers," July 5, 2013, pp 25-25, *available at* http://www.sec.gov/comments/4-606/4606-3119.pdf.
[2] Dr. Michael Finke, "Fiduciary Standard: Findings from Academic Literature," attached to the letter from IMCA, July 5, 2013 to the SEC in response to the request for comments on the "Duties of Brokers, Dealers and Investment Advisers," *available at* http://www.sec.gov/comments/4-606/4606-3121.pdf (hereinafter "Finke Study").

recent bulletin for investors, "[o]ver time, even ongoing fees that are small can have a big impact on your investment portfolio," reducing returns, shrinking a nest egg, and preventing investors from achieving financial goals.[3] This impact was illustrated in an October 2013 Bloomberg Markets Magazine report on data filed with the SEC which showed that "89 percent of the $11.51 billion of gains in 63 managed-futures funds went to fees, commissions, and expenses during the decade from Jan. 1, 2003 to Dec. 31, 2012."[4] Brokers have an incentive to keep clients in managed-futures funds because they receive annual commissions of up to 4 percent of assets invested and investors pay as much as 9 percent in total fees each year.[5]

The Department of Labor (DOL) illustrates the harm associated with fees that accompany non-fiduciary, suitability-based advice this way: "Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of $25,000. If returns on investments in your account over the next 35 years average 7 percent and fees and expenses reduce your average returns by 0.5 percent, your account balance will grow to $227,000 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5 percent, however, your account balance will grow to only $163,000. The 1 percent difference in fees and expenses would reduce your account balance at retirement by 28 percent."[6] If anything, the SEC and DOL examples understate the harmful impact on investors of excessive fees, since they feature only one of the several cost differences among investments commonly sold to retail investors.

<u>The suitability standard allows brokers to sell products with other substandard features</u>

While they may be the most easily quantifiable, excessive costs are not the only concern associated with advice delivered under a suitability standard. In its comment letter, CFA used ratings of variable annuities by Weiss Ratings[7] to help illustrate how factors beyond costs could be affected by a best interest standard, such as the availability of choice and performance. In rating variable annuities, Weiss assesses a number of factors in addition to cost, including both the availability of a wide selection of mutual fund subaccounts with good performance and the financial strength of the insurance company issuing the annuity. In describing the basis for arriving at its recently issued 10-best list, Weiss explained that "mutual fund subaccount performance played an important role in the selection process. After all, a variable annuity can have low costs and a strong Financial Strength Rating, while at the same time offering only mediocre fund performance."[8]

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[3] U.S. Securities and Exchange Commission Investor Bulletin: "How Fees and Expenses Affect Your Investment Portfolio," February 19, 2014, *available at* http://investor.gov/news-alerts/investor-bulletins/investor-bulletin-how-fees-expenses-affect-your-investment-portfolio#.UxpflfldVKg

[4] David Evans, "How Investors Lose 89 Percent of Gains from Futures Funds," Bloomberg Markets Magazine, Oct. 7, 2013, *available at* http://www.bloomberg.com/news/print/2013-10-07/how-investors-lose-89-percent-of-gains-from-futures-funds.html.

[5] *Id.*

[6] U.S. Department of Labor, "A Look at 401(k) Plan Fees," August 2013, *available at* http://www.dol.gov/ebsa/publications/401k_employee.html.

[7] See Weiss Ratings Best and Worst Variable Annuities, *available at* http://weissratings.com/ratings/best-and-worst variable-annuities.aspx.

[8] *Id*.

Lack of fund choice and high surrender fees were also significant factors in determining which annuities ended up on Weiss's 10-worst list. In its comment letter, CFA questioned how some of the funds on the 10-worst list could even exist in a truly competitive market. For example, the list includes two annuities that offer a single fund option (described by Weiss as "weak"), impose high surrender fees, and have high total expenses, including a mortality and expense risk charge (M&E fee) many times higher than other available funds. While these annuities may be deemed to be suitable for an investor, a financial professional subject to a fiduciary duty would find it difficult to defend a recommendation of one of these funds as being in the best interest of the investor.

<u>Financial advisers are more likely to target less sophisticated and less affluent investors with products that are higher-cost or otherwise substandard</u>

IMCA commissioned Dr. Michael Finke, a professor at Texas Tech University, to conduct an in-depth literature review that provides data and other information addressing specific questions related to the benefits and costs resulting from the application of a fiduciary standard of care to the conduct of brokers, dealers and investment advisers.[9] Dr. Finke reviewed a number of academic studies related to the potential benefits to consumers of a fiduciary standard, including studies showing that less sophisticated and less wealthy investors are most likely to suffer the harmful consequences of recommendations that are not based on the best interest of the investor:

- A 2012 study found that commission-compensated insurance agents "will consistently recommend higher commission products to less sophisticated consumers, leading to welfare losses that are greatest among those who can least afford to sustain them."[10]

- An earlier study similarly examined financial firms' "incentive to shroud attributes."[11] The researchers described how producers "will rationally segment the market by level of investor sophistication," with less efficient, more opaque products created to "maximize economic rents from less sophisticated consumers" while more competitive products are simultaneously offered to sophisticated consumers. "Examples of product differentiation through opaque characteristics are evident in the mutual fund market."

- Another study cited by Dr. Finke describes how fund companies use different tactics to attract "less sophisticated investors, who fund families attract through marketing, and more sophisticated, direct-channel investors who are targeted through higher performance."[12]

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[9] See Finke Study.
[10] Finke Study at 6 (citing S. Anagol, S. and H.H. Kim, 2012, "The Impact of Shrouded Fees: Evidence from a Natural Experiment in the Indian Mutual Funds Market," American Economic Review, 102(1): 576-593).
[11] Finke Study at 7 (citing X. Gabaix and D. Laibson, 2006, "Shrouded attributes, consumer myopia, and information suppression in competitive markets," Quarterly Journal of Economics, 121(2), 505-540).
[12] Finke Study at 7 (citing N.M. Stoughton, Y. Wu and J. Zechner, 2011, "Intermediated investment management," The Journal of Finance, 66(3), 947-980).

- This is consistent, Dr. Finke suggests, with evidence from a separate academic study "that successful mutual funds appear either to gain market share through lower expenses or by increasing opaque fees which are then used to incent advisor recommendations."[13]

- Finally, Dr. Finke cites research suggesting that the "latitude of recommendation quality allowed in a suitability model is particularly troubling when clients are older and have experienced cognitive decline that may reduce their ability to perceive self-serving recommendations."[14]

In other words, while opposition to fiduciary rulemaking is often presented as being motivated by concern over the well-being of middle-income investors, the academic literature strongly suggests that it is precisely these less wealthy, often less sophisticated investors who are most at risk from harmful practices permitted under a suitability standard.

<u>A fiduciary standard affords investors legal protections not available under a suitability standard with regard to an adviser's ongoing duty of care</u>

Under a suitability standard, investors are harmed because a broker has no duty to monitor or revise a recommendation, even when the client's circumstances have changed. In its response to the SEC's RFI, the Public Investors Arbitration Bar Association (PIABA), whose members represent individual investors in resolving complaints with brokers, highlighted several examples of the how the fiduciary standard protects investors seeking recourse in ways that a simple suitability standard does not.[15]

Using specific examples, PIABA illustrates how investors can be better protected with a fiduciary standard that requires advisers to: (i) update investment recommendations when a client's personal circumstances change, (ii) review existing investments when a customer changes advisers and provide advice regarding the appropriateness of the investments, and (iii) inform investors of new information that comes to the adviser's attention that impacts that investment's risk profile.

Among the most significant differences in the legal accountability for brokers and advisers is that investment advisers are held to an ongoing fiduciary duty to act in the best interests of their clients. By contrast, most brokers contend, and courts generally agree, that their duties begin and end with the securities transaction.[16] Imposing a fiduciary duty on broker-dealers would better protect investors by limiting the circumstances in which brokers' can argue that, among other things, the investor was negligent or was sophisticated enough to understand

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[13] Finke Study at 7 (citing A. Khorana and H. Servaes, 2012, "What drives market share in the mutual fund industry?" Review of Finance, 16, 81-113).
[14] Finke Study at 6 (citing M.S. Finke and T. Langdon, 2012, "The impact of a broker-dealer fiduciary standard on financial advice," Journal of Financial Planning, 25(7), 28-37).
[15] See letter from Scott C. Ilgenfritz, President, Public Investors Arbitration Bar Association, July 3, 2013 to the SEC in response to the request for comments on the "Duties of Brokers, Dealers and Investment Advisers," *available at* http://www.sec.gov/comments/4-606/4606-3107.pdf.
[16] *See In de Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F.3d 1293, 1303 (2d Cir. 2002). Whether imposition of a fiduciary duty on broker-dealers would address this difference will turn on how the Commission applies the ongoing duty of care in instances where the broker is providing ongoing advice.

the transaction(s) or had ratified the transaction(s) or was estopped from bringing claims or had failed to mitigate his or her damages.

**Financial Incentives Often Cause Brokers to Make Recommendations That Are Not in the Customer's Best Interest**

Under the suitability standard, a broker-dealer is free to recommend the security that pays the broker-dealer the highest compensation, so long as it is otherwise appropriate for the investor. As the Financial Industry Regulatory Authority (FINRA) noted in its October 2013 Report on Conflicts of Interest, such conflicts "are widespread across the financial services industry."[17] The report goes on to state, "[w]hile the existence of a conflict does not, per se, imply that harm to one party's interests will occur, the history of finance is replete with examples of situations where financial institutions did not manage conflicts of interest fairly."[18] In a comment letter to the Commission, Massachusetts Secretary of the Commonwealth William Galvin, the state securities regulator, suggested he was stating the obvious when he pointed out that a broker's recommendations can be influenced by how they are compensated:

> "It is a truism that many of the riskiest investments pay the highest selling compensation. Too often, brokers, who are subject to sharp conflicts of interest, recommend high-commission alternative products that carry inappropriate levels of investment risk, detrimentally high costs, and/or expose investors to factors such as illiquidity or price volatility."[19]

It is significant that those who are on the front line of enforcing the securities laws see a direct connection between conflict-inducing broker-dealer compensation and practices that result in harm to investors. This occurs because broker-dealers are not required to place their client's interest above their own.

Recent media accounts also provide evidence of the significant pressure brokers may be under from their employers to sell proprietary products regardless of the investor's best interests. This is illustrated, for example, by a recent *New York Times* article on J.P. Morgan's aggressive tactics aimed at pushing the sale of in-house products.[20] According to the article, several advisers who resisted the pressure to sell the firm's proprietary products said "they were told to change their tactics or be pushed out." As the article notes, while the promotion of in-house products is not illegal, the concern is that, "driven by fees, banks will push their own products over lower-cost options with stronger returns." Moreover, at least one former J.P. Morgan broker

[17] FINRA, "Report on Conflicts of Interest," October 2013, available at http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf
[18] *Id.*
[19] See letter from William F. Galvin, Secretary of the Commonwealth of Massachusetts, Boston, Massachusetts, June 27, 2013 to the SEC in response to the request for comments on the "Duties of Brokers, Dealers and Investment Advisers," available at http://www.sec.gov/comments/4-606/4606-3088.pdf.
[20] Susanne Craig and Jessica Silver-Greenberg, "Selling the Home Brand: A Look Inside an Elite JPMorgan Unit," The New York Times, March 2, 2013, accessed at http://dealbook.nytimes.com/2013/03/02/selling-the-home-brand-a-look-inside-an-elite-jpmorgan-unit-

left the firm because he did not feel that the firm's policy on selling in-house products allowed him to do what was best for his customers.

Similarly, a recent *Investment News* article noted that MetLife had increased both its minimum production limits for its sales force (by 50 percent) and the percentage of that minimum that must come from the sale of proprietary products (two-thirds).[21] Although the sale of proprietary products or a limited range of products may not, in and of itself, violate a fiduciary duty, it can create a clear conflict of interest with the potential to inflict considerable harm on investors.

This potential harm to investors is evidenced in a Government Accountability Office (GAO) analysis of 401(k) roll-over recommendations by the major call centers. GAO found considerable evidence of questionable practices that appear to be the result, at least in part, of conflicts of interest.[22] Among other things, GAO found that call centers (i) provided questionable information to investors about the benefits of various options available to them and (ii) directly undercut their own 401(k) plans in order to move individuals into Individual Retirement Accounts (IRA). The financial incentives for firms to undercut their own 401(k) plans are significant since roll-overs provide the primary source of money flowing into IRAs. Among its more specific findings, the GAO study noted:

- Financial advisors "encouraged rolling 401(k) plan savings into an IRA even with only minimal knowledge of a caller's financial situation."

- Representatives claimed that 401(k) plans had extra fees and that IRAs "had no fees," or argued that IRAs were always less expensive, notwithstanding the fact that opposite is generally true. IRAs are more expensive for investors, on average, than 401(k) plans.

- Misleading statements made it difficult for investors to understand IRA fees. For example, a GAO investigator called a number of 401(k) plan service providers, most of which offer IRA products, and found that 7 of 30 call center representatives (representing firms administering at least 34 percent of IRA assets at the end of the 1st quarter of 2011) said that their IRAs were 'free or had no fees with a minimum balance,' without clearly explaining that investment, transaction, and other fees could still apply, depending on investment decisions. In the GAO's review of 10 IRA websites, investigators found 5 providers that made similar claims, often with certain conditions such as a $50,000 minimum balance or consent to receive electronic statements explained separately in footnotes.

Numerous additional examples exist in academic research illustrating the pernicious effect that conflicts of interest can and do have on the recommendations of transaction-

[21] Darla Mercado," Under new structure, fewer MetLife advisers pushed to produce more," October 25, 2013, accessed at http://www.investmentnews.com/article/20131025/FREE/131029914?utm_source=issuealert-20131027&utm_medium=in-newsletter&utm_campaign=investmentnews&utm_term=text#
[22] Labor and IRS Could Improve the Rollover Process for Participants, Government Accountability Office, GAO-13-30 (March 2013) ("GAO Report") available at http://www.gao.gov/assets/660/653506.txt.

compensated salespeople. For example, in 2009, Professors Michael Finke and Sandra Huston[23] designed a study to measure the adequacy of life insurance coverage for consumers who used a financial planner versus those who used a broker.[24] The study found that "[c]onsistent with agency theory, the use of financial intermediaries who have the strongest fiduciary duty toward a household is associated with holding life insurance at or above the adequacy threshold. Even though households who employ brokers are demographically similar to those who rely on financial planners, the lack of contracting incentive among brokers … may reduce their willingness to recommend financial products that are substitutes for those that provide direct compensation. In other words, households that obtain life insurance using intermediaries who operate under a fiduciary duty (i.e., financial planners) tend to have a more adequate level of insurance than households that use non-fiduciary intermediaries (i.e., broker-dealers).

A 2012 study by the National Bureau of Economic Research sent mock investors with one of four different portfolios (all cash, index funds, a large position in company stock, and a large position in sector funds) to get portfolio recommendations from financial advisors compensated through product sales.[25] The study found that, because these financial professionals were compensated through product sales, they favored recommendations that provided greater remuneration over recommendations that "were objectively optimal." When advisers mentioned fees, they did so in a way that downplayed them without lying. For example, they often used arguments such as, "[t]his fund has 2% fee but that is not much above industry average."

Despite the data demonstrating the harm to investors as a result of higher fees in connection with transaction-compensated salespeople, one might expect that investors who rely on financial professionals would be less prone than those investing on their own to engage in self-destructive practices, such as chasing returns. On the contrary, Dr. Finke's analysis of the academic literature suggests that the "lack of a fiduciary standard of care coupled with contracting incentives can also encourage advisers to cater to, and perhaps amplify, welfare-reducing investor biases."[26]

Dr. Finke cites research that shows investors' tendency to chase returns in mutual funds leads them to underperform average market returns by 1.56% per year, since they tend to buy overvalued sectors after prices have risen and to sell following a market decline. Researchers found that "this underperformance was significantly greater in commission funds, perhaps because advisors benefitted from acceding to investor demands to buy and sell funds at a greater frequency."[27] A separate, more recent study finds that "commission-compensated insurance

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[23] Associate Professors with the Division of Personal Financial Planning, Texas Tech University.
[24] Dr. Michael Finke, Dr. Sandra Huston, and William Waller, "Do Contracts Impact Comprehensive Financial Advice,?" Working Paper, July 4, 2009, available at http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID1431173_code57590.pdf?abstractid=1429807&mirid=1.
[25] Sendhil Mullainathan, Markus Nöth and Antoinette Schoar, "The Market For Financial Advice: An Audit Study," March 2012, Working Paper 17929, National Bureau of Economic Research, *available at* http://www.nber.org/papers/w17929.
[26] Finke Study at 5.
[27] Finke Study at 5 (citing G.C. Friesen and T.R.A. Sapp, "Mutual fund flows and investor returns: An empirical examination of fund investor timing ability," Journal of Banking & Finance, 31(9), 2796-2816).

agents will play into a client's biases if these biases help them sell a higher commission product."[28]

**A Fiduciary Standard Could Help Reduce the Harm to Investors Resulting From Market Conditions**

The marketplace for investment products is among the most competitive in the world, offering investors an immense array of options designed to serve every investment need. This fact raises the question of how objectively inferior investment products (e.g., those that combine extremely high costs with poor performance) continue to exist and in some cases attract significant assets, particularly in the broker-sold marketplace. In other words, investors who invest through broker-dealers operating under a suitability standard of care do not appear to benefit from that market competition.

A key reason for this, as discussed in the previous section, is that investment products that cannot compete based on quality and cost succeed instead because those who sell them are rewarded with generous financial incentives. Brokers operating under a suitability standard are free to recommend products that reward them financially, even where better options are available, as long as their recommendation is generally suitable. Indeed, the broker-sold investment marketplace is characterized by "reverse competition," where investment products compete to be sold, not bought, and do so on terms that may actively induce brokers to ignore the best interests of their customers.

Imposition of a fiduciary standard has the potential to fundamentally change the basis on which investment products compete in the broker-sold market. As Dr. Finke concluded based on his review of the academic literature, "the majority of retail investor welfare loss from suitability standards arises from self-serving recommendations of products that are more expensive than the ideal, and reduced incentives to both create more efficient financial products and to invest in the knowledge required to make high quality recommendations. To the extent that fiduciary standards help align the interests of the agent and retail investor, it is possible that a combination of improved price disclosure and more effective disincentives to make self-serving recommendations will have little impact on the supply of advice while improving investor outcomes." [29]

Adoption of a fiduciary standard for broker-dealers' retail investment advice would promote market competition on pro-investor terms. This would be done not by eliminating all conflicts of interest, but by applying an over-arching best interest obligation on broker-dealer recommendations and by requiring brokers to appropriately manage their conflicts of interest. If brokers were required to have and document a reasonable basis for believing their recommendations are in the best interest of the investor, investment products would face increased pressure to compete based on features that promote client interests. That one change has the potential to deliver dramatic benefits to investors in the form of reduced costs, reduced exposure to unnecessary risks, and improved long-term performance.

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[28] Finke Study at 5 (citing S. Anagol and H.H. Kim, 2012, "The Impact of Shrouded Fees: Evidence from a Natural Experiment in the Indian Mutual Funds Market," American Economic Review, 102(1): 576-593).
[29] Finke Study at 17.

**There is No Evidence to Support the Contention That a Fiduciary Standard of Care Will Harm Investors**

Some opponents of fiduciary rulemaking have argued that investors, particularly middle-income investors, could be harmed if brokers stop serving this market, thereby leaving middle-income investors without access to affordable financial advice. In advancing this argument, critics make an inaccurate comparison between brokers and investment advisers. These critics draw a false conclusion that, because investment advisers tend to serve higher income clients than brokers that, therefore, brokers practicing under a fiduciary standard would be compelled to serve higher income clients as well.

In addition, the argument that investors could lose access to affordable advice is based on the false assumption that adoption of a fiduciary standard for broker-dealers' investment advice would force brokers to abandon transaction-based compensation arrangements. And, it assumes that broker-dealers would face significantly higher liability risks under a fiduciary standard than they currently face under the suitability standard. Several studies have been conducted in recent years that explore the real-world impact that a fiduciary duty has on the cost of service, the availability of services to middle-income customers, and the liability risks that financial professionals face. These studies strongly refute the claim that adopting a fiduciary standard for all financial professionals who provide personalized investment advice will increase costs or cause-middle income investors to lose access to products or services.

<u>Aité Group study</u>

The Financial Planning Coalition's submission to the SEC included a study conducted by the Aité Group that supports the conclusion that a uniform fiduciary standard will benefit retail customers and their financial advisers, and will not impose significant costs.[30] The study concludes that financial advisers and broker-dealers at investment advisory firms who deliver services to their customers under a fiduciary standard experience stronger asset growth, stronger revenue growth, and obtain a greater share of client assets than their counterparts who provide services primarily under a non-fiduciary model. Notwithstanding opposition arguments that a fiduciary standard would increase compliance burdens on brokers, the study found that fiduciary financial advisers do not spend any more of their time on compliance or other back-office tasks.

Specifically, both the financial advisers associated with investment advisory firms and the fiduciary registered representatives surveyed for the study report that, since 2007, they have achieved higher customer asset and stronger revenue growth than the financial advisers at broker-dealers who primarily work on a non-fiduciary commission basis. These findings suggest that transitioning to a fiduciary model is not likely to have a negative effect on broker-dealer financial advisers. To the contrary, operating under a fiduciary standard is likely to improve both their relationships with customers, the quality of advice they provide to those customers, and their bottom-line profits.

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[30] See Attachment A, "Aité Fiduciary Study Findings," in the letter from the Financial Planning Coalition, July 5, 2013 to the SEC in in response to the request for comments on the "Duties of Brokers, Dealers and Investment Advisers," available at http://www.sec.gov/comments/4-606/4606-3126.pdf.

Finke/Langdon Study

Dr. Michael Finke and Thomas Langdon, professors at Texas Tech University and Roger Williams University, respectively, conducted an illuminating study that includes an analysis of the availability of financial services to investors in states that treat broker-dealers as fiduciaries as compared to states that apply a lesser standard of conduct to broker-dealers.[31] The authors identified four states that impose an unambiguous fiduciary standard on broker-dealers (the "fiduciary states"), 14 states that do not impose a fiduciary standard on broker-dealers (the "non-fiduciary states"), and 32 states that impose a limited fiduciary standard ("limited fiduciary states"). They then compared the "saturation rate" (the number of registered representatives of broker-dealers that are not dually-registered compared to the number of households) among the three types of states.

The Finke and Langdon study finds no statistically significant difference in the ratio of registered representatives to total households in states in which broker-dealers have a full fiduciary duty, a limited fiduciary duty, or no fiduciary duty to customers. This study suggests that applying a uniform fiduciary duty standard on broker-dealers will have little if any effect on the availability of investment advice to customers, including customers with moderate levels of income or assets.

The authors also surveyed registered representatives located in fiduciary and non-fiduciary states regarding the conduct of their business. The survey covered such items as: the brokers' ability to serve moderate wealth customers; the ability to offer a variety of products; the ability to provide product recommendations that are in their customers' best interest; and whether representatives experience a greater compliance burden. The difference in responses from representatives in fiduciary states and those in non-fiduciary states was not statistically significant. The authors found (i) that the percentage of clients with an income of less than $75,000 is statistically equal between both groups, and (ii) that there is no statistically significant difference in either the percentage of brokers who believe they serve the needs of high-wealth clients or in the percentage of brokers who believe they serve the needs of low and moderate-wealth clients. Nearly all respondents believe they are able to provide products and advice that meet the needs of customers.

In contrast to the speculation and conjecture that characterizes the argument that a fiduciary standard would reduce investor access to affordable services, the Finke-Langdon study provides real-world empirical evidence that the imposition of a uniform fiduciary standard would neither reduce the availability of retail advice to investors nor unduly constrain the ability of financial advisors to provide a broad range of products or tailored advice to retail investors.

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[31] The Finke and Langdon study is available in the Journal of Financial Planning (July 2012) at http://www.fpanet.org/journal/TheImpactoftheBrokerDealerFiduciaryStandard/.

Cerulli Associates Data

Finally, the Cerulli Associates data[32] referenced in the Financial Planning Coalition's letter concerning the conversion of fee-based (non-fiduciary) brokerage accounts to fiduciary, non-discretionary (fiduciary) advisory accounts suggests that a fiduciary standard will impose little if any additional cost or burden on brokers. In fact, the Cerulli data show the opposite; that there is already a strong brokerage industry trend toward providing investment advice on a fiduciary basis and that the costs of such a transition will not be significant.

The industry data indicate that the number of these accounts, and their amount of assets in the accounts, have grown dramatically since the conversion. Cerulli Associates found that, even after the broad market declines of 2008, the client assets in non-discretionary advisory accounts rose by almost 75% from approximately $329.6 billion at the end of the conversion process in 2007 to $574 billion in the third quarter of 2012. Meanwhile, the level of fees charged to customers for this service model at the major national firms has stayed flat or decreased since 2007. In sum, the experience of converting fee-based (non-fiduciary) brokerage accounts to non-discretionary advisory (fiduciary) accounts demonstrates that the expense of operating under a fiduciary model has not prevented the number of accounts and level of assets in those accounts from continuing to grow substantially.

**Better Disclosure and Investor Education Alone Will Not Solve the Problem**

Despite the clear benefits to investors of adopting a uniform fiduciary standard, some continue to suggest that the Commission can cure the significant investor harm that currently exists by simply improving disclosures, better educating investors about the differences between brokers and advisers, and relying on investors to choose the business model that is best for them. It is in this context that the well-documented problem of investor confusion becomes relevant. Numerous studies over the years have demonstrated that investors do not understand the differences between brokers and advisers, including the differences in the legal obligations to clients. Indeed, a 2008 RAND Study found that most investors cannot identify whether their own financial adviser is a broker or investment adviser even after the differences have been explained to them.[33] Earlier Commission efforts to design effective disclosure regarding the different legal obligations of brokers and advisers proved futile, even after extensive redesign based on investor testing.[34]

We are not aware of any new research that would suggest that disclosure and education can offer an effective solution to this problem. To the contrary, the Commission's comprehensive study of financial literacy provides convincing evidence of the extreme

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[32] As referenced in the Financial Planning Coalition letter to the SEC, Cerulli Associates, Cerulli Quantitative Update: Advisor Metrics, Exhibit 1.02 (2012).

[33] Angela A. Hung, Noreen Clancy, Jeff Dominitz, Eric Talley, Claude Berrebi, Farrukh Suvankulov, Rand Institute for Civil Justice, "Investor and Industry Perspectives on Investment Advisers and Broker-Dealers," released January 2008 by the SEC and available at http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

[34] See Siegel & Gale, LLC and Gelb Consulting Group, Inc., Results of Investor Focus Group Interviews About Proposed Brokerage Account Disclosures, Report to the Securities and Exchange Commission, March 10, 2005.

limitations of disclosure as an effective investor protection tool.[35] Despite decades of increased attention to improving investor knowledge, the SEC staff study found that investors typically do not understand basic financial concepts, such as compound interest and inflation.

A review of studies and surveys on investor knowledge, prepared by the Library of Congress for the SEC, found that many investors do not understand key financial concepts, such as diversification or the differences between stocks and bonds, and are not fully aware of investment costs and their impact on investment returns. Moreover, investors lack critical knowledge about investment fraud. In addition, surveys demonstrate that certain subgroups, including women, African-Americans, Hispanics, the oldest segment of the elderly population, and those who are poorly educated, have an even greater lack of investment knowledge than the average person in the general population.

Academic research confirms that disclosure is not enough to protect consumers. For example, in 2007, employees with low saving rates were randomly assigned to a study in which they were paid $50 each to read a short survey explaining their 401(k) plan, including a calculation of how much money they would personally gain by taking full advantage of the employer match. Relative to a control group, this group did not significantly increase its average 401(k) saving rate.[36] In a March 2009 study, researchers found that the adoption of an easy-to-read summary prospectus by the SEC, which simplifies mutual fund disclosure, seemed to have no effect on investor choices.[37]

Moreover, academic research has shown that conflicts of interest disclosures can actually have the opposite of the intended effect because investors tend to place more trust in the financial adviser's recommendations and financial advisers tend to be less concerned about acting in the customer's best interest when conflicts are disclosed. A 2005 study found that in certain situations, disclosure can sometimes lead advisers to give more biased advice by providing individuals with "moral license" to engage in self-interested behavior.[38] The results of this study were confirmed by a more sophisticated study in 2011, which found that disclosure alone lessens moral reluctance to provide biased advice.[39]

Investors who cannot distinguish between brokers and advisers, who do not understand the different legal standards that apply to their recommendations, and who do not understand the

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[35] Staff of the Securities and Exchange Commission, Study Regarding Financial Literacy Among Investors (As Required by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act), August 2012.
[36] *See* Choi, *et al*, "Are Empowerment and Education Enough? Underdiversification in 401(k) Plans," Brookings Papers on Economic Activity 2: 151–98 (2005), *available at* http://scholar.harvard.edu/files/laibson/files/are_empowerment_and_education_enough_under-diversification_in_401k_plans.pdf.
[37] *See* John Beshear, *et al*, "How Does Simplified Disclosure Affect Individuals' Mutual Fund Choices?" Kennedy School of Government Harvard University, Working Paper No. RWP09_16 (March 2009), *available at* http://www.hks.harvard.edu/var/ezp_site/storage/fckeditor/file/MRCBG_FWP_2009_02-2009_Madrian_Mutual_Fund.pdf.
[38] Daylian M. Cain, *et al*, *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. Legal Stud. 1 (2005).
[39] Daylian M. Cain, *et al*, *When Sunlight Fails to Disinfect: Understanding the Perverse Effects of Disclosing Conflicts of Interest*, 37 J. CONSUMER RES. 836 (2011).

ramifications of disclosed conflicts of interest cannot be expected to make an informed decision about which business model would best serve their interests.[40] Certainly, there is no reasonable basis for believing that a disclosure and education-based approach would promote informed decisions by investors unless brokers were also prohibited from using titles and marketing their services in ways that are designed to portray them as trusted and expert financial advisers.

**Conclusion**

The bifurcated approach to regulating investment advice offered by broker-dealers and investment advisers reflects the failure of regulatory policy to keep pace with changes in market practices. There is no justification for applying different standards of care to financial professionals who are offering the same services to investors. Over the years, broker-dealers have not only identified themselves as financial advisers, but they have offered virtually identical services to investors in order to compete. The Commission has permitted, at least tacitly, this evolution by failing to apply the appropriate regulatory standard.

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[40] Dr. Sunita Sah, *et al*, "The Burden of Disclosure: Increased Compliance with Distrusted Advice," Working Paper, Dec. 2011, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1615025&download=yes (The study reflected that eliminating conflicts of interest is also key to enhancing the benefits of disclosure. The study found that the choosers were aware that their advisers had not put their interests first, but due to the pressure of the situation, the chooser was more likely to comply with the advice, even though they were less satisfied with their choice.).

Investors suffer concrete harm – in the form of higher costs and poorer performance – as a result. The Commission has an opportunity to reduce this harm to investors without imposing undue costs or regulatory burdens by applying a fiduciary standard to both broker-dealers and investment advisers when they offer personalized investment advice to retail customers. We urge the Commission to move forward expeditiously with a rulemaking, consistent with Section 913 of the Dodd-Frank Act, to achieve this goal.

Sincerely,

Joyce A. Rogers
Senior Vice President
Government Affairs
AARP

Barbara Roper
Director of Investor Protection
CFA

Kevin R. Keller, CAE
Chief Executive Officer
CFP Board

Lauren Schadle, CAE
Executive Director/ CEO
FPA®

Mercer Bullard
President and Founder
Fund Democracy, Inc.

Geof Brown, CAE
Chief Executive Officer
NAPFA

Cc: Hon. Tim Johnson
Hon. Mike Crapo
Hon. Jeb Hensarling
Hon. Maxine Waters

## SECURITIES AND EXCHANGE COMMISSION

**[Release No. 34–73339; File No. SR–FINRA–2014–006]**

**Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change, as Modified by Amendment No. 1, Relating to Per Share Estimated Valuations for Unlisted DPP and REIT Securities**

October 10, 2014.

### I. Introduction

On January 31, 2014, Financial Industry Regulatory Authority, Inc. ("FINRA") (f/k/a National Association of Securities Dealers, Inc. ("NASD")) filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act" or "Exchange Act") [1] and Rule 19b–4 thereunder,[2] a proposed rule change to amend provisions in the NASD and FINRA rulebooks addressing per share estimated valuations for unlisted direct participation program ("DPP") and real estate investment trust ("REIT") securities. In particular, FINRA proposes revising NASD Rule 2340 (Customer Account Statements) to modify the requirements relating to the inclusion of a per share estimated value for unlisted DPP and REIT securities on a customer account statement and FINRA Rule 2310 (Direct Participation Programs) to modify the requirements applicable to members' participation in a public offering of DPP or REIT securities.

The proposed rule change was published for comment in the **Federal Register** on February 19, 2014.[3] The Commission received eighteen (18) comment letters in response to the Notice of Filing.[4] On March 14, 2014, FINRA extended the time period in which the Commission must approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change to May 20, 2014. On May 20, 2014, the Commission issued an order instituting proceedings pursuant to Section 19(b)(2)(B) of the Act [5] to determine whether to approve or disapprove the proposed rule change. The order was published for comment in the **Federal Register** on May 27, 2014.[6] The Commission received six (6) comment letters in response to the Proceedings Order.[7]

On July 11, 2014, FINRA filed a letter responding to comments and Amendment No. 1 to the proposed rule change.[8] A notice of the amendment was published for comment in the **Federal Register** on July 22, 2014.[9] The Commission received six (6) comment letters in response to the Notice of Amendment.[10] On September 16, 2014, FINRA filed a letter responding to these comments.[11]

This order approves the proposed rule change, as modified by Amendment No. 1.

### II. Description of the Proposal, as Modified by Amendment No. 1

*A. Proposed Revisions to NASD Rule 2340 (Customer Account Statements)*

FINRA proposes to amend NASD Rule 2340 to require general securities members to include in customer account statements a per share estimated value for an unlisted DPP or REIT security, developed in a manner reasonably designed to ensure that the per share estimated value is reliable, as well as to make related disclosures.[12] FINRA also proposes two methodologies for calculating the per share estimated value for a DPP or REIT security that would be deemed to have been developed in a manner reasonably designed to ensure that it is reliable: (1) The net investment methodology; and (2) the appraised value methodology.[13] Each methodology is described in greater detail below, along with other proposed revisions.

1. Net Investment Methodology

Under the proposal, the net investment methodology would reflect the "net investment" disclosed in the issuer's most recent periodic or current

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] Exchange Act Release No. 71545 (Feb. 12, 2014), 79 FR 9535 (Feb. 19, 2014) (Notice of Filing of Proposed Rule Change Relating to Per Share Estimated Valuations for Unlisted DPP and REIT Securities) ("Notice of Filing"). The comment period closed on March 12, 2014.

[4] Letters to Elizabeth Murphy, Secretary, SEC, from Mark Goldberg, Chairman, Investment Program Association, dated February 5, 2014; David T. Bellaire, Esq., Executive Vice President and General Counsel, Financial Services Institute, dated February 5, 2014; Mark Kosanke, President, Real Estate Investment Securities Association, dated February 11, 2014; Steven A. Wechsler, President and Chief Executive Officer, National Association of Real Estate Investment Trusts, dated February 14, 2014; Jeff Johnson, Chief Executive Officer, Dividend Capital Diversified Property Fund Inc., dated February 28, 2014; Michael Crimmins, Chief Executive Officer and Managing Director, KBS Capital Markets Group, dated February 28, 2014; Scott Ilgerfritz, Immediate Past-President, Public Investors Arbitration Bar Association, dated March 11, 2014; Thomas Price, Managing Director, Securities Industry and Financial Markets Association, dated March 12, 2014; Steve Morrison, Senior Vice President and Associate Counsel, LPL Financial, dated March 12, 2014; Jacob Frydman, Chairman and Chief Executive Officer, United Realty Trust Incorporated, dated March 12, 2014; Dechert LLP, dated March 12, 2014; David Hirschmann, President and Chief Executive Officer, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce, dated March 12, 2014; Steven A. Wechsler, President and Chief Executive Officer, National Association of Real Estate Investment Trusts, dated March 12, 2014; Kirk Montgomery, Head of Regulatory Affairs, CNL Financial Group, LLC, dated March 12, 2014; Mark Goldberg, Chairman, Investment Program Association, dated March 12, 2014; David T. Bellaire, Esq., Executive Vice President and General Counsel, Financial Services Institute, dated March 12, 2014; Martel Day, Principal, NLR Advisory Services, LLC, dated March 12, 2014; and Mark Kosanke, President, Real Estate Investment Securities Association, dated March 12, 2014. Comment letters are available at *www.sec.gov*.

The Commission discussed these comments in the Proceedings Order. *See infra* note 6.

[5] 15 U.S.C. 78s(b)(2)(B).

[6] Exchange Act Release No. 72193 (May 20, 2014), 79 FR 30217 (May 27, 2014) (Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change Relating to Per Share Estimated Valuations for Unlisted DPP and REIT Securities) ("Proceedings Order"). The comment period closed on June 26, 2014.

[7] Letters to Elizabeth Murphy, Secretary, SEC, from Kenneth Mills, dated June 24, 2014; Jason Doss, President, Public Investors Arbitration Bar Association, dated June 25, 2014; Mark Kosanke, President, Real Estate Investment Securities Association, dated June 26, 2014; Thomas F. Price, Managing Director, Operations, Technology and BCP, Securities Industry and Financial Markets Association, dated June 26, 2014; David T. Bellaire, Executive Vice President and General Counsel, Financial Services Institute, dated June 26, 2014; and Peter Peters, dated July 15, 2014. Comment letters are available at *www.sec.gov*.

[8] Letter to Kevin O'Neill, Deputy Secretary, SEC, from Matthew E. Vitek, Associate General Counsel, FINRA, dated July 11, 2014 ("FINRA's First Response Letter"). FINRA's First Response Letter is available at *www.sec.gov*.

[9] Exchange Act Release No. 72626 (July 16, 2014); 79 FR 42590 (July 22, 2014) (Notice of Filing of Amendment No. 1 to Proposed Rule Change Relating to Per Share Estimated Valuations for Unlisted DPP and REIT Securities) ("Notice of Amendment"). The comment period closed on August 12, 2014.

[10] Letters to Elizabeth Murphy, Secretary, SEC, from Mark Goldberg, Chairman, Investment Program Association, dated July 28, 2014 ("IPA Letter"); Steven A. Wechsler, President and Chief Executive Office, National Association of Real Estate Investment Trusts, dated August 12, 2014 ("NAREIT Letter"); Frederick P. Baerenz, President and Chief Executive Officer, AOG Wealth Management, dated August 12, 2014 ("AOG Letter"); Daniel R. Gilbert, Chief Investment and Operating Officer, NorthStar Asset Management Group, Inc., dated August 12, 2014 ("NorthStar Letter"); David T. Bellaire, Executive Vice President and General Counsel, Financial Services Institute, dated August 12, 2014 ("FSI Letter"); and Andrea Seidt, President, North American Securities Administrators Association, Inc., and Commissioner, Ohio Division of Securities, dated August 22, 2014 ("NASAA Letter"). Comment letters are available at *www.sec.gov*.

[11] Letter to Brent J. Fields, Secretary, SEC, from Matthew E. Vitek, Associate General Counsel, FINRA, dated September 16, 2014 ("FINRA's Second Response Letter"). FINRA's Second Response Letter is available at *www.sec.gov*.

[12] *See* Proposed NASD Rule 2340(c).

[13] *See* Proposed NASD Rule 2340(c)(1).

report. More specifically, the proposal would require "net investment" to be based on the "amount available for investment" percentage in the "Estimated Use of Proceeds" section of the offering prospectus; [14] alternatively, where "amount available for investment" is not provided, the proposal would require "net investment" to be based on another equivalent disclosure that reflects the estimated percentage deduction from the aggregate dollar amount of securities registered for sale to the public of sales commissions, dealer manager fees, and estimated issuer offering and organization expenses.[15]

The proposal would not require the calculation of "net investment" to involve the deduction from the per share estimated value of "over-distributions." [16] The proposal would, however, require members that use the net investment methodology to provide a per share estimated value for a DPP or REIT security to disclose in the customer account statement the following statement: "IMPORTANT—Part of your distribution includes a return of capital. Any distribution that represents a return of capital reduces the estimated per share value shown on your account statement." [17] The proposal would require the member to disclose this statement prominently and in proximity to the disclosure of distributions and the per share estimated value.[18]

In addition, the proposal would clarify that when an issuer provides a range of amounts available for investment, the proposal would allow a general securities member to use the maximum offering percentage unless the member has reason to believe that such percentage is unreliable. If the member has reason to believe that it is unreliable, the member must use the minimum offering percentage.[19]

Finally, the proposal would allow a member to use the net investment methodology at any time before 150 days following the second anniversary of the breaking of escrow.[20]

2. Appraised Value Methodology

Under the proposal, the appraised value methodology would consist of the appraised valuation disclosed in the issuer's most recent periodic or current report. More specifically, the proposal would require: (1) That the valuation be based on valuations of the assets and liabilities of the DPP or REIT; and (2) that those valuations: (a) Be performed at least annually; (b) be conducted by, or with the material assistance or confirmation of, a third-party valuation expert or service; and (c) be derived from a methodology that conforms to standard industry practice. The proposal would allow a member to use the appraised value methodology at any time.[21]

The proposed rule change would, however, provide a different requirement for DPPs subject to the Investment Company Act of 1940 ("1940 Act") (*e.g.*, business development companies). Specifically, FINRA acknowledged that business development companies that fall under the definitions of DPP are subject to the 1940 Act, which already requires the issuer to determine and publish its net asset value on a regular basis.[22] Thus, for these DPPs, the proposed rule would require the appraised value methodology to be consistent with the valuation requirements of the 1940 Act and the rules thereunder.[23]

3. General Disclosures

The proposal would also require members to include specific disclosures on customer account statements that provide a per share estimated value for a DPP or REIT security (calculated using either the net investment methodology or the appraised value methodology). In particular, the proposal would require a member to include disclosures stating that the DPP or REIT security is not listed on a national securities exchange, is generally illiquid, and that, even if a customer is able to sell the security, the price received may be less than the per share estimated value provided in the statement.[24]

*B. Proposed Revisions to FINRA Rule 2310 (Direct Participation Programs)*

FINRA also proposes to amend FINRA Rule 2310(b)(5) to prohibit a member from participating in a public offering of the securities of a REIT or DPP unless the issuer of the DPP or REIT has agreed to disclose:

(1) A per share estimated value of the DPP or REIT security that is: (a) Developed in a manner reasonably designed to ensure it is reliable, and (b) disclosed in the DPP's or REIT's periodic reports filed pursuant to Sections 13(a) or 15(d) of the Act; an explanation of the method by which the value was developed; and the date of the valuation; and

(2) a per share estimated value of the DPP or REIT security that is: (a) Based on valuations of the assets and liabilities of the DPP or REIT performed at least annually by, or with the material assistance or confirmation of, a third-party valuation expert or service; (b) derived from a methodology that conforms to standard industry practice; and (c) disclosed in the DPP's or REIT's periodic reports filed pursuant to Sections 13(a) or 15(d) of the Act within 150 days following the second anniversary of breaking escrow (and in each annual report thereafter); and a concomitant written opinion or report by the issuer, delivered at least annually to the member that explains the scope of the review, the valuation methodology used, and the basis for the reported value.

The proposed rule change would, however, except DPPs subject to the 1940 Act from the requirements of proposed Rule 2310(b)(5). As stated above, FINRA acknowledged that such DPPs are subject to an existing regulatory framework (the 1940 Act) that already requires the issuer of their securities to determine and publish their net asset value on a regular basis.[25]

*C. Technical Change*

FINRA also proposes making a change to its Rules Manual to conform to the other revisions discussed above by deleting FINRA Rule 5110(f)(2)(L) (Corporate Financing Rule—Underwriting Terms and Arrangements). That paragraph currently provides that it is unfair and unreasonable for a member or person associated with a member to participate in a public offering of a REIT unless the trustee will disclose in each annual report distributed to investors a per share estimated value of the trust securities, the methodology by which it

[14] "This disclosure is typically included in the prospectus for REIT offerings and is described in the SEC's Securities Act Industry Guide 5 (Preparation of registration statements relating to interests in real estate limited partnerships)." Notice of Filing at note 12.

[15] *See* Proposed NASD Rule 2340(c)(1)(A).

[16] *See* Notice of Filing at note 20 (generally describing "over-distributions" as a return of investor capital as a distribution rather than the use of that capital to generate return on investment); *see also* Notice of Amendment (clarifying that "over-distributions" should be excluded from the calculation of "net investment").

[17] *See* Proposed NASD Rule 2340(c)(2)(A).

[18] *Id.*

[19] *See* Proposed NASD Rule 2340(c)(1)(A).

[20] *See Id. See also* Notice of Filing at note 11 (stating that "[g]enerally, offering proceeds are placed in escrow until the minimum conditions of the offering are met, at which time the issuer is permitted to access the offering proceeds").

[21] *See* Proposed NASD Rule 2340(c)(1)(B).

[22] *See* Notice of Amendment.

[23] *See* Proposed NASD Rule 2340(c)(1)(B).

[24] *See* Proposed NASD Rule 2340(c)(2)(B).

[25] *See* Notice of Amendment.

was developed, and the date of the data used to develop the value.

The text of the proposed rule change is available at the principal office of FINRA, on FINRA's Web site at *http://www.finra.org*, and at the Commission's Public Reference Room.

## III. Description of Comments on the Proposal, as Amended, and FINRA's Response

### *A. Comments*

As stated above, the Commission received six (6) comment letters in response to the Proceedings Order.[26] Those commenters generally reiterated concerns expressed in response to the Notice of Filing.

In addition, the Commission received six (6) comment letters in response to the Notice of Amendment.[27] Four (4) of these commenters fully supported the proposal.[28] Two (2) other commenters, however, raised concerns (discussed below).[29]

One of the concerned commenters supported aspects of the proposal.[30] This commenter, however, encouraged rejecting the proposal's requirement for members to report initial share prices, stating that substituting "a flawed share pricing system with a different flawed pricing system is apt to lead to confusion rather than clarity." [31] This commenter also suggested that market forces are sufficiently driving improvements in the unlisted DPP and REIT industry, noting changes in fee structures.[32]

The second concerned commenter also supported aspects of the proposal.[33] This commenter, however, opposed the following other aspects of the proposal:

(1) The commenter opposed excluding over-distribution from the valuation calculation under the net investment methodology, stating that excluding it would decrease the accuracy and transparency of the disclosed values of DPP and REIT securities.[34]

(2) The commenter also expressed concern that members could use the net investment methodology's requirements concerning offering and organization expenses to manipulate valuation of DPP and REIT securities.[35]

(3) In addition, the commenter recommended that FINRA require disclosure of the identity of the third-party valuation expert or service used to obtain a valuation under the appraised value methodology and clarify that such third-party must be independent.

(4) Finally, the commenter opposed the extension of the effective date of the proposal, as amended, stating that "industry should not need an additional year-and-a-half to make the necessary changes" and "[investors] should not be forced to wait another year for more transparent price reporting." [36]

### *B. FINRA's Response*

In its response letter, FINRA stated that it has considered the concerns raised by the two concerned commenters.[37] FINRA also stated, however, that it believes that the proposal, as amended, "significantly improves the transparency of the per share estimated value of DPP and REIT securities on customer account statements." [38] Accordingly, FINRA declined making any additional changes in response to commenters' concerns but stated that it would "continue to monitor practices in this area to determine whether additional changes are necessary." [39]

## IV. Discussion and Commission Findings

The Commission has carefully considered the proposal, as amended; the comments received; and FINRA's responses to the comments. Based on its review of the record, the Commission finds that the proposal is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.[40] In particular, the Commission finds that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that FINRA's rules be designed to prevent fraudulent and manipulative acts and practices; promote just and equitable principles of trade; and, in general, protect investors and the public interest.[41]

The proposal, as amended, is designed to address longstanding concerns with the current industry practice of displaying a DPP or REIT security's immutable offering price as its per share estimated value on customer account statements throughout the offering period (which can last several years),[42] despite the fact that the value of the DPP or REIT security fluctuates. FINRA's proposed rule change would require members to include in customer account statements per share estimated values of unlisted DPP and REIT securities that are developed in a manner reasonably designed to ensure they are reliable. The Commission believes that the proposal would, therefore, greatly improve the accuracy and transparency of the value of DPP and REIT securities and, in turn, better protect the investing public.

As discussed above, the Commission received eighteen (18) comment letters in response to the Notice of Filing, six (6) comment letters in response to the Proceedings Order, six (6) comment letters in response to the Notice of Amendment, and two (2) response letters from FINRA. The Commission appreciates the points raised by the commenters, and the Commission believes that FINRA responded appropriately to their concerns.[43] The

[26] *See supra* note 7.

[27] *See supra* note 10.

[28] FSI Letter, IPA Letter, NAREIT Letter, and NorthStar Letter.

[29] AOG Letter and NASAA Letter.

[30] AOG Letter (stating that "providing sponsor companies with a formula and timeline . . . for appraising and reporting the values [other than the initial value] of non-traded REITS is very valuable" and "[providing] broker-dealers assurance that they can rely on those values is also very helpful").

[31] *Id.*

[32] *Id.*

[33] NASAA Letter (stating that "[r]equiring securities to be valued on the customer account statement enhances transparency to the customer").

[34] *See supra* note 16 and surrounding text.

[35] *See supra* note 19 and surrounding text.

[36] NASAA Letter.

[37] FINRA's Second Response Letter. *See, e.g.*, FINRA's First Response Letter (summarizing and responding to commenters' concerns about calculating over-distributions); FINRA's First Response Letter (proposed NASD Rule 2340(c)(1)(A) (stating that if a member has reason to believe that the maximum offering percentage is unreliable, the member must use the minimum offering percentage); FINRA's First Response Letter (extending the effective date to provide industry participants sufficient time to make adjustments to product structures and any necessary operational changes, as well as to limit the impact of the amended proposal on current offerings); and proposed NASD Rule 2340(c)(1)(B) (stating that the valuation expert or service must be a third-party).

[38] FINRA's Second Response Letter.

[39] *Id.*

[40] In approving the proposal, as amended, the Commission has considered the impact on efficiency, competition, and capital formation. *See* 15 U.S.C. 78c(f).

*See, e.g.*, Proceedings Order at 7 (noting commenters' concern about the potential economic impact of the proposal, as originally proposed; *also* FINRA's First Response Letter, which provided a detailed economic impact statement in response to those commenters). The Commission has received no additional public comment on the potential economic impact of the proposed rule change, as amended.

[41] 15 U.S.C. 78o–3(b)(6).

[42] *See* Notice of Filing at note 8 and surrounding text (stating that "Rule 415(a)(5) under the Securities Act of 1933 ('Securities Act') provides that certain types of securities offerings, including continuous offerings of DPPs and REITs, may continue for no more than three years from the initial effective date of the registration statement. Under Rule 415(a)(6), the SEC may declare another registration statement for a DPP or REIT effective such that an offering can continue for another three-year offering period").

[43] FINRA did not directly respond to the commenter's recommendation to require disclosure of the name of the third-party expert or service for purposes of proposed NASD Rule 2340(c)(1)(B). The

Continued

Commission notes that, while one commenter on the amended proposal suggested market forces should be sufficient to drive improvements in the unlisted DPP and REIT industry,[44] given current industry practice with respect to disclosure of DPP and REIT values, the Commission believes that FINRA's amended proposal is warranted.

Also, given commenters' concern regarding the complexity of calculating over-distributions, the Commission supports FINRA's amended approach of requiring enhanced disclosure surrounding them. More specifically, the Commission believes that, at this time, this approach would improve investor awareness and understanding in a practical manner.

In addition, one commenter on the amended proposal expressed concern that members could use the net investment methodology's requirements concerning offering and organization expenses to manipulate DPP and REIT values.[45] Under the amended proposal, however, if a member has reason to believe a calculation of the offering and organization expenses using the maximum offering percentage is unreliable, the member must use the minimum offering percentage.[46]

The same commenter further recommended that FINRA require disclosure of the identity of the service used to obtain a valuation under the appraised value methodology and clarify that such service must be independent.[47] Regarding disclosure of the valuation service's identity, the Commission notes that this information may be available through an issuer's prospectus. Regarding the independence of the service, the amended proposal requires the use of a "third-party valuation expert," which both the Commission and FINRA interpret as being an independent entity.[48]

Finally, the commenter opposed the extension of the effective date under the amended proposal, stating that investors should not have to wait for more transparent price reporting.[49] FINRA extended the effective date, however, to provide industry participants sufficient time to make adjustments to product structures and any necessary operational changes, as well as to limit the impact of the amended proposal on current offerings.[50]

In sum, the Commission believes that the proposal, as amended, represents a significant improvement to current industry practice concerning the disclosure of the value of unlisted DPP and REIT securities. As amended, the proposal would help ensure that investors receive more accurate information regarding the nature and worth of their holdings of DPP and REIT securities. While the Commission believes that this outcome would improve accuracy and transparency and, consequently, investor protection, it will continue to monitor the activity in this market for potential abuses.

For the reasons stated above, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations thereunder.

## V. Conclusion

*It is therefore ordered,* pursuant to Section 19(b)(2) of the Act,[51] that the proposed rule change (SR–FINRA–2014–006), as modified by Amendment No. 1, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[52]

**Kevin M. O'Neill,**

*Deputy Secretary.*

[FR Doc. 2014–24681 Filed 10–16–14; 8:45 am]

**BILLING CODE 8011–01–P**

Commission notes, however, that this information may be available in an issuer's prospectus.

[44] AOG Letter.

[45] NASAA Letter.

[46] *See* FINRA's First Response Letter.

[47] *Id.*

[48] *See, e.g.,* FINRA's First Response Letter (discussing the economic impact of requiring "independent valuations").

[49] NASAA Letter.

[50] FINRA's First Response Letter.

[51] 15 U.S.C. 78s(b)(2).

[52] 17 CFR 200.30–3(a)(12).

## SECURITIES AND EXCHANGE COMMISSION

**[Release No. 34–73342; File No. SR–NYSEArca–2014–114]**

## Self-Regulatory Organizations; NYSE Arca, Inc.; Notice of Filing of Proposed Rule Change To List and Trade Shares of the iShares Interest Rate Hedged 0–5 Year High Yield Bond ETF, iShares Interest Rate Hedged 10+ Year Credit Bond ETF, and the iShares Interest Rate Hedged Emerging Markets Bond ETF Under NYSE Arca Equities Rule 8.600

October 10, 2014.

Pursuant to Section 19(b)(1)[1] of the Securities Exchange Act of 1934 (the "Act")[2] and Rule 19b–4 thereunder,[3] notice is hereby given that, on September 29, 2014, NYSE Arca, Inc. (the "Exchange" or "NYSE Arca") filed with the Securities and Exchange Commission (the "Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

### I. Self-Regulatory Organization's Statement of the Terms of the Substance of the Proposed Rule Change

The Exchange proposes to list and trade the following under NYSE Arca Equities Rule 8.600 ("Managed Fund Shares"): iShares Interest Rate Hedged 0–5 Year High Yield Bond ETF; iShares Interest Rate Hedged 10+ Year Credit Bond ETF; and the iShares Interest Rate Hedged Emerging Markets Bond ETF. The text of the proposed rule change is available on the Exchange's Web site at *www.nyse.com,* at the principal office of the Exchange, and at the Commission's Public Reference Room.

### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of those statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant parts of such statements.

*A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change*

1. Purpose

The Exchange proposes to list and trade shares ("Shares") of the following under NYSE Arca Equities Rule 8.600, which governs the listing and trading of Managed Fund Shares:[4] iShares Interest Rate Hedged 0–5 Year High Yield Bond

[1] 15 U.S.C. 78s(b)(1).

[2] 15 U.S.C. 78s(b)(1).

[3] 17 CFR 240.19b–4.

[4] A Managed Fund Share is a security that represents an interest in an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1) ("1940 Act") organized as an open-end investment company or similar entity that invests in a portfolio of securities selected by its investment adviser consistent with its investment objectives and policies. In contrast, an open-end investment company that issues Investment Company Units, listed and traded on the Exchange under NYSE Arca Equities Rule 5.2(j)(3), seeks to provide investment results that correspond generally to the price and yield performance of a specific foreign or domestic stock index, fixed income securities index or combination thereof.

# Regulatory Notice 15-02

# DPP and Unlisted REIT Securities

## SEC Approves Amendments to FINRA Rule 2310 and NASD Rule 2340 to Address Values of Direct Participation Program and Unlisted Real Estate Investment Trust Securities

**Effective Date: April 11, 2016**

January 2015

### Notice Type
- Rule Amendment

### Suggested Routing
- Compliance
- Legal
- Senior Management

### Key Topics
- Customer Account Statements
- Direct Participation Programs
- Unlisted Real Estate Investment Trusts

### Referenced Rules & Notices
- FINRA Rule 2310
- NASD Rule 2340

## Executive Summary

The SEC approved amendments to NASD Rule 2340 (Customer Account Statements) to modify the requirements relating to the inclusion of per share estimated values for direct participation program (DPP) and unlisted real estate investment trust (REIT) securities on account statements, and to FINRA Rule 2310 (Direct Participation Programs) to make corresponding changes to the requirements applicable to members' participation in public offerings of DPP or REIT securities.[1] The amendments become effective on April 11, 2016.

The amended rule text is available at www.finra.org/notices/15-02.

Questions concerning this *Notice* should be directed to:

- Joseph E. Price, Senior Vice President & Counsel, Advertising Regulation and Corporate Financing, at (240) 386-4642 or Joseph.Price@finra.org;
- Paul M. Mathews, Vice President & Director, Corporate Financing, at (240) 386-4639 or Paul.Mathews@finra.org; or
- James S. Wrona, Vice President & Associate General Counsel, Office of General Counsel, at (202) 728-8270 or Jim.Wrona@finra.org.

## Background & Discussion

NASD Rule 2340 currently requires a general securities member to include on account statements an estimated value of a DPP or REIT security from the annual report, an independent valuation service or any other source, unless the member can demonstrate the estimated value is inaccurate. FINRA Rule 2310 provides that a member may not participate in a DPP or REIT offering unless the general partner or sponsor will disclose a per share estimated value in each annual report.

Financial Industry Regulatory Authority

The general industry practice is to use the offering price (or "par value") of DPP and REIT securities as the per share estimated value during the offering period, which can continue as long as seven and one-half years. The offering price, typically $10 per share, often remains constant on customer account statements during this period even though various costs and fees have reduced investors' principal and underlying assets may have decreased in value.

The SEC recently approved FINRA's proposed amendments to Rule 2340 and Rule 2310 that require general securities members to provide more accurate per share estimated values on customer account statements, shorten the time period before a valuation is determined based on an appraisal and provide various important disclosures. The effective date of the amendments is April 11, 2016.

## I. NASD Rule 2340 (Customer Account Statements)

NASD Rule 2340 generally requires that general securities members provide periodic account statements to customers, on at least a quarterly basis, containing a description of any securities positions, money balances or account activity since the last statement. Paragraph (c) addresses the inclusion of per share estimated values for DPP and REIT securities held in customer accounts or included on customer account statements. The rule also provides for several disclosures regarding the illiquidity and resale value of DPP and REIT securities.

The SEC has approved amendments to Rule 2340(c) to require, among other things, general securities members to include in customer account statements a per share estimated value for a DPP or REIT security developed in a manner reasonably designed to ensure that the per share estimated value is reliable. In addition, the amended rule provides two methodologies for calculating the per share estimated value for a DPP or REIT security that is deemed to have been developed in a manner reasonably designed to ensure that it is reliable: (1) the net investment methodology and (2) the appraised value methodology. The amended rule also imposes various enhanced disclosure obligations, as discussed below.

### A. Net Investment Methodology

The amendments to Rule 2340(c)(1)(A) require "net investment" to be based on the ''amount available for investment'' percentage in the "Estimated Use of Proceeds'' section of the offering prospectus. Where ''amount available for investment'' is not provided, the amended rule requires ''net investment'' to be based on another equivalent disclosure that reflects the estimated percentage deduction from the aggregate dollar amount of securities registered for sale to the public of sales commissions, dealer manager fees and estimated issuer offering and organization expenses. In addition, the amended rule clarifies that when an issuer provides a range of amounts available for investment, a member may use the maximum offering percentage unless the member has reason to believe that such percentage is unreliable. If the member has reason to believe that it is unreliable, the member must use the minimum offering percentage. The rule permits the net investment value to be used until 150 days following the second anniversary of breaking escrow in the public offering.

### B. Appraised Value Methodology

The appraised value methodology, which can be used at any time, consists of the appraised valuation disclosed in the issuer's most recent periodic or current report filed with the SEC. As amended, Rule 2340(c)(1)(B) requires that the per share estimated value disclosed in an issuer's most recent periodic or current report be based on valuations of the assets and liabilities of the DPP or REIT, and that those valuations be:

- performed at least annually;
- conducted by, or with the material assistance or confirmation of, a third-party valuation expert or service; and
- derived from a methodology that conforms to standard industry practice.

Where a DPP is subject to the Investment Company Act of 1940 (1940 Act) (e.g., business development companies), instead of a valuation that meets the appraisal requirements listed immediately above, the rule requires that the appraised value must be consistent with the valuation requirements of the 1940 Act and the rules thereunder.

### C. Disclosures

New Rule 2340(c)(2)(A) requires members that use the "net investment" methodology to provide, if applicable, enhanced disclosure relating to the return of investors' capital (often referred to as "over distributions") in order to address potential misunderstanding by customers when their capital is returned to them through a distribution that otherwise could appear to represent earnings on their investment. Rule 2340(c)(2)(A) requires an account statement that provides a "net investment" per share estimated value for a DPP or REIT security to disclose, if applicable, prominently and in proximity to disclosure of distributions and the per share estimated value the following statements: "IMPORTANT – Part of your distribution includes a return of capital. Any distribution that represents a return of capital reduces the estimated per share value shown on your account statement."

The disclosure under new Rule 2340(c)(2)(A) applies only to an account statement that provides a "net investment" per share estimated value where part of the distribution includes a return of capital. Thus, for example, this requirement does not apply to an account statement that provides an "appraised value" for the per share estimated value, which already would reflect returns of capital.

However, the disclosures under new Rule 2340(c)(2)(B) are required for all account statements that provide a per share estimated value for a DPP or REIT security. Pursuant to this new provision, a member must disclose that the DPP or REIT securities are not listed on a securities exchange, are generally illiquid and that, even if a customer is able to sell the securities, the price received may be less than the per share estimated value provided in the account statement.

### II. FINRA Rule 2310 (Direct Participation Programs)

FINRA Rule 2310(b)(5) generally provides that a member may not participate in a public offering of DPP or REIT securities unless specified disclosures about the value of such securities will be made by the general partner or sponsor of the DPP or REIT in each annual report distributed to investors pursuant to Section 13(a) of the Exchange Act. FINRA amended the requirements to correspond to the amendments to NASD Rule 2340(c). As amended, Rule 2310(b)(5) prohibits a member from participating in a public offering of the securities of a REIT or DPP unless the issuer of the DPP or REIT has agreed to disclose:

- a per share estimated value of the DPP or REIT security, developed in a manner reasonably designed to ensure it is reliable, in the DPP or REIT periodic reports filed pursuant to Section 13(a) or 15(d) of the Exchange Act;
- an explanation of the method by which the value was developed; and
- the date of the valuation.

In addition, amended Rule 2310(b)(5) prohibits a member from participating in a public offering of the securities of a REIT or DPP unless the issuer of the DPP or REIT has agreed to disclose, in a periodic or current report filed pursuant to Section 13(a) or 15(d) of the Exchange Act within 150 days following the second anniversary of breaking escrow and in each annual report thereafter, a per share estimated value:

- based on the valuations of the assets and liabilities of the DPP or REIT performed at least annually by, or with the material assistance or confirmation of, a third-party valuation expert or service;
- derived from a methodology that conforms to standard industry practice; and
- accompanied by a written opinion or report by the issuer, delivered at least annually, that explains the scope of the review, the valuation methodology used and the basis for the reported value.

The amendments to Rule 2310(b)(5) do not apply to DPPs that are subject to the 1940 Act as such DPPs are already required to determine and publish net asset value on a regular basis.

## Endnotes

1. *See* Securities Exchange Act Release No. 73339 (October 10, 2014), 79 FR 62489 (October 17, 2014) (Order Approving SR-FINRA-2014-006, as Modified by Amendment No. 1).

# *Client Account Statement Rule Changes:*

## *Rules 2340 and 2310*

## What does it all mean?

GRIFFIN CAPITAL
guardians of wealth

**Griffin Capital Corporation**

***Kevin Shields*** *| Chairman & CEO*

# Summary of Risk Factors

We are an "emerging growth company" under the federal securities laws and will be subject to reduced public company reporting requirements. Investing in our common stock involves a high degree of risk. You should purchase these securities only if you can afford a complete loss of your investment. See "Risk Factors" beginning on page 19 of our Prospectus for a discussion of certain factors that should be carefully considered by prospective investors before making an investment in the shares offered hereby. These risks include but are not limited to the following:

- No public market currently exists for our shares and we may not list our shares on a national exchange immediately after completion of this offering, if at all. It will be difficult to sell your shares. If you sell your shares, it will likely be at a substantial discount. Our charter does not require us to pursue a liquidity transaction at any time.
- We may pay distributions from sources other than our cash flows from operations, including net proceeds of this offering or from borrowings in anticipation of future cash flows, and it is likely that we will do so to fund a portion of our initial distributions. We are not prohibited from undertaking such activities by our charter, bylaws or investment policies, and we may use an unlimited amount from any source to pay our distributions.
- This is an initial public offering; we have no prior operating history, and the prior performance of real estate programs sponsored by affiliates of our sponsor may not be indicative of our future results.

# Summary of Risk Factors

- This is a "best efforts" offering. If we are unable to raise substantial funds in this offering, we may not be able to invest in a diverse portfolio of real estate and real estate-related investments, and the value of your investment may fluctuate more widely with the performance of specific investments.
- We are a "blind pool" because we have not identified any properties to acquire with the net proceeds from this offering. As a result, you will not be able to evaluate the economic merits of our future investments prior to their purchase. We may be unable to invest the net proceeds from this offering on acceptable terms to investors, or at all.
- There are substantial conflicts of interest among us and our sponsor, advisor, property manager and dealer manager.
- Our advisor will face conflicts of interest relating to the purchase of properties, including conflicts with Griffin Capital Essential Asset REIT, Inc., and such conflicts may not be resolved in our favor, which could adversely affect our investment opportunities.
- We have no employees and must depend on our advisor to select investments and conduct our operations, and there is no guarantee that our advisor will devote adequate time or resources to us.
- We will pay substantial fees and expenses to our advisor, its affiliates and participating broker-dealers, which will reduce cash available for investment and distribution.
- We may incur substantial debt, which could hinder our ability to pay distributions to our stockholders or could decrease the value of your investment
- We may fail to qualify as a REIT, which could adversely affect our operations and our ability to make distributions.

# FINRA RN 15-02: Proposed Account Statement Rule

Proposed changes to Rules 2340 and 2310

- Rule Relates to Per Share Estimated Valuation for Unlisted DPP and real estate investment trusts
- Progression: 11-44 to 12-14 to 14-06 to 15-02
- IPA submitted detailed response March 21, 2014
- FINRA submitted letter to SEC extending timeline on action to October 17, 2014
- SEC adopted SR-FINRA 2014-006 October 10, 2014
- FINRA RN 15-02: Effective Date Set at April 11, 2016

# FINRA RN 15-02: Proposed Account Statement Rule

*Existing Rule: FINRA 09-09 for DPP and PNLR*

- Must develop initial valuation no later than 18 months after close of offering
- Estimated valuation included on customer statements may be based on data up to 18 months old
- No disclosure required regarding impact of any distributions in excess of earnings
- Disclosures regarding valuation methodology limited in scope
- Account statement must include disclosures that securities are generally illiquid and estimated value may not be realized upon such liquidation

# FINRA RN 15-02: Proposed Account Statement Rule

FINRA RN 15-02 proposes:

1. ***Broker-dealers*** provide per share estimated value of security on customer account statements in a manner reasonably designed to provide a reliable value – using one of two methodologies that are presumptively reliable:

   I. Net Investment Methodology (NIM) or

   II. Appraised Value Methodology (AVM)

# FINRA RN 15-02: Proposed Account Statement Rule

## FINRA RN 15-02 proposes:

- NIM equals Gross Offering Price less sales commissions, dealer-manager fees and organizational and offering expenses (based upon maximum offering amount)
- AVM is based upon an appraisal of the assets and liabilities of the program by or with the *material assistance of a third party valuation expert* in conformance with standard industry practice

# FINRA RN 15-02: Proposed Account Statement Rule

## FINRA RN 15-02 proposes:

- AVM may be used any time during the offering period
- Disclosures:
  I. Prior to reporting pursuant to AVM, account statement must include disclosure 'part of distribution constitutes return of capital, which reduces estimated per share value shown on account statement'

  II. Regardless of valuation methodology used, must state 'DPP and PNLR are not listed on a national exchange, generally illiquid and price received may be less than per share estimated value'

# FINRA RN 15-02: Proposed Account Statement Rule

## FINRA RN 15-02 proposes:

2. Timing and Frequency
   - NIM applicable anytime before 150 days following second anniversary of breaking escrow
   - After adopting AVM, appraisals must be performed every year thereafter
3. BDCs: DPPs are exempt – subject to '40 Act regulation
4. Effective Date: no earlier than 18 months following SEC approval – ***April 11, 2016,*** provides sufficient time for:
   I. Industry education about proper interpretation
   II. Re-program IT systems for compliance
   III. Create investor education material and adapt existing

# FINRA RN 15-02: Proposed Account Statement Rule

***Non-Listed REIT Exemplar***

| | | |
|---|---|---|
| Equity Investment | | $1,000,000 |
| Sales Commission | 7.0% | 70,000 |
| Dealer-Manager Fee | 3.0% | 30,000 |
| Organizational and Offering Expenses | 1.0% | 10,000 |
| Total Offering Load | 11.0% | 110,000 |
| Net Investment (Account Stmt. Price) | 89.0% | $890,000 |
| | | |
| Leverage Ratio | 45.0% | 728,182 |
| Total Asset Purchase Price | | $1,618,182 |
| | | |
| Fees as a Percentage of Equity | | 11.0% |
| Fees as a Percentage of Asset Purchase Price | | 6.8% |

# FINRA RN 15-02: Proposed Account Statement Rule

***Home Purchase Example***

| | | |
|---|---|---|
| Equity Investment | | $1,000,000 |
| Leverage Ratio | 45.0% | 818,182 |
| Total Asset Purchase Price | | $1,818,182 |
| | | |
| Sales Commissions and Closing Costs | 7.0% | 127,273 |
| Net Sales Proceeds | | $1,690,909 |
| Less Leverage (Mortgage Debt) | | 818,182 |
| Net Cash Proceeds (Account Stmt. Price) | | $872,727 |
| | | |
| Fees as a Percentage of Equity | | 12.7% |
| Fees as a Percentage of Asset Purchase Price | | 7.0% |

# FINRA RN 15-02: Proposed Account Statement Rule

***Non-Listed REIT Exemplar***

| | |
|---|---|
| Fees as a Percentage of Equity | 11.0% |
| Fees as a Percentage of Asset Purchase Price | 6.8% |

***Home Purchase Example***

| | |
|---|---|
| Fees as a Percentage of Equity | 12.7% |
| Fees as a Percentage of Asset Purchase Price | 7.0% |

# FINRA RN 15-02: Proposed Account Statement Rule

***What Does it all Mean?***

Incumbent upon industry to educate investors that:

1. Adoption of 15-02 does not represent a change in fee structure, just how such fees are disclosed on the account statement
2. Value on the account statement does not represent market value of the security prior to issuing a net asset value
3. The presentation of the Net Investment Methodology is not materially different than if we reflected the purchase of our home net of fees and expenses
4. Industry will coalesce around a share class design to mitigate impact of 15-02.

# *Client Account Statement Rule Changes:*
## *Rules 2340 and 2310*
### What does it all mean?

## Griffin Capital Corporation
***Kevin Shields** | Chairman & CEO*

*This is an excerpt of a full report comparing the performance of non-traded REITs to publicly-traded REITs. The entire report is available through the link at the bottom of the page.*

# Heard on the Beach

## Devolution

**August 27, 2014**

Green Street Advisors

### Executive Summary


In the presence of a highly credible and successful publicly traded REIT industry, the ten-fold expansion in fund raising that the non-traded REIT (NTR) sector has enjoyed over the last fifteen years comes as a big surprise. Who knew investors needed a higher-cost, more conflict-laden, less-liquid vehicle?

The drawbacks of NTRs relative to their publicly traded cousins have long been obvious, but, until recently, it has been impossible to directly compare their performance. A flurry of liquidity events in the sector now affords the opportunity to gauge the round-trip total returns generated by 34 NTRs. Key findings:

- On average, NTRs lagged their publicly traded peers in the same property sector by 360 bps/year. Three-quarters of the NTRs failed to keep pace.
- NTRs focusing on sectors where listed REITs trade at very large premiums to NAV fared far better than most.

The second point provides a strategic roadmap for success for any NTR or, for that matter, any private real estate market participant. When real estate is priced dearly on Wall Street, it can make sense to instead buy it on Main Street.

Those opportunities are, however, few and far between, and the best advice for anyone trying to access the commercial property asset class is, as always, "Buy publicly traded REITs."


To download the full report, go to:

www.GreenStreetAdvisors.com/FeaturedResearch

**Important disclosure on page 2**



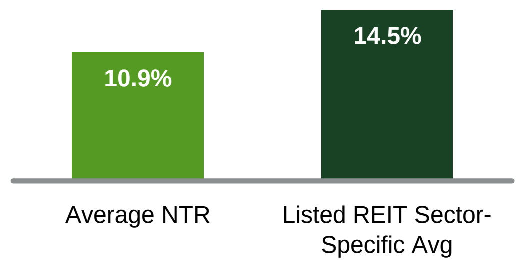
*This excerpt is from Green Street Advisors' Heard on the Beach Report, August 27, 2014.*

**Report Card:** Non-traded REITs (NTRs) that have undergone a liquidity event have, in aggregate, failed to deliver total returns on par with their publicly traded peers. The high up-front costs associated with NTRs are difficult to overcome.

**A Comprehensive Study**

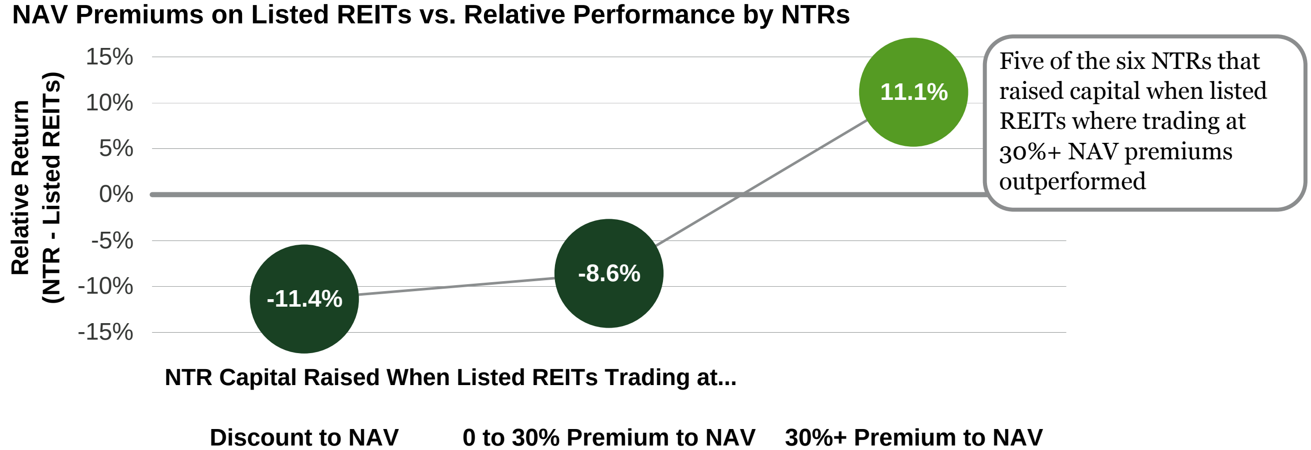
– 34 NTR's have experienced liquidity events
– Returns are estimated based on public filings
– These 34 NTRs raised $54 billion
– That's roughly half of the total capital raised by all NTRs
– Findings were shared with sponsors
– Comparisons vs Listed REITs are within same property type over same time span

**Annualized $-Weighted Returns**




**Keep an Eye on Public Premiums:** 75% (26 of 34) of the NTRs failed to deliver returns commensurate with those delivered by listed REITs in the same property sector. Most of the successful NTRs raised capital when listed REITs in the same property sector were trading at very large premiums.

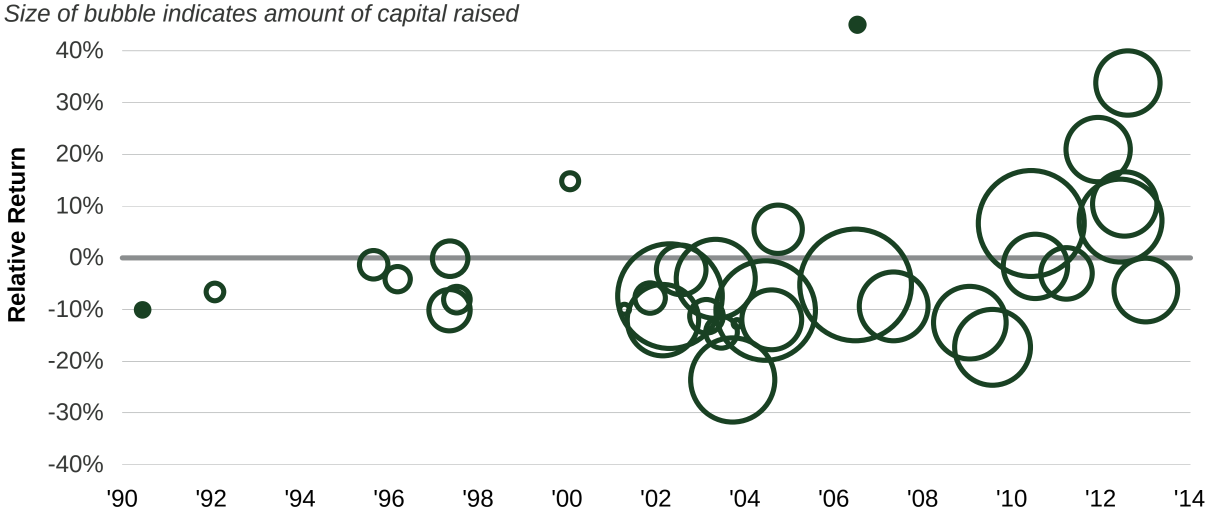
**NAV Premiums on Listed REITs vs. Relative Performance by NTRs**




**Getting Better:** Until recently, there had never been a large NTR that outperformed listed REITs. Recent performance by NTRs has been far more impressive, particularly those sponsored by American Realty Capital.

**Relative Returns (vs. Listed REITs) by Vintage and Deal Size**

*Size of bubble indicates amount of capital raised*



## Access the full report here:

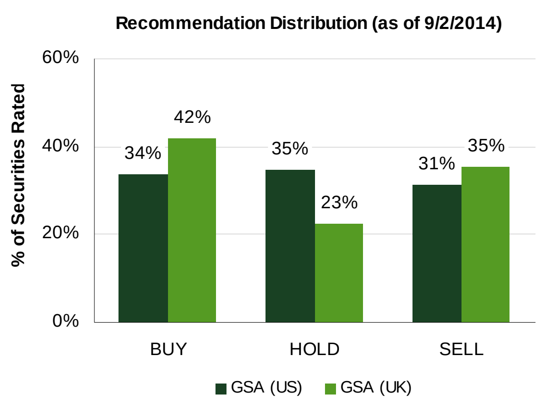
www.GreenStreetAdvisors.com/FeaturedResearch

### About Green Street Advisors, Inc.

Founded in 1985, Green Street Advisors is the preeminent independent research, trading, and consulting firm concentrating on Real Estate Investment Trusts (REITs), other publicly traded real estate securities, and the private commercial real estate markets in North America and Europe. Additional information on Green Street Advisors is available online at www.greenstreetadvisors.com

**Green Street's Disclosure Information**

At any given time, Green Street publishes roughly the same number of "BUY" recommendations that it does "SELL" recommendations.




Green Street's "BUYs" have historically achieved far higher total returns than its "HOLDs", which, in turn, have outperformed its "SELLs".

**Total Return of Green Street's Recommendations[1,2]**

| Year | Buy | Hold | Sell | Universe[3] |
|---|---|---|---|---|
| 2014 YTD | 25.4% | 21.4% | 15.6% | 20.8% |
| 2013 | 4.1% | 0.6% | 1.7% | 2.2% |
| 2012 | 24.5% | 24.7% | 18.9% | 23.0% |
| 2011 | 18.9% | 7.6% | -4.7% | 7.6% |
| 2010 | 43.3% | 32.8% | 26.6% | 33.8% |
| 2009 | 59.0% | 47.7% | 6.0% | 37.9% |
| 2008 | -28.1% | -30.9% | -52.6% | -37.3% |
| 2007 | -6.9% | -22.4% | -27.8% | -19.7% |
| 2006 | 45.8% | 29.6% | 19.5% | 31.6% |
| 2005 | 26.3% | 18.5% | -1.8% | 15.9% |
| 2004 | 42.8% | 28.7% | 16.4% | 29.4% |
| 2003 | 43.3% | 37.4% | 21.8% | 34.8% |
| 2002 | 17.3% | 2.8% | 2.6% | 5.4% |
| 2001 | 34.9% | 19.1% | 13.0% | 21.1% |
| 2000 | 53.4% | 28.9% | 5.9% | 29.6% |
| 1999 | 12.3% | -9.0% | -20.5% | -6.9% |
| 1998 | -1.6% | -15.1% | -15.5% | -12.1% |
| 1997 | 36.7% | 14.8% | 7.2% | 18.3% |
| 1996 | 47.6% | 30.7% | 18.9% | 32.1% |
| 1995 | 22.9% | 13.9% | 0.5% | 13.5% |
| 1994 | 20.8% | -0.8% | -8.7% | 3.1% |
| 1993 | 27.3% | 4.7% | 8.1% | 12.1% |
| **Cumulative Total Return** | **11260.1%** | **912.7%** | **6.2%** | **1021.3%** |
| **Annualized** | **24.5%** | **11.3%** | **0.3%** | **11.9%** |

The results shown above are hypothetical; they do not represent the actual trading of securities. Actual performance will vary from the hypothetical performance shown above due to, but not limited to 1) advisory fees and other expenses that one would pay; 2) transaction costs; 3) the inability to execute trades at the last published price (the hypothetical returns assume execution at the last closing price); 4) the inability to maintain an equally-weighted portfolio in size (the returns above assume an equal weighting); and 5) market and economic factors will almost certainly cause one to invest differently than projected by the model that simulated the above returns. All returns include the reinvestment of dividends. Past performance, particularly hypothetical performance, can not be used to predict future performance.

1. Results are for recommendations made by Green Street's North American Research Team only (includes securities in the US, Canada, and Australia). Uses recommendations given in Green Street's "Real Estate Securities Monthly" from January 28, 1993 through September 2, 2014. Historical results from January 28, 1993 through October 1, 2013 were independently verified by an international "Big 4" accounting firm. The accounting firm did not verify the stated results subsequent to October 1, 2013. As of October 1, 2013, the annualized total return of Green Street's recommendations since January 28, 1993 was: Buy +24.5%, Hold +10.9%, Sell -0.3%, Universe +11.5%.
2. Company inclusion in the calculation of total return has been based on whether the companies were listed in the primary exhibit of Green Street's "Real Estate Securities Monthly". Beginning April 28, 2000, Gaming C-Corps and Hotel C-Corps, with the exception of Starwood Hotels and Homestead Village, were no longer included in the primary exhibit and therefore no longer included in the calculation of total return. Beginning March 3, 2003, the remaining hotel companies were excluded.
3. All securities covered by Green Street with a published rating that were included in the calculation of total return. Excludes "not rated" securities.

*Per NASD rule 2711, "Buy" = Most attractively valued stocks. We recommend overweight position; "Hold" = Fairly valued stocks. We recommend market-weighting; "Sell" = Least attractively valued stocks. We recommend underweight position.*

*Green Street will furnish upon request available investment information regarding the recommendation*

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## DESCRIPTION OF SECURITIES

We are a corporation formed under the laws of the State of Maryland. Your rights as a stockholder are governed by Maryland law, our charter and our bylaws. The following summarizes the material terms of our common stock as described in our charter and bylaws which you should refer to for a full description. Copies of these documents are filed as exhibits to the registration statement of which this prospectus is a part. You also can obtain copies of these documents if you desire. See "Where You Can Find More Information" below.

### General Description of Shares

Our charter authorizes us to issue up to 400,000,000 shares of common stock and 50,000,000 shares of preferred stock, each share having a par value of $0.001. Of the total shares of common stock authorized, 320,000,000 are classified as Class A Shares and 80,000,000 are classified as Class T Shares.

Each share of Class A and Class T common stock is entitled to participate in distributions on its respective class of shares when and as authorized by the board of directors and declared by us and in the distribution of our assets upon liquidation. The per share amount of distributions on Class A and Class T Shares will differ because of different allocations of class-specific expenses. See "— Distribution Policy" below. Each share of common stock will be fully paid and non-assessable by us upon issuance and payment therefor. Shares of common stock are not subject to mandatory redemption. The shares of common stock have no preemptive rights (which are intended to insure that a stockholder has the right to maintain the same ownership interest on a percentage basis before and after the issuance of additional securities) or cumulative voting rights (which are intended to increase the ability of smaller groups of stockholders to elect directors). We have the authority to issue shares of any class or securities convertible into shares of any class or classes, to classify or to reclassify any unissued stock into other classes or series of stock by setting or changing the preferences, conversion or other rights, voting powers, restrictions, limitations as to distributions, qualifications and terms and conditions of redemption of the stock, all as determined by our board of directors. In addition, the board of directors, with the approval of a majority of the entire board and without any action by the stockholders, may amend our charter from time to time to increase or decrease the aggregate number of shares or the number of shares of any class or series that we have authority to issue. The issuance of any preferred stock must be approved by a majority of our independent directors who do not have an interest in the transaction and who have access, at our expense, to our counsel or independent legal counsel.

We will not issue stock certificates unless expressly authorized by our board. Shares will be held in "uncertificated" form, which will eliminate the physical handling and safekeeping responsibilities inherent in owning transferable stock certificates and eliminate the need to return a duly executed stock certificate to the transfer agent to effect a transfer. Transfers can be effected by mailing to DST a duly executed transfer form available upon request from DST or from our website at www.InlandResidentialTrust.com. Upon the issuance of our shares and upon the request of a stockholder, we will send to each such stockholder a written statement which will include all information that is required to be written upon stock certificates under Maryland law.

***Class A Shares***

We will pay our dealer manager selling commissions equal to 6.0% of the price per Class A Share sold, or $1.50 per Class A Share, with certain exceptions. Our dealer manager anticipates reallowing (paying) the full amount of the selling commissions to participating soliciting dealers as compensation for their services in soliciting and obtaining subscriptions. See “Plan of Distribution — Compensation We Pay For the Sale of Our Shares” for additional information. In addition, we will also pay a dealer manager fee of approximately $0.69 per Class A share, or 2.75% of the price per share sold. Certain purchasers of Class A Shares may be eligible for volume discounts. See “Plan of Distribution — Volume Discounts (Class A Shares Only)” for additional information.

There are no distribution and stockholder servicing fees charged with respect to the Class A Shares.

We may also sell our Class A Shares at a discount to the offering price of $25.00 per share through the following distribution channels in the event that the investor:

(1) purchases shares through fee-based programs, also known as wrap accounts;

(2) purchases shares through certain registered investment advisors;

(3) purchases shares through soliciting dealers and any of their respective directors, officers, employees or affiliates who request and are entitled to alternative fee arrangements with their clients; or

(4) purchases shares as a result of a volume discount.

Investors purchasing shares through one of the above distribution channels in our offering will pay $23.50 per Class A Share (other than shares purchased as a result of a volume discount), reflecting the absence of selling commissions. The net proceeds to us will not be affected by any such reduction in selling commissions.

Inland Securities or any of its or our directors, officers, employees or affiliates or any directors, officers and employees of its affiliates, or any family members of those individuals (including spouses, parents, grandparents, children and siblings), may purchase Class A Shares net of sales commissions and the dealer manager fee for $22.81 per Class A Share.

***Class T Shares***

We will pay our dealer manager selling commissions equal to 2.0% of the price per Class T Share sold, or approximately $0.48 per Class T Share. In addition, we will also pay a dealer manager fee of approximately $0.66 per share, or 2.75% of the price per share sold.

We will also pay the dealer manager a distribution and stockholder servicing fee of 1.0% per annum of the purchase price per share (or, once reported, the amount of our estimated value per share) for Class T Shares sold in the primary offering. The distribution and stockholder servicing fee will accrue daily and be paid monthly in arrears. The dealer manager may reallow the distribution and stockholder servicing fee to the soliciting dealer who sold the Class T Shares or, if applicable, to a subsequent broker-dealer of record of the Class T Shares so long as the subsequent broker-dealer is party to a soliciting dealer agreement, or servicing agreement, with the dealer manager that provides for such reallowance. The distribution and stockholder servicing fees are ongoing fees that are not paid at the time of purchase. See "Plan of Distribution — Compensation We Pay for the Sale of Our Shares — Distribution and Stockholder Servicing Fee (Class T Shares Only)."

The per share amount of distributions on Class A and Class T Shares will differ because of the distribution and stockholder servicing fee that we pay on the Class T Shares. The distribution and stockholder servicing fee will be paid on each Class T Share that is purchased in the primary offering. We will cease paying the distribution and stockholder servicing fee with respect to any particular Class T Share and that Class T Share will convert into a Class A Share by multiplying each Class T Share to be converted by the "Conversion Rate" described herein on the earlier of (i) a listing of the Class A Shares on a national securities exchange; (ii) a merger or consolidation of the Company with or into another entity, or the sale or other disposition of all or substantially all of the Company's assets; (iii) the end of the month in which the Dealer Manager determines that total underwriting compensation paid in the primary offering plus the distribution and stockholder servicing fee paid on all Class T Shares sold in the primary offering is equal to 10% of the gross proceeds of the primary offering from the sale of both Class A Shares and Class T Shares; and (iv) the end of the month in which the underwriting compensation paid in the primary offering plus the distribution and stockholder servicing fee paid with respect to that Class T Share equals 10% of the gross offering price of that Class T Share. In the case of a Class T Share purchased in the primary offering at a price equal to $23.95, the maximum distribution and stockholder servicing fee that may be paid on that Class T Share will be equal to approximately $1.26 per share. Although we cannot predict the length of time over which this fee will be paid due to potential changes in the estimated value of our Class T Shares, this fee would be paid over approximately 5.25 years from the date of purchase, assuming a constant estimated value of $23.95 per Class T Share. The Conversion Rate will be equal to the quotient, the numerator of which is the estimated value per Class T Share (including any reduction for distribution and stockholder servicing fees as described herein) and the denominator of which is the estimated value per Class A Share. See "ERISA Considerations — Annual Valuation Requirement." Persons wishing to purchase Class T Shares at multiple times during the primary offering must open a separate account for each purchase . We will further cease paying the distribution and stockholder servicing fee on any Class T Share that is redeemed or repurchased, as well as upon the Company's dissolution, liquidation or the winding up of the Company's affairs, or a merger or other extraordinary transaction in which the Company is a party and in which the Class T Shares as a class are exchanged for cash or other securities. If $1 billion in shares (consisting of $800 million in Class A Shares, at $25.00 per share, and $200 million in Class T Shares, at $23.95 per share) are sold in the primary offering, then the maximum amount of distribution and stockholder servicing fees payable is estimated to be up to $10.5 million, before the 10% limit on Class T Shares is reached. These estimates will change if the actual allocation of Class A and Class T Shares differs from our estimate. The aggregate amount of underwriting compensation for the Class A Shares and Class T Shares, including the distribution and stockholder servicing fee for the Class T Shares, will not exceed FINRA's 10% cap on underwriting compensation.

***Voting Rights.*** The Class A and Class T Shares will vote together as a single class, and, subject to the restrictions on transfer and ownership of stock set forth in our charter and except as may otherwise be specified in our charter, each share is entitled to one vote on each matter submitted to a vote at a meeting of our stockholders. Generally, all matters to be voted on by stockholders at a meeting of stockholders duly called and at which a quorum is present must be approved by a majority of the votes cast by the holders of all shares of common stock present in person or represented by proxy, voting together as a single class, subject to any voting rights granted to holders of any preferred stock, although the affirmative vote of a majority of shares present in person or by proxy at a meeting at which a quorum is present is necessary to elect each director.

**Rights Upon Liquidation**

If we liquidate (voluntarily or otherwise), dissolve or wind up, immediately before such liquidation, dissolution or winding up, our Class T Shares will automatically convert to Class A Shares at the Conversion Rate, and our net assets, or the proceeds therefrom, will be distributed to the holders of Class A Shares, which will include all converted Class T Shares, in accordance with their proportionate interests.

**Q: Why are you offering two classes of common stock and what are the similarities and differences between the classes?**

A: We are offering two classes of our common stock in order to provide investors with more flexibility in making their investment in us. Investors can choose to purchase shares of either class of common stock in the offering. Each share of our common stock, regardless of class, will be entitled to one vote per share on matters presented to the common stockholders for approval. The differences between each class relate to the stockholder fees and selling commissions payable in respect of each class. The following summarizes the differences in fees and selling commissions between the classes of our common stock.

***Class A Shares***

- Subject to the 10% limit on underwriting compensation, Class A Shares have a higher front-end selling commission, which is a one-time fee charged at the time of purchase of the shares, than charged on the Class T Shares. There are ways to reduce these charges. See “Plan of Distribution — Volume Discounts (Class A Shares Only)” for additional information.

- No annual distribution or stockholder servicing fees.

***Class T Shares***

- Subject to the 10% limit on underwriting compensation, Class T Shares have a lower front-end selling commission than Class A Shares.

- The Company pays, subject to, among other things, the 10% limit on underwriting compensation, distribution and stockholder servicing fees in an annual amount equal to 1.0% of the purchase price per Class T Share sold in the primary offering (or, once reported, the amount of our estimated value per share), payable on a monthly basis. This fee is not charged on Class A Shares and, all things equal, will result in the per share distributions on the Class T Shares being less than the per share distributions on the Class A Shares. There is no assurance we will pay distributions in any particular amount, if at all.

The distribution and stockholder servicing fee will be paid on each Class T Share that is purchased in the primary offering. We will cease paying the distribution and stockholder servicing fee with respect to any particular Class T Share and that Class T Share will convert into a Class A Share by multiplying each Class T Share to be converted by the “Conversion Rate” described herein on the earlier of (i) a listing of the Class A Shares on a national securities exchange; (ii) a merger or consolidation of the Company with or into another entity, or the sale or other disposition of all or substantially all of the Company’s assets; (iii) the end of the month in which the Dealer Manager’s determines that total underwriting compensation paid in the primary offering plus the distribution and stockholder servicing fee paid on all Class T Shares sold in the primary offering is equal to 10% of the gross proceeds of the primary offering from the sale of both Class A Shares and Class T Shares; and (iv) the end of the month in which the underwriting compensation paid in the primary offering plus the distribution and stockholder servicing fee paid with respect to that Class T Share equals 10% of the gross offering price of that Class T Share. In the case of a Class T Share purchased in the primary offering at a price equal to $23.95, the maximum distribution and stockholder servicing fee that may be paid on that Class T Share will be equal to approximately $1.26 per share. Although we cannot predict the length of time over which this fee will be paid due to potential changes in the estimated value of our Class T Shares, this fee would be paid over approximately 5.25 years from the date of purchase, assuming a constant estimated value of $23.95 per Class T Share. The Conversion Rate will be equal to the quotient, the numerator of which is the estimated value per Class T Share (including any reduction for distribution and stockholder servicing fees as described herein) and the denominator of which is the estimated value per Class A Share. See “ERISA Considerations — Annual Valuation Requirement.” Persons wishing to purchase Class T Shares at multiple times during the primary offering must open a separate account for each purchase. See “Description of Securities — General Description of Shares — Class T Shares” for further details. In addition to the above circumstances, we will further cease paying the distribution and stockholder servicing fee on any Class T Share that is redeemed or repurchased or upon the Company’s liquidation, dissolution or winding up.

If we liquidate (voluntarily or otherwise), dissolve or wind up our affairs, then, immediately before such liquidation, dissolution or winding up, our Class T Shares will automatically convert to Class A Shares at the Conversion Rate and our net assets, or the proceeds therefrom, will be distributed to the holders of Class A Shares, which will include all converted Class T Shares, in accordance with their proportionate interests.

The per share amount of distributions on Class A Shares and Class T Shares will differ because of the distribution and stockholder servicing fee. If the distribution and stockholder servicing fee paid by the Company exceeds the amount distributed to holders of Class T Shares in a particular period, the estimated value per Class T Share would be permanently reduced by an amount equal to the Excess Fee for the applicable period divided by the number of Class T Shares outstanding at the end of the applicable period, reducing both the estimated value of the Class T Shares used for conversion purposes and the Conversion Rate described herein.

Inland Securities or any of its or our directors, officers, employees or affiliates or any directors, officers and employees of its affiliates, or any family members of those individuals (including spouses, parents, grandparents, children and siblings), may purchase Class A Shares net of sales commissions and the dealer manager fee for $22.81 per Class A Share.

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October 24, 2013

**Maryland Trial Court Upholds Maryland's Narrow Futility Demand Exception and Special Committee's Approval of Acquisition of REIT's External Manager**

In an opinion issued yesterday, Judge Althea Handy of the Maryland Business and Technology Case Management Program in the Circuit Court for Baltimore City dismissed, with prejudice, the Amended Complaint in a suit challenging the acquisition by Cole Real Estate Investments, Inc., a Maryland corporation (formerly known as Cole Credit Property Trust III, Inc.) ("CREI"), of its external manager, Cole Holdings Corporation, an Arizona corporation, for stock of CREI and $20 million in cash. The transaction was reviewed and approved by a Special Committee of the Board of Directors of CREI, composed of the three independent directors. The Special Committee also reviewed and rejected two subsequent acquisition proposals by American Realty Capital Properties, Inc., a Maryland corporation ("ARCP"). (ARCP and CREI yesterday announced an acquisition by ARCP of CREI.)

The plaintiff stockholders filed a putative class action, alleging breach of fiduciary duties, aiding and abetting, unjust enrichment, waste and breach of the duty of candor and seeking an injunction of the stockholder vote on certain charter amendments and damages.

Plaintiffs argued that their allegations constituted direct claims for damages to the stockholders arising from (a) the issuance of the new shares in the transaction and (b) insufficient due diligence before rejecting ARCP's offers. Judge Handy disagreed, holding their claims were derivative in nature because there were no allegations of any separate harm to plaintiffs apart from any harm to CREI. The Court then held that plaintiffs were required to make demand on the Board, subject to Maryland's narrow futility exception, set forth in the decision of the Court of Appeals of Maryland (our highest state court) in *Werbowsky v. Collomb* in 2001. This narrow exception applies only where (a) demand or a delay in waiting for a response to a demand would cause "irreparable harm to the corporation" or (b) a majority of the board is "so personally conflicted and committed to" the transaction "that they could not be expected to respond to a demand in good faith and within the ambit of the business judgment rule." To succeed in the conflict exception, according to the Court of Appeals, plaintiffs must identify "clearly" and in "a very particular manner" the disqualifying conflicts of a majority of the board.

Judge Handy recognized the sufficiency of plaintiffs' allegations that the two management directors "were personally and directly conflicted in terms of the Merger" and that a demand made on them "would have been futile." However, with respect to the three members of the Special Committee, the Court held that allegations that they would continue to serve as directors and "earn hundreds of thousands of dollars in [director] fees" were "insufficient" to invoke the futility exception under the *Werbowsky* case. Indeed, the Court of Appeals in *Werbowsky* specifically rejected continued service and compensation as a director as a ground for demand futility. Judge Handy noted that plaintiffs alleged no other conflict as to the three Committee members and thus demand was required.

Having rejected plaintiffs' arguments for the futility exception, Judge Handy nevertheless went on "to address Defendants' alleged breaches of their fiduciary duties in light of the business judgment rule." Starting from the three-part statutory standard of conduct for directors in Section 2-405.1(a) of the Maryland General Corporation Law (which expressly applies to actions of members of a board committee) and quoting from the Supreme Court of Delaware in *Barkan v. Amsted Indus., Inc.*, that "there is no single blueprint that a board must follow to fulfill its duties," the Court noted that plaintiffs had failed to plead the "particularized facts" necessary to overcome the presumption in favor of the actions of the members of the Special Committee.

Judge Handy dismissed the Amended Complaint with prejudice because she had already allowed plaintiffs to amend once and the problems she identified, especially on the demand futility issue, should have been corrected, if plaintiffs had any facts to address those issues, in the Amended Complaint.

Although the Court held that "dismissal of Plaintiffs' entire Consolidated Complaint [was] proper" for the reasons stated above, she specifically included in her dismissal a rejection of plaintiffs' "duty of candor" claim because the duty of candor has been "rigidly" limited by the Court of Appeals to "cash-out mergers" and also because plaintiffs had failed to plead direct claims against defendants for the reasons stated above.

Judge Handy's decision is another recognition by the judges of the Maryland Business and Technology Case Management Program that the actions of directors, particularly independent directors, of Maryland corporations will continue to receive broad judicial deference.

* * * *

As always, please feel free to call any of us or any of our colleagues at any time for any questions concerning Maryland law.

Jim Hanks
Sharon Kroupa
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April 9, 2014

**Board Classification in Maryland: Evaluating Section 3-803 of the MGCL**

Since 1999, Section 3-803 of the Maryland General Corporation Law (the "MGCL") has permitted the board of directors of a Maryland corporation or the board of trustees of a Maryland real estate investment trust with a class of equity securities registered under the Securities Exchange Act of 1934 and at least three independent directors or trustees to elect to classify itself notwithstanding any contrary provision in the charter, declaration of trust or bylaws and without a stockholder vote. This statute, adopted by the Maryland legislature specifically to address the abuses of hostile takeovers, has recently received negative commentary from governance scorekeepers and activists. Green Street Advisors has urged boards to opt out of Section 3-803, REIT Zone Publications has issued several missives similarly attacking Section 3-803 and a union group, focused on the hotel industry, has sent stockholder proposals seeking an opt-out from this provision of Maryland law.

As is regrettably common with corporate governance scorekeepers and activists, they take an unbending one-size-fits-all position. On this issue, they declare with utter certainty that it is never appropriate for the board of any Maryland corporation or REIT to classify itself without stockholder approval under any circumstance now or in the future. Recently, they have asserted that, as is permitted by the MGCL, the boards of all Maryland companies should opt out of the provisions of Section 3-803 and condition any future opt-in on a stockholder vote. This approach ignores the fact that the directors, who are statutorily required to act in the best interests of the company, have the most information about the company and are, therefore, in the best position to evaluate the governance of the company.

Classified boards have been a common feature of corporate governance for nearly 100 years. At the most, they defer a change of control of the board for a year. We continue to believe that a classified board serves important and legitimate corporate governance objectives, including (a) providing a modest measure of continuity and stability in business strategies, operations and management; (b) enabling the board to focus on long-term value maximization strategies rather than short-term stock price movements; and (c) protecting the company from coercive takeovers by encouraging would-be acquirers to negotiate with the board, as the stockholders' elected representatives. In addition, a board's power under Section 3-803 to classify itself provides a valuable tool to promptly and effectively respond to a hostile attack that is not in the best interests of stockholders, which would likely not be possible if it were necessary to obtain stockholder approval in advance. Let's be clear: A classified board will not stop a fully-financed premium bid for a company, but it will prevent a sudden shift of the board into the hands of people seeking a low-ball sale of the company or other transaction not necessarily in the best interests of the company or all the stockholders.

Unlike the governance scorekeepers and activists, we do not take a hard and fast, arbitrary position with no exceptions or acknowledgement of differing situations. We recognize that a classified board and the board's power to classify itself may not be right for all companies at all times and under all circumstances. We also recognize that there are arguments in favor of a declassified board or opting out of Section 3-803, including that a declassified board enables stockholders to register their views annually on the performance of the entire board and each director and that declassifying or opting out of Section 3-803 would be popular with many institutional investors and corporate governance critics. We think these arguments should be weighed by a board together with the benefits of classification in various circumstances, and we are especially concerned about a board effectively renouncing for all future boards of the company the availability of a protection against hostile takeovers.

We have advised many boards on opting into Section 3-803 and on considering whether to retain the power to classify itself. In addition, we have recently received questions from clients and others on Section 3-803. In general, we recommend that a board:

- Receive legal, financial and other relevant advice (including empirical data) on the advantages and disadvantages, for the company, of a classified board and Section 3-803;

- Analyze the company's existing and desired governance profile, considering its overall takeover risk profile and available defenses;

- Evaluate options in between remaining subject to Section 3-803 and opting out of it entirely (*e.g.*, providing that any opt-in to Section 3-803 be submitted for stockholder approval within twelve months); and

- Discuss the board's position on these issues with and solicit the views of the company's major stockholders.

Electing to opt out of Section 3-803 is a significant and likely permanent loss to a company's defenses against hostile takeovers and we recommend that a board carefully evaluate the facts as they relate to the particular company.

* * * *

As always, please do not hesitate to call any of us if you have any questions or comments about any of the foregoing or any other matter of Maryland law.

| | | | |
|---|---|---|---|
| Jim Hanks | Sharon Kroupa | Patsy McGowan | Michael Leber |
| Mike Schiffer | Chris Pate | Carmen Fonda | Jeff Keehn |
| Brian Field | Hirsh Ament | Michael Sheehan | Nick Collevecchio |
| Gabe Steele | Dan Mendelsohn | Gueter Aurelien | |

*This memorandum is not intended to provide legal advice or opinion. Such advice may only be given when related to specific fact situations for which Venable LLP has accepted an engagement as counsel.*

# NASDAQ LISTING AND TENDER OFFER

# CLOSING CHECKLIST

| DOCUMENT OR ACTION |
| --- |
| **NASDAQ Listing** |
| 1. HCT Listing Application |
| a. Reserve ticker symbol |
| b. Obtain CIK number |
| c. Obtain CUSIP number |
| 2. Certification re: Corporate Governance Documents |
| a. Copy of Amended and Restated Audit Committee Charter |
| b. Copy of Nominating & Corporate Governance Committee Charter |
| c. Copy of Compensation Committee Charter |
| d. Copy of Amended and Restated Code of Ethics |
| e. Copy of Corporate Governance Guidelines |
| 3. Pay Application Fee |
| 4. Pay Registration Fee |
| 5. Listing Agreement |
| 6. Written confirmation from Transfer Agent that the security to be listed is or will be eligible for a Direct Registration Program |
| 7. File Form 8-A |
| 8. Request that NASDAQ file its Form 8-A certification with the SEC |
| 9. Notice of Issuance from NASDAQ |
| 10. Respond to comments from NASDAQ |
| 11. Amended and Restated Bylaws |
| 12. 2014 Outperformance Award Agreement |

| DOCUMENT OR ACTION | |
|---|---|
| 13. | Subordinated Incentive Listing Fee Note |
| 14. | Amendment to Restricted Share Plan |
| 15. | Amended and Restated Advisory Agreement |
| 16. | Amended and Restated OP Agreement |
| 17. | Notice to stockholders re: amendment and suspension of DRIP and termination of share repurchase program |
| 18. | Memo re: trading restrictions / temporary blackouts for directors and officers, employees and respective families |
| 19. | Confirm that D&O insurance will continue to provide sufficient coverage after listing |
| 20. | EDGAR codes for Section 16 filers |
| 21. | Form 3s and 4s for Section 16 filers |
| 22. | Confirm Transfer Agent process complete |
| 23. | Revise website terms and conditions and privacy policy |
| 24. | Board resolutions (listing, tender offer, etc.) |
| 25. | Board resolutions (amendments to credit agreement, OP agreement, etc.) |
| 26. | Form 8-K re: amended agreements and bylaws |
| **Tender Offer** | |
| 1. | Schedule TO and Offer to purchase |
| 2. | Letter of Transmittal |
| 3. | Notice of guaranteed delivery |
| 4. | Form of letter to stockholders |
| 5. | Form of letter to brokers, dealers, commercial banks, trust companies and other nominees |

| DOCUMENT OR ACTION |
| --- |
| 6. Form of letter to clients (including instructions and forms) |
| 7. Form of notice of withdrawal for registered stockholders |
| 8. Form of notice of withdrawal for DTC participants |
| 9. Form of WSJ/NYT advertisement |
| 10. Amendment to Credit Agreement |
| 11. Subordination and Standstill Agreement |
| 12. Press release announcing preliminary results of tender offer and Form 8-K |
| 13. Press release announcing final results of tender offer and Form 8-K |
| 14. Establish satisfaction or waiver of any funding conditions |
| 15. Press release announcing satisfaction or waiver of funding conditions |
| 16. [Form of letter to Stockholders /Custodians for stockholders expressing an interest in other ARC alternative investment products] |
| 17. Settlement of Tendered Shares |
| 18. “Sweep up” of fractional shares |
| **Shelf Registration Statement** |
| 1. File Form S-3ASR |
| 2. Legal opinion re legality of securities |
| 3. Legal opinion re tax matters |
| 4. Consent of independent accounting firm |
| 5. Form of “open-ended” indenture |
| 6. Ratio of earnings to fixed charges exhibit 12.1 |

Congress of the United States
Washington, DC 20515

January 13, 2014

The Honorable Thomas Perez
Secretary
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

Dear Secretary Perez:

We would like to congratulate you on your new position as Secretary of Labor. As members of the New Democrat Coalition, we look forward to working with you on the important challenges and opportunities facing our country.

The New Democrat Coalition played a major role with respect to the Dodd-Frank Wall Street Reform and Consumer Protection Act in advocating for a regulatory approach that would reduce systemic risk and increase transparency and certainty in our markets. With respect to fiduciary standards, a key objective of the Dodd-Frank Act was to protect investors while reducing confusion. That should be an important consideration in the Department's coordination with other regulators.

In this regard, Members of the New Democrat Coalition had written Secretary Solis in 2011 with concerns about the Department's proposal to redefine the term "fiduciary" for purposes of the Employee Retirement Income Security Act of 1974 and for purposes of certain Internal Revenue Code provisions affecting Individual Retirement Accounts and similar arrangements. We were very pleased that Secretary Solis agreed with our recommendation that the rule as initially proposed needed to be withdrawn, so that further work could be done on the issue.

As you consider a re-proposal of this regulation, we write to express our strong interest in establishing a dialogue with you, particularly with respect to our two core concerns regarding the fiduciary definition.

First, we continue to believe that any new definition should not limit access to investment education and information. We certainly want to protect plan participants, IRA owners, and plan sponsors from unfair and deceptive practices. But this should be done in a way that does not restrict access to critical investment assistance. While the original rule would have had little effect on wealthy investors or large businesses, it inadvertently could have significantly restricted the availability of investment help to low- and middle-income individuals and small businesses. Additionally, the original rule could have created problems under existing prohibited transaction rules and limited access plan participant's access to investment advice even when it was in their best interest. We ask you to work with us to ensure that any re-proposal does not have similar effects.

Second, we strongly believe that there needs to be coordination with other regulators to ensure that all regulatory efforts with respect to fiduciary standards work together in a way that serves retirement savers effectively.

We were heartened by your commitment in your confirmation hearing to work with the Hill on this critical project. Given our history with respect to the Dodd-Frank Act and the fiduciary issue, we would very much like to establish a dialogue with you on the fiduciary project. As you consider the future path of any proposal, and before you send any proposal to the Office of Management and Budget, we respectfully request the opportunity to have a dialogue on how to best protect low and middle-income individuals and small businesses, while ensuring access to investment education, information, and affordable investment products and services.

Sincerely,

Rush Holt

RUSH HOLT
Member of Congress

Carolyn McCarthy

Carolyn McCarthy
Member of Congress

Ron Kind

Ron Kind
Member of Congress

Patrick Murphy

Patrick Murphy
Member of Congress

Ann McLane Kuster

Ann M. Kuster
Member of Congress

Terri Sewell

Terri A. Sewell
Member of Congress

Joe Garcia

Joe Garcia
Member of Congress

Mike McIntyre

Mike McIntyre
Member of Congress

James A. Himes
Member of Congress

Cedric L. Richmond
Member of Congress

Loretta Sanchez
Member of Congress

Ron Barber
Member of Congress

Kurt Schrader
Member of Congress

Daniel B. Maffei
Member of Congress

Gerald E. Connolly
Member of Congress

Pedro R. Pierluisi
Member of Congress

John Barrow
Member of Congress

William L. Owens
Member of Congress

Bradley S. Schneider
Member of Congress

Juan Vargas
Member of Congress

Bill Foster
Member of Congress

Gregory W. Meeks
Member of Congress

David Scott
Member of Congress

Elizabeth H. Esty
Member of Congress

Adam B. Schiff
Member of Congress

Sean Patrick Maloney
Member of Congress

John K. Delaney
Member of Congress

Scott H. Peters
Member of Congress

John C. Carney, Jr.
Member of Congress

Joe Courtney
Member of Congress

# NYSE Listing and Tender Offer

## Closing Checklist

| DOCUMENT OR ACTION |
| --- |
| **NYSE Listing** |
| 1. NYSE Listing Application |
| a. Reserve ticker symbol |
| b. Obtain CIK number |
| c. Obtain CUSIP number |
| 2. Certification re: Corporate Governance Documents |
| a. Copy of Audit Committee Charter |
| b. Copy of Nominating & Corporate Governance Committee Charter |
| c. Copy of Compensation Committee Charter |
| d. Copy of Amended and Restated Code of Business Conduct and Ethics |
| e. Copy of Corporate Governance Guidelines |
| 3. Pay Application Fee |
| 4. Pay Registration Fee |
| 5. Listing Agreement |
| 6. Written confirmation from Transfer Agent that the security to be listed is eligible for a Direct Registration Program |
| 7. File Form 8-A |
| 8. Request that NYSE file its Form 8-A certification with the SEC |
| 9. Interview market makers |
| 10. Notice of Issuance from NYSE |
| 11. Respond to comments from NYSE |
| 12. Amended and Restated Bylaws |

| DOCUMENT OR ACTION | |
|---|---|
| 13. | Articles of Amendment re: Name Change |
| 14. | Second Amended and Restated Charter |
| 15. | 2014 Outperformance Award Agreement |
| 16. | Subordinated Incentive Listing Fee Note |
| 17. | Amendment to Restricted Share Program |
| 18. | Sixth Amended and Restated Advisory Agreement |
| 19. | Fourth Amended and Restated OP Agreement |
| 20. | Notice to stockholders re: amendment and suspension of DRIP and termination of share repurchase program |
| 21. | Memo re: trading restrictions / temporary blackouts for directors and officers, employees and respective families |
| 22. | Confirm that D&O insurance will continue to provide sufficient coverage after listing |
| 23. | EDGAR codes for Section 16 filers |
| 24. | Form 3s and 4s for Section 16 filers |
| 25. | Confirm Transfer Agent process complete |
| 26. | Revise website terms and conditions and privacy policy |
| 27. | Board resolutions (listing, tender offer, etc.) |
| 28. | Board resolutions (amendments to credit agreement, OP agreement, etc.) |
| 29. | Form 8-K re: name change and FAQs |
| 30. | Form 8-K re: amended agreements and bylaws |
| 31. | Press release re Listing on NYSE |
| 32. | Press release re commencement of tender offer |

| DOCUMENT OR ACTION |
| --- |
| 33. Press release re television appearances |
| 34. Contribution and Exchange Agreement |
| **Tender Offer** |
| 1. Schedule TO and Offer to purchase |
| 2. Letter of Transmittal |
| 3. Notice of guaranteed delivery |
| 4. Form of letter to stockholders |
| 5. Form of letter to brokers, dealers, commercial banks, trust companies and other nominees |
| 6. Form of letter to clients (including instructions and forms) |
| 7. Form of notice of withdrawal for registered stockholders |
| 8. Form of notice of withdrawal for DTC participants |
| 9. Form of WSJ/NYT advertisement |
| 10. Credit Agreement |
| 11. Press release announcing preliminary results of tender offer and Form 8-K |
| 12. Press release announcing final results of tender offer and Form 8-K |
| 13. Establish satisfaction or waiver of any funding conditions |
| 14. Press release announcing satisfaction or waiver of funding conditions |
| 15. [Form of letter to Stockholders /Custodians for stockholders expressing an interest in other ARC alternative investment products] |
| 16. Settlement of Tendered Shares |
| 17. “Sweep up” of fractional shares |
| **Shelf Registration Statement** |

| DOCUMENT OR ACTION | |
|---|---|
| 1. | File Form S-3ASR |
| 2. | Legal opinion re legality of securities |
| 3. | Legal opinion re tax matters |
| 4. | Consent of independent accounting firm |
| 5. | Form of “open-ended” indenture |
| 6. | Ratio of earnings to fixed charges exhibit 12.1 |

# RECENT NON-TRADED REIT LIQUIDITY EVENTS

| NON-TRADED REIT | LIQUIDITY EVENT | LIQUIDITY TYPE | DATE OF LIQUIDITY EVENT | AMEND & RESTATE CHARTER BEFORE LISTING? |
|---|---|---|---|---|
| Cole Corp. Income Trust | Merged with SIR | | Jan-15 | |
| Griffin Am Healthcare II | Merged with NorthStar | | Dec-14 | |
| Monogram Residential | Listed on NYSE | Mod. Dut. Auction TO | Nov-14 | No (Amended Dec-14) |
| Inland Diversified | Merged with Kite Realty | | Jul-14 | |
| New York REIT | Listed on NYSE | Tender Offer | Apr-14 | No (Amended June-14) |
| ARC Healthcare | Listed on NASDAQ | Tender Offer | Apr-14 | No (Springing charter effective on listing) |
| Bluerock Residential | Listed on NYSE | Phased-In Liquidity & TO | Mar-14 | Yes |
| CPA 16 | Merged with WP Carey | | Jan-14 | |
| ARCT IV | Merged with ARCP | | Jan-14 | |
| Columbia Prop Trust | Listed on NYSE | Mod. Dut. Auction TO | Oct-13 | Yes |
| Retail Prop America | Listed on NYSE | Phased-In Liquidity | Oct-13 | Yes |
| Cole Credit Property Trust II | Merged with Spirit Realty | | Jul-13 | |
| Cole RE/Cole III | Listed on NYSE | Mod. Dut. Auction TO | Jun-13 | Yes |
| Apple REIT Six | Acquired by Blackstone | | May-13 | |
| Chambers Street | Listed on NYSE | Mod. Dut. Auction TO | May-13 | No (Amended June-14) |
| ARCT III | Merged with ARCP | | Feb-13 | |
| CPA 15 | Merged with WP Carey | | Sep-12 | |

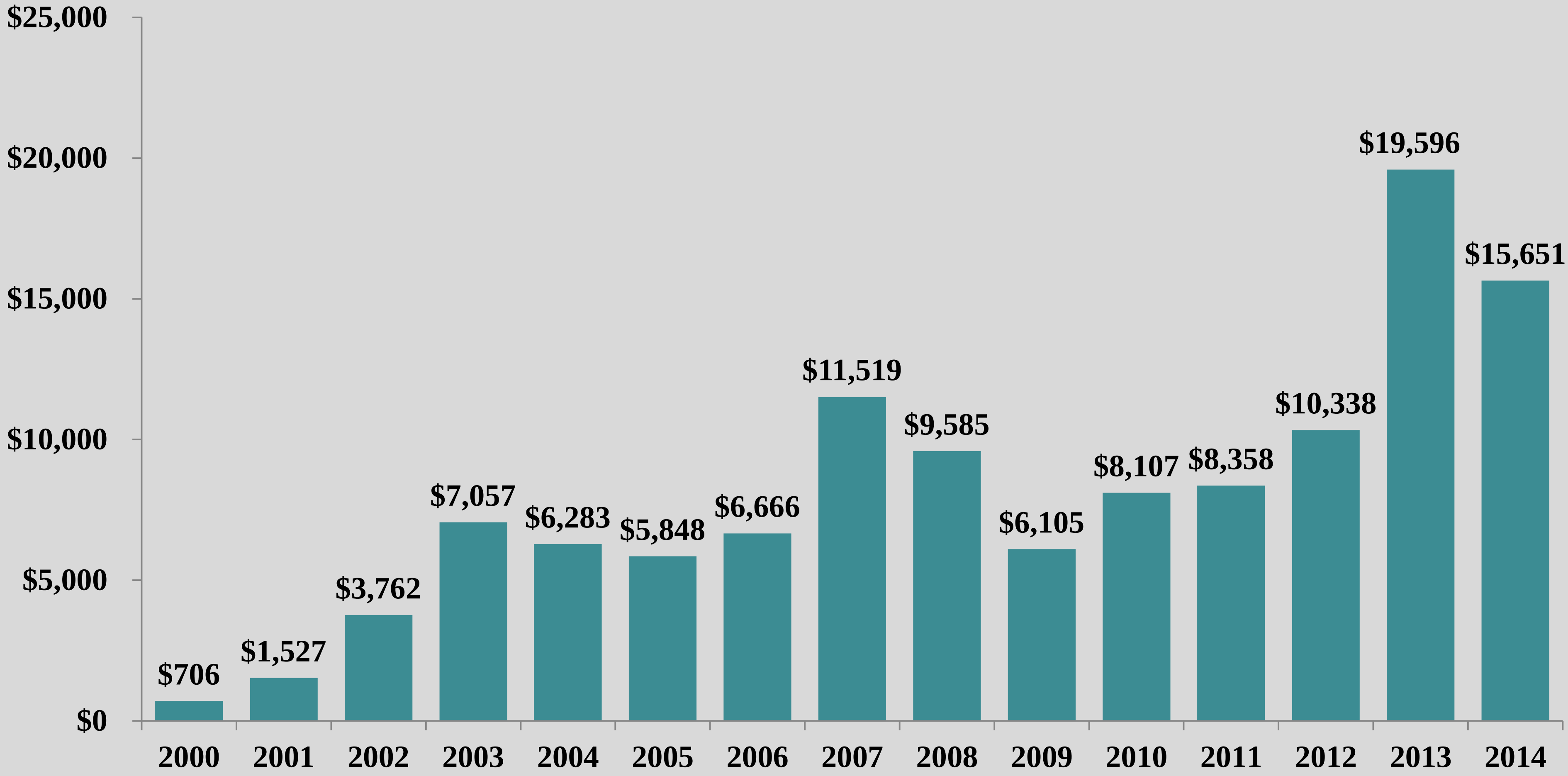
| NON-TRADED REIT | LIQUIDITY EVENT | LIQUIDITY TYPE | DATE OF LIQUIDITY EVENT | AMEND & RESTATE CHARTER BEFORE LISTING? |
|---|---|---|---|---|
| HTA | Listed on NYSE | Phased-In Liq. & Mod. Dut. Auction TO | Jun-12 | Yes |
| ARCT | Listed on NASDAQ | Mod. Dut. Auction TO | Mar-12 | No (Amended July-12) |
| CPA 14 | Merged w/CPA 16 – Global | | May-11 | |

# Retail Investor Capital Flows

# Public Non-Listed REIT Fundraising

## 2000 – 2014

**($ millions)**




*Source:* The Stanger Market Pulse

# 2013 Top Real Estate Sponsors

## (Dollars in Millions)

| # | Sponsor | 2013 | Market Share |
|---|---|---|---|
| 1 | American Realty Capital | $7,805.0 | 39.8% |
| 2 | Cole Capital | 3,567.9 | 18.2% |
| 3 | Griffin Capital Corporation | 2,103.1 | 10.7% |
| 4 | Hines Interest Limited Partnership | 772.2 | 3.9% |
| 5 | Dividend Capital | 770.8 | 3.9% |
| 6 | W.P. Carey Inc. | 655.7 | 3.3% |
| 7 | NorthStar Asset Management Group I | 649.2 | 3.3% |
| 8 | Carter/Validus Advisors | 514.2 | 2.6% |
| 9 | Steadfast REIT Investments, LLC | 506.4 | 2.6% |
| 10 | CNL Financial Group | 476.2 | 2.4% |
| | **Totals - Top Ten** | **$17,820.6** | **90.8%** |

*Source:* The Stanger Market Pulse

# 2014 Top Real Estate Sponsors

## (Dollars in Millions)

| # | Sponsor | 2014 | Market Share |
|---|---|---|---|
| 1 | American Realty Capital | $6,064.0 | 38.8% |
| 2 | Griffin Capital Corporation | 1,698.1 | 10.9% |
| 3 | W.P. Carey Inc. | 1,483.2 | 9.5% |
| 4 | Cole Capital | 1,315.2 | 8.4% |
| 5 | NorthStar Asset Management Group Inc. | 1,129.6 | 7.2% |
| 6 | Carter/Validus Advisors | 1,037.0 | 6.6% |
| 7 | CNL Financial Group | 622.0 | 4.0% |
| 8 | KBS Capital Advisors LLC | 576.9 | 3.7% |
| 9 | Hines Interest Limited Partnership | 380.3 | 2.4% |
| 10 | Inland Real Estate Investment Corp | 344.4 | 2.2% |
| | **Totals - Top Ten** | **$14,650.4** | **93.6%** |

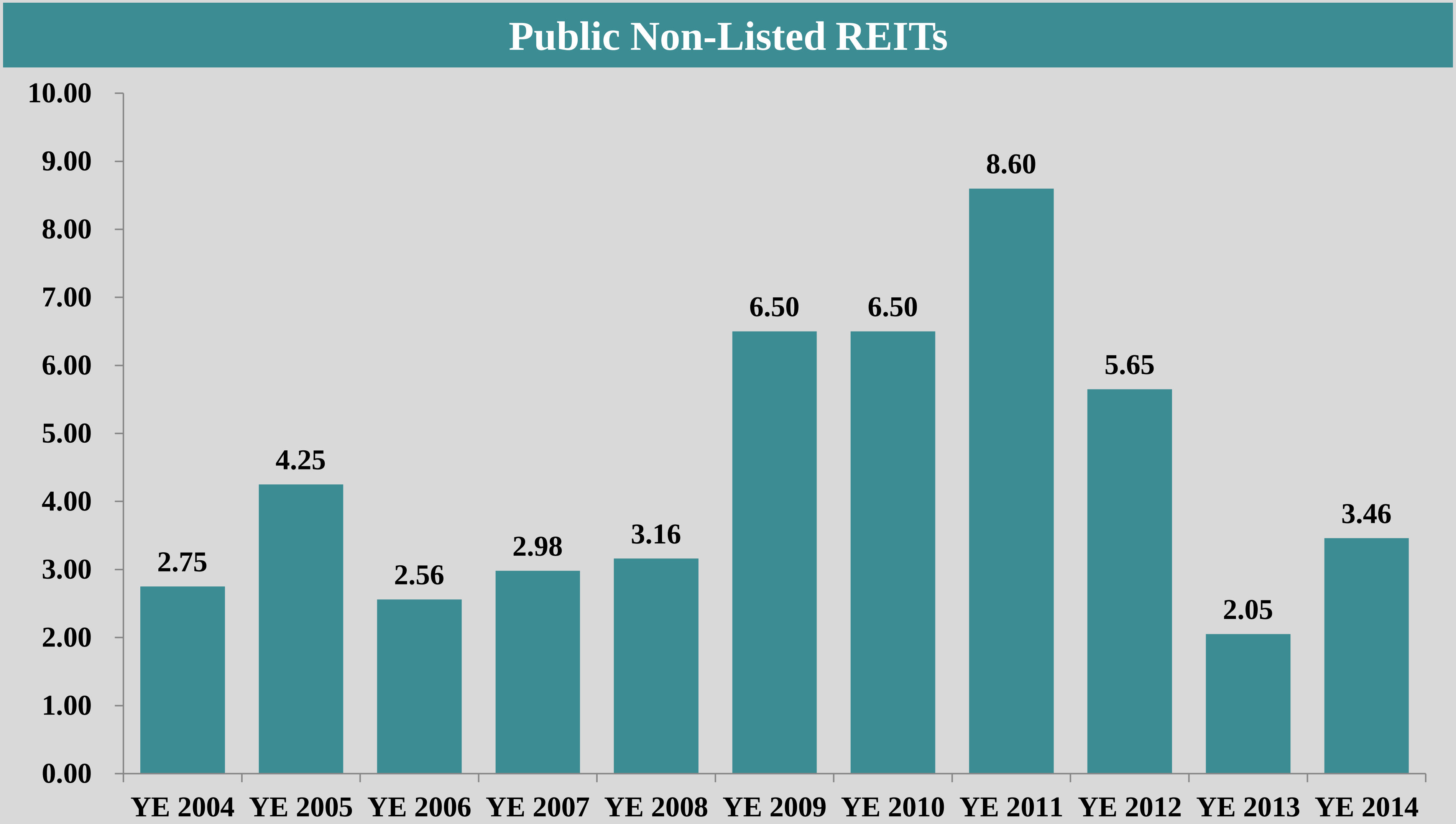
# 2015 Top Real Estate Sponsors

## Sorted by February 2015 Sales

## (Dollars in Millions)

| # | Sponsor | January | February |
|---|---|---|---|
| 1 | American Realty Capital | $152.0 | $194.8 |
| 2 | Griffin Capital Corporation | 855.4 | 99.4 |
| 3 | KBS Capital Advisors LLC | 52.2 | 74.2 |
| 4 | NorthStar Asset Management Group Inc. | 151.8 | 51.8 |
| 5 | Inland Real Estate Investment Corp | 37.1 | 47.9 |
| 6 | Dividend Capital | 28.5 | 38.5 |
| 7 | Carter/Validus Advisors | 24.5 | 34.1 |
| 8 | CNL Financial Group | 125.7 | 32.9 |
| 9 | Steadfast REIT Investments, LLC | 28.8 | 30.6 |
| 10 | W.P. Carey Inc. | 19.0 | 29.3 |
| | All Others | 56.4 | 78.1 |
| | **Totals** | **$1,531.4** | **$711.6** |

# Stanger Market Clearing Index:



# Liquidity Events

# 2012 Non-Listed REIT Liquidity Events

## (Dollars in Millions, Except Per Share)

| REIT | Initial Liquidity Date | Capital Raised | Issue Price | Price at Monetization | Price 3/10/2015 |
|---|---|---|---|---|---|
| ARCT American Realty Capital Trust ARCT / NASDAQ | 3/1/2012 | $1,832.1 | $10.00 | $10.49/$13.01 | $14.51 |
| RPAI Retail Properties of America, Inc. | 4/9/2012 | 4,219.7 | $25.00 | $8.00 | $15.66 |
| CPA:15 | 9/28/2012 | 1,476.2 | $10.00 | $12.65 | $16.69 |
| HTA Healthcare Trust of America | 6/6/2012 | 2,195.7 | $20.00 | $19.84 | $26.60 |
| **2012 Total** | | **$9,723.7** | | | |

# 2013 Non-Listed REIT Liquidity Events

## (Dollars in Millions, Except Per Share)

| REIT | Initial Liquidity Date | Capital Raised | Issue Price | Price at Monetization | Price 3/10/2015 |
|---|---|---|---|---|---|
| AR Capital American Realty Capital Trust III, Inc. | 2/28/2013 | $1,700.0 | $10.00 | $13.23 | $8.86 |
| COLE II | 7/17/2013 | 1,969.6 | $10.00 | $9.45 | $11.72 |
| Apple REIT Six | 5/14/2013 | 963.1 | $11.00 | $11.50 | $11.10 |
| Chambers Street | 5/21/2013 | 2,388.0 | $10.00 | $10.00 | $7.69 |
| COLE | 6/20/2013 | 4,555.6 | $10.00 | $11.14 | $10.20 |
| Columbia Property Trust | 10/16/2013 | 5,150.1 | $40.00 | $22.54 | $25.71 |
| CatchMark Timber Trust | 12/12/2013 | 295.1 | $25.00 | $13.50 | $11.91 |
| **2013 Total** | | **$17,021.5** | | | |

# 2014 Non-Listed REIT Liquidity Events

## (Dollars in Millions, Except Per Share)

| REIT | Initial Liquidity Date | Capital Raised | Issue Price | Price at Monetization | Price 3/10/2015 |
|---|---|---|---|---|---|
| American Realty Capital Trust IV, Inc. | 1/3/2014 | $1,736.5 | $25.00 | $30.54 | $27.79 |
| Paladin REIT | 1/30/2014 | 75.3 | $10.00 | $7.25 | $7.25 |
| CPA®:16 Global | 1/31/2014 | 1,103.3 | $10.00 | $11.25 | $12.15 |
| American Realty Capital Healthcare Trust, Inc. | 4/7/2014 | 1,738.0 | $10.00 | $10.55 | $11.73 |
| NYRT New York REIT | 4/15/2014 | 1,715.6 | $10.00 | $10.75 | $10.02 |
| Cole I | 5/19/2014 | 100.9 | $10.00 | $7.25 | $7.25 |
| UDF IV United Development Funding IV | 6/4/2014 | 607.0 | $20.00 | $19.60 | $17.27 |
| Inland Diversified Real Estate Trust, Inc. | 7/1/2014 | 1,105.1 | $10.00 | $10.67 | $11.35 |
| KBS Real Estate Investment Trust II | 7/7/2014 Asset Sale | 500.0 | $10.00 | NA | NA |
| Monogram Residential Trust | 11/21/2014 | 1,459.8 | $10.00 | $9.25 | $9.30 |

# 2014 Non-Listed REIT Liquidity Events

## (Dollars in Millions, Except Per Share)

| REIT | Initial Liquidity Date | Capital Raised | Issue Price | Price at Monetization | Price 3/10/2015 |
|---|---|---|---|---|---|
| GRIFFIN-AMERICAN HEALTHCARE REIT II | 12/3/2014 | 2,840.6 | $10.00 | $11.50 | $11.53 |
| **2014 Total** | | **$12,982.1** | | | |

# 2015 Non-Listed REIT Liquidity Events

## (Dollars in Millions, Except Per Share)

| REIT | Initial Liquidity Date | Capital Raised | Issue Price | Price at Monetization | Price 3/10/2015 |
|---|---|---|---|---|---|
| **Announced** | | | | | |
| Inland American Real Estate Trust, Inc. | Pending Spin Off | 1,804.4 | $10.00 | NA | NA |
| Cole Corporate Income Trust, Inc. | Pending Merger | 1,642.0 | $10.00 | $9.07 | $8.49 |
| Plymouth REIT | Pending IPO | 10.6 | $10.00 | NA | NA |
| Signature Office REIT | Pending Merger | 496.5 | $25.00 | NA | NA |
| **2015 Total** | | **$3,953.5** | | | |
| **Prospective** | | | | | |
| Apple Hospitality REIT | Prospective Listing | 4,000.0 | $11.00 | N/A | N/A |

# Mountain of Non-Listed REITs to Recycle

## (Dollars in Millions)

| # | Non-Listed REIT | Offering Close Date | Shares / OP Units Outstanding 9/30/2014 | Latest Reported Price | Market Capitalization |
|---|---|---|---|---|---|
| 1 | American Realty Capital - Retail Centers of America, Inc. | 9/12/2014 | 86,433,947 | $10.00 | $864.3 |
| 2 | American Realty Capital Global Trust, Inc. | 6/30/2014 | 176,205,378 | 10.00 | 1,762.1 |
| 3 | American Realty Capital Healthcare Trust II, Inc. | 11/17/2014 | 81,457,535 | 25.00 | 2,036.4 |
| 4 | American Realty Capital Trust V, Inc. | 9/30/2013 | 64,821,722 | 25.00 | 1,620.5 |
| 5 | Apple Hospitality REIT, Inc. | 12/9/2010 | 373,820,814 | 10.25 | 3,831.7 |
| 6 | Apple REIT Ten, Inc. | 7/31/2014 | 91,334,230 | 11.00 | 1,004.7 |
| 7 | Behringer Harvard Opportunity REIT I, Inc. | 12/28/2007 | 56,500,472 | 3.58 | 202.3 |
| 8 | Behringer Harvard Opportunity REIT II, Inc. | 3/15/2012 | 25,908,217 | 9.72 | 251.8 |
| 9 | Carey Watermark Investors Incorporated | 12/19/2014 | 91,491,484 | 10.00 | 914.9 |
| 10 | Carter Validus Mission Critical REIT, Inc. | 6/6/2014 | 173,412,008 | 10.00 | 1,734.1 |
| 11 | CNL Growth Properties, Inc. | 4/11/2014 | 22,526,171 | 9.90 | 223.0 |
| 12 | CNL Lifestyle Properties, Inc. | 4/6/2011 | 325,214,000 | 6.85 | 2,227.7 |
| 13 | Cole Corporate Income Trust, Inc. | 9/30/2013 | 197,817,978 | 10.00 | 1,978.2 |
| 14 | Cole Credit Property Trust IV, Inc. | 2/25/2014 | 302,462,883 | 10.00 | 3,024.6 |
| 15 | Corporate Property Associates 17 - Global, Inc. | 12/20/2012 | 325,903,988 | 9.50 | 3,096.1 |
| 16 | Global Income Trust, Inc. | 4/23/2013 | 8,419,689 | 8.90 | 74.9 |
| 17 | Griffin Capital Essential Asset REIT, Inc. | 4/22/2014 | 133,907,451 | 9.56 | 1,280.2 |
| 18 | Hines Global REIT, Inc. | 4/11/2014 | 269,486,000 | 8.90 | 2,398.4 |
| 19 | Hines Real Estate Investment Trust, Inc | 12/31/2009 | 242,877,419 | 6.50 | 1,578.7 |
| 20 | Industrial Income Trust, Inc. | 7/18/2013 | 210,254,000 | 10.40 | 2,186.6 |
| 21 | Inland American Real Estate Trust, Inc. | 4/6/2009 | 861,824,767 | 6.94 | 5,981.1 |
| 22 | KBS Legacy Partners Apartment REIT, Inc. | 3/31/2014 | 19,970,415 | 10.14 | 202.5 |
| 23 | KBS Real Estate Investment Trust II, Inc. | 12/31/2010 | 190,753,163 | 5.86 | 1,117.8 |
| 24 | KBS Real Estate Investment Trust, Inc. | 5/30/2008 | 188,474,659 | 4.52 | 851.9 |

# Mountain of Non-Listed REITs to Recycle

## (Dollars in Millions)

| # | Non-Listed REIT | Offering Close Date | Shares / OP Units Outstanding 9/30/2014 | Latest Reported Price | Market Capitalization |
|---|---|---|---|---|---|
| 25 | KBS Strategic Opportunity REIT, Inc. | 11/14/2012 | 59,903,681 | $12.24 | $733.2 |
| 26 | Landmark Apartment Trust of America | 7/17/2011 | 66,998,759 | 8.15 | 546.0 |
| 27 | Lightstone Value Plus REIT II, Inc. | 9/27/2014 | 18,380,020 | 10.00 | 183.8 |
| 28 | Lightstone Value Plus REIT, Inc. | 10/10/2008 | 26,303,061 | 11.80 | 310.4 |
| 29 | NorthStar Real Estate Income Trust, Inc. | 7/19/2013 | 117,099,835 | 10.02 | 1,173.3 |
| 30 | Phillips Edison - ARC Shopping Center REIT, Inc. | 12/11/2013 | 180,573,225 | 10.00 | 1,805.7 |
| 31 | Plymouth Industrial REIT, Inc. | 5/6/2014 | 1,325,792 | 10.00 | 13.3 |
| 32 | Resource Real Estate Opportunity REIT, Inc. | 12/13/2013 | 6,835,343 | 10.00 | 68.4 |
| 33 | Sentio Healthcare Properties, Inc. | 4/29/2011 | 16,147,780 | 11.63 | 187.8 |
| 34 | Signature Office REIT, Inc. | 6/10/2013 | 20,473,024 | 25.00 | 511.8 |
| 35 | SmartStop Self Storage, Inc. | 9/22/2013 | 60,799,150 | 10.81 | 657.2 |
| 36 | Steadfast Income REIT, Inc. | 12/20/2013 | 76,507,922 | 10.24 | 783.4 |
| 37 | Strategic Realty Trust, Inc. | 2/7/2013 | 11,403,029 | 7.11 | 81.1 |
| 38 | Summit Healthcare REIT, Inc. | 11/23/2010 | 23,028,014 | 2.09 | 48.1 |
| 39 | TIER REIT, Inc. | 12/31/2008 | 299,696,686 | 4.48 | 1,342.6 |
| | | | | | $48,890.9 |

# Regulatory Initiatives

# SR-FINRA 2014-06
# Final Rule Approved By SEC

- Value Must Be Reported on Account Statement
  (Unless Deemed Unreliable)
- Member Firm Can Only Participate in Offerings Where Issuer Agrees to Disclose Valuations Conforming to Rule
  (Including Methodology, Scope, Date, Basis for Value)
- Two Presumptively Reliable Methods
  - Net Investment
  - Appraised Value
- Enhanced Disclosure Re: Distributions > "Earnings"
- Accelerated Timing of First Valuation
- Implementation Period

# SR-FINRA 2014-06
# Valuation Methodologies

- **Net Investment**
  - "Amount Available For Investment" From Estimated Use of Proceeds In Prospectus
  - Aggregate $ Registered Less % Deduction for Sales Commissions, Dealer Manager Fees and O&O

    (Based on Max Offering, Unless Reason to Believe Unreliable)
  - May Use Until 150 Days After 2nd Anniversary of Escrow Break

- **Appraised Value**
  - May Disclose at Any Time, But Must Disclose no Later Than Limitation Date for Net Investment Use
  - Based on Valuations of Program Assets and Liabilities
  - Performed at Least Annually
  - By or With Material Assistance/Confirmation of 3rd Party Expert
  - Methodology Conforms to Standard Industry Practice

# SR-FINRA 2014-06
# Other Provisions

- **Enhanced Disclosure Regarding Excess Distributions**
  - Prior to Disclosure of Appraised Valuation, Account Statement Must Include, If Applicable, This Required Disclosure:

    *"IMPORTANT – Part of your distribution includes a return of capital. Any distribution that represents a return of capital reduces the estimated per share value shown on your account statement."*
  - Must be Prominent and Proximate to Disclosure of Distributions and Per Share Estimated Value.

- **Acceleration of Appraised Valuations**
  - No Later Than 150 Days After 2$^{nd}$ Anniversary of Escrow
  - Previously Was 18 Months After Closing of Offering Period.

- **Implementation (To be Defined by FINRA in Final RN)**
  - Final: April 11, 2016

# SR-FINRA 2014-06
# Industry Responses

1. Sell Through With Greater Education of Broker and Investors

2. Product Innovation

   - Deferred Commission  Structures/ Daily NAV

# Non-Listed REIT Sales by Share Class

## Dollars in Millions

| Sponsor/Program | Effective Date | Amount Registered | Class | Max Up-Front Fee | Most Recent 3 Months October | November | December | Total | Total Sales by Class | % Sales by Class |
|---|---|---|---|---|---|---|---|---|---|---|
| **American Realty Capital** | | | | | | | | | | |
| ARC Daily Net Asset Value Trust, Inc. | 8/15/2011 | $1,500.0 | Retail | 7.0% | 0.1 | 0.2 | 0.1 | 0.4 | 12.9 | 50% |
| | | | Institutional | 0.7% | 0.1 | 0.0 | 0.1 | 0.3 | 13.1 | 50% |
| | | | **TOTAL** | | **0.3** | **0.2** | **0.2** | **0.6** | **26.0** | |
| **Carter/Validus Advisors** | | | | | | | | | | |
| Carter Validus Mission Critical REIT II, Inc. | 5/29/2014 | $2,250.0 | **Class A** | **7.0%** | **12.9** | **18.1** | **20.8** | **51.8** | **70.1** | 100% |
| | | | **Class T** | **3.0%** | **0.0** | **0.0** | **0.0** | **0.0** | **0.0** | 0% |
| | | | **TOTAL** | | **12.9** | **18.1** | **20.8** | **51.8** | **70.1** | |
| **Cole Capital** | | | | | | | | | | |
| Cole Real Estate Income Strategy (Daily NAV), Inc. | 12/6/2011 | $3,500.0 | Class A | 3.75% | 0.6 | 0.2 | 0.1 | 0.9 | 3.0 | 2% |
| | | | Class I | None | 0.3 | 0.1 | 0.0 | 0.4 | 1.7 | 1% |
| | | | Class W | None | 6.6 | 1.5 | 0.5 | 8.7 | 129.7 | 97% |
| | | | **TOTAL** | | **7.5** | **1.8** | **0.6** | **9.9** | **134.4** | |
| **Dividend Capital** | | | | | | | | | | |
| Dividend Capital Diversified Property Fund, Inc. | 1/27/2006 | $4,044.0 | Class A | 3.0% | 0.4 | 0.3 | 0.7 | 1.4 | 8.5 | 8% |
| | | | Class I | None | 2.6 | 1.7 | 0.7 | 5.0 | 88.6 | 81% |
| | | | Class W | None | 2.2 | 0.2 | 0.1 | 2.4 | 11.8 | 11% |
| | | | **TOTAL** | | **5.2** | **2.2** | **1.5** | **8.9** | **108.9** | |
| **LaSalle Investment Management, Inc.** | | | | | | | | | | |
| Jones Land LaSalle Income Property Trust, Inc. | 10/1/2012 | $2,700.0 | A Shares | 3.5% | 8.7 | 6.5 | 7.1 | 22.3 | 207.3 | 80% |
| | | | M Shares | None | 4.8 | 1.5 | 3.6 | 10.0 | 50.8 | 20% |
| | | | **TOTAL** | | **13.5** | **8.0** | **10.7** | **32.3** | **258.1** | |
| **RREEF America LLC** | | | | | | | | | | |
| RREEF Property Trust, Inc. | 1/3/2013 | $2,250.0 | Class A | 3.0% | 0.3 | 0.7 | 0.9 | 1.9 | 22.2 | 49% |
| | | | Class B | None | 0.2 | 0.3 | 1.5 | 2.0 | 23.2 | 51% |
| | | | **TOTAL** | | **0.5** | **1.0** | **2.4** | **3.9** | **45.4** | |

# Non-Listed REIT Sales by Share Class

## Dollars in Millions

| Sponsor/Program | Effective Date | Amount Registered | Class | Max Up-Front Fee | Most Recent 3 Months: October | November | December | Total | Total Sales by Class | % Sales by Class |
|---|---|---|---|---|---|---|---|---|---|---|
| **W.P. Carey Inc.** | | | | | | | | | | |
| Corporate Property Associates 18 - Global, Inc. | 5/7/2013 | $1,250.0 | Class A | 7.0% | 0.0 | 0.0 | 0.0 | 0.0 | 977.4 | 86% |
| | | | Class C | 1.5% | 19.5 | 15.1 | 18.0 | 52.5 | 165.7 | 14% |
| | | | **TOTAL** | | **19.5** | **15.1** | **18.0** | **52.5** | **1,143.1** | |
| **Summary by Commission Structure:** | | | | | | | | | | |
| Retail Commission | | | | | 13.0 | 18.3 | 20.9 | 52.2 | 1,060.4 | 59% |
| Low/No Commission | | | | | 46.3 | 28.2 | 33.3 | 107.8 | 725.6 | 41% |
| **Total** | | | | | **59.4** | **46.5** | **54.2** | **160.0** | **1,786.1** | |

**Low commission is defined as less than 7% up front fee*

# Non-Traded Equity REIT Fundraising – 2013

## (Dollars in Millions)

| Sector | Equity Raised | Exit Opportunity |
|---|---|---|
| Net Lease | $7,206.6 | Strong |
| Healthcare | 3,491.3 | Strong |
| Diversified | 3,242.7 | Moderate |
| Retail | 1,674.2 | Moderate |
| Multifamily | 990.9 | Moderate |
| Industrial | 740.5 | Moderate |
| Hotel | 612.5 | Moderate |
| Other | 514.2 | N/A |
| Self Storage | 106.3 | Strong |
| Office | 68.2 | Moderate |
| | $18,647.4 | |

# Non-Traded Equity REIT Fundraising 2014

## (Dollars in Millions)

| Sector | Equity Raised | Exit Opportunity |
|---|---|---|
| Healthcare | $5,219.5 | Strong |
| Net Lease | 4,628.0 | Strong |
| Diversified | 2,220.2 | Moderate |
| Retail | 1,439.6 | Weak |
| Hotel | 1,049.4 | Moderate |
| Industrial | 224.7 | Moderate |
| Multifamily | 194.9 | Weak |
| Self Storage | 17.5 | Strong |
| | $14,993.7 | |

*Healthcare includes NorthStar Healthcare Income

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**The White House**

Office of the Press Secretary

For Immediate Release February 23, 2015

# FACT SHEET: Middle Class Economics: Strengthening Retirement Security by Cracking Down on Backdoor Payments and Hidden Fees

*"That's what middle-class economics is—the idea that this country does best when everyone gets their fair shot, everyone does their fair share, and everyone plays by the same set of rules." President Barack Obama, State of the Union Address, January 20, 2015*

Middle class economics means that Americans should be able to retire with dignity after a lifetime of hard work. But today, the rules of the road do not ensure that financial advisers act in the best interest of their clients when they give retirement investment advice, and it's hurting millions of working and middle class families.

A system where Wall Street firms benefit from backdoor payments and hidden fees if they talk responsible Americans into buying bad retirement investments—with high costs and low returns—instead of recommending quality investments isn't fair. These conflicts of interest are costing middle class families and individuals billions of dollars every year. On average, they result in annual losses of 1 percentage point for affected investors. To demonstrate how small differences can add up: A 1 percentage point lower return could reduce your savings by more than a quarter over 35 years. In other words, instead of a $10,000 retirement investment growing to more than $38,000 over that period after adjusting for inflation, it would be just over $27,500. Today, President Obama is taking a step to crack down on those Wall Street brokers who benefit from backdoor payments or hidden fees and don't put the best interest of working and middle class families first.

Many advisers do not accept backdoor payments or hidden fees and work on a different business model that puts their customers' best interest first. They are hardworking men and women who got into this work to help families achieve their dreams and want a system that provides a level playing field for offering quality advice. But outdated regulations, loopholes, and fine print make it hard for working and middle class families to know who they can trust.

During the financial crisis, we saw the devastation caused on Main Street when outdated policies let lenders steer their customers into bad mortgage products. That's why in the wake of the crisis, the President fought to create the Consumer Financial Protection Bureau. Since then, the CFPB has cracked down on many of the abusive lending practices that led borrowers to lose their homes.

Because of outdated rules protecting retirement savings, we're seeing similar types of bad incentives and bad advice lead to billions of dollars of losses for American families saving for retirement every year—with some families losing tens of thousands of dollars of their retirement savings. That's why today, the President directed the Department of Labor to move forward with a proposed rulemaking to protect families from bad retirement advice by requiring retirement advisers to abide by a "fiduciary" standard—putting their clients' best interest before their own profits.

- **Backdoor Payments & Hidden Fees Are Hurting the Middle Class:** Today's report from the White House Council of Economic Advisers (CEA) shows conflicts of interest cost middle-class families who receive conflicted advice huge amounts of their hard-earned savings. It finds conflicts likely lead, on average, to:
  - 1 percentage point lower annual returns on retirement savings.
  - $17 billion of losses every year for working and middle class families.
- **A Wide Array of Research Shows Why Conflicts Hurt Working and Middle Class Families:** A strong set of independent research shows that these losses result from brokers getting backdoor payments or hidden fees for:
  - Steering clients' savings into funds with higher fees and lower returns even before fees.
  - Inappropriate rollovers out of lower-cost retirement plans into higher-cost vehicles.
- **President Obama is Cracking Down on Conflicts of Interest:** Today, the President called on the Department of Labor to crack down on Wall Street and protect families from conflicted and bad retirement advice. DOL will move forward with a proposed rulemaking that would require retirement advisers to abide

by a "fiduciary" standard—putting their clients' best interest before their own profits.

- **Proposed Rule Coming Soon:** In the coming months, the Department of Labor will issue a notice of proposed rulemaking, beginning a process in which it will seek extensive public feedback on the best approach to modernize the rules on retirement advice and set new standards, while minimizing any potential disruption to good practices in the marketplace.

**Our Retirement Rules Have Not Kept Up with Seismic Shifts in How People Save**

Over the past several decades, the share of Americans' employer-based retirement savings that takes the form of traditional pensions—where investment decisions are generally made by professionals—has fallen sharply. Today, Americans are largely responsible for making their own choices about how much to save and how to invest their retirement savings.

To help make informed choices, families often look for trusted advice on how to manage their hard-earned nest egg. However, despite the significant changes in the retirement landscape, the regulations that set the basic rules of the road on giving investment advice to retirement savers have not been updated in almost forty years. Under these outdated rules, savers cannot count on receiving the unbiased advice that they need and expect. In other words, today's rules allow brokers to put their bottom line ahead of their clients' retirement security. A system where middle class families shoulder 100% of the risk for their investments, but brokers receive incentives for directing them into investments that aren't in their best interest isn't fair.

If more retirement advisers were fiduciaries, they would have to put the customer's best interest before their own.

**Report Released Today Finds Huge Losses to the Middle-Class from Conflicts of Interest**

A new report from the President's Council of Economic Advisers shows that that the current, broken regulatory environment creates misaligned incentives that cost working and middle class families billions of dollars a year—with some individual families losing tens of thousands of dollars of their retirement savings. These incentives cause some Wall Street brokers to encourage working and middle class families to move from low-cost employer plans to IRA accounts that typically entail higher fees—and to steer working and middle class families into higher-cost products within the IRA market. Many advisers currently act as fiduciaries and provide advice in their clients' best interest, but many others do not. CEA's analysis of the latest academic research finds that:

- Conflicted advice leads to lower investment returns for working and middle class families. Working and middle class families receiving conflicted advice earn returns roughly 1 percentage point lower each year (for example, conflicted advice reduces what would be a 6 percent return to a 5 percent return).
- An estimated $1.7 trillion of IRA assets are invested in products that generally provide payments that generate conflicts of interest. Thus, CEA estimates the aggregate annual cost of conflicted advice is about $17 billion each year.
- A typical worker who receives conflicted advice when rolling over a 401(k) balance to an IRA at age 45 will lose an estimated 17 percent from her account by age 65. In other words, if a worker has $100,000 in retirement savings at age 45, without conflicted advice it would grow to an estimated $216,000 by age 65 adjusted for inflation, but if she receives conflicted advice it would only grow to $179,000—a loss of $37,000 or about 17 percent.
- A retiree who receives conflicted advice on how to invest his IRA at retirement will lose an estimated 12 percent of the value of his savings if drawn down over 30 years compared to a retiree who receives unconflicted advice.

A marketplace where some advisers are encouraged to steer their clients into inferior products based on these payments creates bad incentives and an unfair playing field for the many firms who choose instead to put their clients' interests first.

**Updating our Outdated Retirement Protections**

Since 1974, the Department of Labor has protected America's tax-preferred retirement savings under the Employee Retirement Income Security Act (ERISA), working closely with the Treasury Department and the Pension Benefit Guaranty Corporation. ERISA provided the Department of Labor with this authority, recognizing the special importance of consumer protections for a basic retirement nest egg and the large tax subsidies provided for them. In the coming months, the Department of Labor will propose a new rule that will seek to:

- **Require retirement advisers to put their client's best interest first, by expanding the types of retirement investment advice subject to ERISA:** The definition of retirement investment advice has not been meaningfully changed since 1975, despite the dramatic shift in our private retirement system away from defined benefit plans and into self-directed IRAs and 401(k)s. The Department's proposal will update the definition to better match the needs of today's working and middle class families. Whether you are an employer trying to design a quality plan for your workers, a worker starting to save, or a retiree trying to avoid spending down your nest egg too quickly, you deserve access to quality advice, without fear that financial bias is clouding your broker's judgment.
- **Preserve the ability of working and middle class families to choose different types of advice:** The

Department's proposal will continue to allow private firms to set their own compensation practices by proposing a new type of exemption from limits on payments creating conflicts of interest that is more principles-based. This exemption will provide businesses with the flexibility to adopt practices that work for them and adapt those practices to changes we may not anticipate, while ensuring that they put their client's best interest first and disclose any conflicts that may prevent them from doing so. This fulfills the Department's public commitment to ensure that all common forms of compensation, such as commissions and revenue sharing, are still permitted, whether paid by the client or the investment firm.

- **Preserve access to retirement education:** The Department's proposal will allow advisers to continue to provide general education on retirement saving across employer-sponsored plans and IRAs without triggering fiduciary duties.

The Department's proposal will seek to crack down on irresponsible behavior in today's market for financial advice by better aligning the rules between employer-based retirement savings plans and IRAs. To balance increased protection for working and middle class families while minimizing disruptions to their access to advice, the Administration is committed to a robust and transparent process for receiving input on the proposal. When the Department of Labor issues a Notice of Proposed Rulemaking (NPRM) in the coming months, there will be opportunities to submit comments in writing and in a public hearing. The Administration welcomes and invites stakeholders from all perspectives to submit comments as the proposal moves forward. Only after reviewing all the comments will the Administration decide what to include in a final rule—and even once the Department of Labor ultimately issues a final rule, it will not go into effect immediately.

To learn more, visit DOL.gov/ProtectYourSavings.