



SECURITIES BULLETIN

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Department
Of Commerce
Division of Securities

OHIO SECURITIES BULLETIN

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CLASSIC AND TRENDING INVESTMENT SCHEMES

HOW WHAT YOU LEARNED IN ELEMENTARY SCHOOL WILL HELP MAKE BETTER CHOICES -By Licensing Compliance Counsel Kelly Igoe

There is national media coverage of scandals. Morning news programs regurgitate the perils of not being an informed investor on a regular basis. Even with the investor outreach and education available, American investors are still being taken by scam artists every day. The Ohio Division of Securities Enforcement, Licensing and Registration sections are working hard to keep Ohioans safe, but we need your help not only with the classic schemes, but also keeping up with the emerging new trends. Remembering those few guidelines taught to us in elementary school can mean the difference between being an informed investor versus a victim of securities fraud.

THERE IS NO SUCH THING AS A STUPID QUESTION

Be an ambassador to the industry and share your knowledge of compliance with your clients and help them understand and know what questions to ask to be an informed investor.

PONZI SCHEMES: Still the most prevalent classic scam. As an Investment Adviser, ensuring that clients understand the product should be paramount to meeting your fiduciary duty. Make sure you answer the questions before they are asked. Getting ahead of the questions will only give you more credibility with the client. In Ohio, Ponzi schemes are the number one way that investors are taken advantage of each year.

Help your clients understand that you are a licensed person, whether an Investment Adviser or an insurance salesperson, by

providing your CRD Number or Insurance Agent License Number. Ensure that your client understands the products being sold to them and that they can ask any questions. In a Ponzi scheme, the victims commonly confirm that they were pressured and made to feel like they needn't ask any questions. Most Ponzi schemes are successful because the investor knew or knew of the promoter, and they fail to check on important credentials and ask questions.

Investors can check the licensing status of a securities professional online at <http://brokercheck.finra.org/> or by calling the Ohio Division of Securities at 1-877-N-VEST-411.

FINISH ALL OF YOUR HOMEWORK

REGULATION D, RULE 506 OFFERINGS: Private placement offerings (PPO) often referred to as "Reg D" or "Rule 506" offerings, when fraudulent, are among the classic threats to investors. The issue surrounding this type of offering is that they generally have less oversight (compared to other offerings) because they are ostensibly only available to accredited investors. The real kicker is that the issuers of these offerings do not have to file with the SEC or the individual states until AFTER the sale to investors. The Federal JOBS act now allows for general solicitation and advertising of these private placements prior to any filing with federal or state regulators, which could lead to new problems.

(Continued on page 2)

CLASSIC AND TRENDING INVESTMENT SCHEMES (Continued)

(Continued from page 1)

Securities professionals must take the necessary steps to understand the complexity of these offerings and share this knowledge before recommending these investments to or counseling clients.

- There are reputable private placement issuers; however, investors should always check to see whether the individual selling them the investment and receiving a commission is licensed.
- All offering documents should be thoroughly reviewed and the risks understood. Throw the red flag if a promise of “high returns with little to no risk” is spoken.
- Look for sloppy offering documents, with typographical or spelling errors.
- Watch for aggressive sales tactics. Walk away from the “once in a lifetime opportunity.”
- PPOs that are legitimate will have a lot of people surrounding the entity, such as lawyers, accountants, brokerage firms and other parties, and these individuals should be contacted to discuss the offering at your leisure. Be careful if it looks as though you are the only one interested.

DO NOT TALK TO STRANGERS

History repeats itself, as emerging new trends usually mimic the current news headlines of the moment. Right now, the news of the legalization of marijuana is a hot topic and a new trend in investing and investment fraud. The **MARIJUANA INDUSTRY INVESTMENTS** have captured the attention of investors that want to capitalize on this new legal market. Promoters are selling opportunities to investors in the form of industry products and services. Investors are being targeted by aggressive sales tactics and highly optimistic leading information that is untrue or misleading. These investment opportunities are taking the form of micro-cap companies, publicly traded companies with market capitalization between approximately \$50 million to \$300 million,¹ selling low-priced securities followed by a “pump and dump” scheme.² Micro-cap stocks are vulnerable to fraud because there is little information publically available.

Help your clients complete the investment homework and watch the red flags associated with a micro-cap opportunity. Look at the SEC’s website and confirm that the security you’re interested in is trading and has not been suspended. Don’t pay attention to offers that you receive over email, or fax. Consider who owns the majority of the issuer, and look for exaggerated press releases.

If you believe that you or your clients have been a victim, or potential victim of securities fraud, call our Hotline at 1-877-N-VEST-411.³

¹See <http://www.investopedia.com/terms/m/microcapstock.asp>.

²Refers to a scam that attempts to boost the price of a stock through recommendations based on false, misleading or exaggerated statements. The perpetrators of this scheme, who already have an established position in the company’s stock ownership, sell their positions after the hype has led to a higher share price. See <http://www.investopedia.com/terms/p/pumpanddump.asp>.

³Also, for more information on how to protect you and your family from fraudulent investments, visit the SEC’s website <http://www.investor.gov/>.



**Be careful.
I am a con artist.**

**Don't be a victim of financial fraud.
Before investing your money with anyone,**

call 1-877-N-VEST-411

visit CONARTIST.OHIO.GOV



**Department
Of Commerce**
Division of Securities

COMMENTS FROM COMMISSIONER ANDREA SEIDT



Fall greetings. This is the time of year where the Division finds itself surrounded by the hustle and bustle of various fall conferences and starts preparing for the oncoming wave of annual licensing renewals. I just returned from two important conferences – the North American Securities Administrators Association (NASAA) Fall Conference,

which took place the last week of September, and the annual Ohio Securities Conference, held on October 2.

The NASAA Conference featured panels on the new retirement population, the arc and growing complexity of main stream investment products over time, and a keynote address by former SEC Chairman Arthur Levitt. NASAA Committees in the Broker-Dealer, Investment Adviser, Investor Education, CRD/IARD, Corporation Finance, and Enforcement Sections hosted open forums as NASAA itself ushered in a new management team led by incoming NASAA President Judith Shaw from Maine and NASAA's new Executive Director Joseph Brady. For me, the conference marked a bittersweet end of my term as NASAA Past-President. While I will certainly miss my national leadership role at NASAA, I am reinvigorated in focusing my undivided attention on the Division's efforts here in Ohio.

I can think of no better way of returning to my agenda in Ohio than participating in the annual Ohio Securities Conference. With this month marking my seven-year anniversary as Ohio Securities Commissioner, I have had the great fortune of watching this event evolve and grow into the first rate event it has become. I must commend this year's conference co-chairs Anne Followell and Kelly Igoe for arranging all of the special comfort touches at the venue, the beautiful Columbus Renaissance Hotel, and for building a stellar agenda packed with speakers of national renown. The Division also wishes to thank Commerce Director Jacqueline Williams and our co-sponsor the University of Toledo College of Law's Dean D. Benjamin Barros for delivering a strong kickoff to the event.

For those unable to attend, the morning sessions included panel presentations on the issues of elder financial exploitation and virtual currency followed by the Advisory Commit-

tee luncheons and panels on crowdfunding, 2015 regulatory updates, and a criminal case study highlighting partnership and cooperation between the Division and the criminal division of the Ohio Attorney General's Office. There is simply nowhere else in the state that Ohio securities practitioners can obtain this type or quality of content.



2015 OHIO SECURITIES CONFERENCE

Thank you to the following guest speakers for making the Ohio Securities Conference such a success: Dr. Georgia Anetzberger (Case Western Reserve University), Christopher Majeski (Bank of America/Merrill Lynch), Jesse Kramig (Ohio Attorney General's Office), Eric C. Chaffee (University of Toledo College of Law), J. Scott Colesanti (Hofstra University School of Law), William J. Luther (Kenyon College), Thomas E. Geyer (Bailey Cavalieri), Jack Bjerke (Baker Hostetler), Daniel Kasaris (Ohio Attorney General's Office), Leo Fernandez (Ohio Bureau of Criminal Investigations), and Richard Ward (Ohio Bureau of Criminal Investigations).

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Did you know ...

- Over \$36 billion is lost every year to financial exploitation of our nation's elder investors?
- 954,000 seniors are currently skipping meals as a result of financial abuse?
- Perpetrators are often family and caregivers that our elders trust most?

Please help us respond to this crisis by joining the Division's

ELDER FINANCIAL ABUSE WORKING GROUP

Contact the working group Chair
Brian Peters, Brian.Peters@com.ohio.gov,
for information on how to join.

DIVISION RULES CHANGES

Effective Monday, August 24, 2015, the rules of the Division were amended to clarify some requirements and to lessen the burden of others. The following are some of the highlights of the changes. For a complete copy of the rules, please refer to the Commerce website: <http://www.com.ohio.gov/ProposedRules.aspx>

RULES GOVERNING INVESTMENT ADVISERS (IAs) AND THEIR INVESTMENT ADVISER REPRESENTATIVES (IARs):

Ohio Administrative Code (OAC) 1301:6-3-14.1 has been revised to provide for notice filer investment advisers to submit a Form ADV Part 2A. This change brings notice filers in line with licensees and with the requirements after the Form ADV Part 2 was revised in October 2010.

The change in OAC 1301:6-3-15.1 (A)(16) revises the definition of “qualified client” for purposes of performance fees, and mirrors the federal definition. The definition now reflects the increased dollar thresholds that were changed federally under the Dodd Frank Wall Street Reform and Consumer Protection Act.

OAC 1301:6-3-15.1 (B) and (G) have been revised to bring the Form ADV filing requirements for state-licensed IAs consistent with the federal requirements and the current instructions to the Form ADV. State-registered IAs are now required to make an “annual updating amendment,” in addition to other amendments as required by the Form ADV. The Division has also changed its requirements for completion, filing, and delivery of the Form ADV Part 2.

To clarify the intent of the original language, OAC 1301:6-3-15.1 (E)(1)(d) language was revised to read “bank reconciliations,” rather than “cash reconciliations.”

For the same reason, OAC 1301:6-3-15.1 (E)(1)(f) was revised to clarify the form and frequency of the financial statements and internal audit work papers required to be maintained. The change clarifies the rule by expressly requiring “quarterly” financial statements to include an “income statement and balance sheet.”

In keeping with modern communication practices, OAC 1301:6-3-15.1 (E)(1)(k) and (p) have both been clarified to include all internet advertising and social media posts as part of the records that must be maintained.

OAC 1301:6-3-15.1 (E)(7) follows along the same lines as the prior change. In recognizing the prevalence of electronic medium in today’s securities industry, the rule now allows

for electronic (a/k/a “cloud”) storage of investment advisory records and data by third party providers. The IA licensees remain obligated to ensure compliance with all Division requirements regarding organization, access, retrieval, and retention of those records.

Following what is a “best practices” concept, OAC 1301:6-3-15.1 (H)(2) was revised to require all advisory contracts to be signed and dated by both the adviser and the client.

Three different changes have been made to OAC 1301:6-3-44. In section (A), the rule was changed to include social media sites in the definition of “advertising.” In section (C), the solicitor rule was revised to include state securities regulatory violations among the disqualifying provisions. In section (E), language was added to codify the fiduciary duty IAs and IARs owe their clients.

RULES GOVERNING DEALERS AND THEIR SALESPERSONS

OAC 1301:6-3-15 (B) formerly provided a list of who qualifies as a designated principal for dealer firms. The rule has been clarified to state that the designated principal shall be a natural person who is identified on Schedule A of Form BD of the dealer. This will assist the firm in coordinating with the federal requirements.

OAC 1301:6-3-16 (E) has been expanded to allow a securities salesperson to be affiliated with two dealers, provided the dealers are affiliated as defined by Form BD and the salesperson is properly licensed with both dealers.

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OHIO SECURITIES BULLETIN

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Adobe Acrobat Reader is required to view these documents.

EXCHANGE TRADED FUNDS: COUSINS TO MUTUAL AND INDEX FUNDS¹

By Division Counsel D. Michael Quinn

In the simplest terms, Exchange Traded Funds (ETFs) are funds that track indexes like the NASDAQ-100 Index, S&P 500, Dow Jones, etc. When you buy shares of an ETF, you are buying shares of a portfolio that tracks the yield and return of its native index. The main difference between ETFs and other types of index funds is that ETFs do not try to outperform their corresponding index, but simply replicate its performance. They do not try to beat the market, they try to be the market.²

One way to better understand ETFs is to compare them to mutual funds and index funds. However, a brief description of an index may be helpful. Stock market indices are a method of measuring the combined value, and the movement, of a particular group of stocks. The most widely recognized index is the Dow Jones Industrial Average, which is a price-weighted average of 30 actively traded stocks listed on the New York Stock Exchange, intended to represent different industries. The S&P 500 is an index comprised of a group of 500 large-cap stocks (companies with a large capitalization) that are selected by a committee to closely track (i.e. resemble) the large-cap securities equity market as a whole. An equivalent index tracking the small-cap stocks is the Russell 2000.

MUTUAL FUNDS

A mutual fund is an investment vehicle that is made up of a pool of funds collected from many investors for the purpose of investing in a pool of securities such as stocks, money market instruments and similar assets.³ The net asset value of the fund is based on the net asset value of all securities in which they have invested, priced at the end of the trading day. Mutual funds are oper-

ated by money managers, who invest the fund's capital and attempt to produce capital gains and income for the fund's investors. A mutual fund's portfolio is structured and maintained to match the investment objectives stated in its prospectus.⁴ A mutual fund gives a small investor access to professional money managers and a greater diversification than they could achieve on their own. Trading decisions are made by the manager and are not always transparent. It is also difficult to get out during a day of volatility. In addition, capital gains or losses are incurred with each trade by the fund, potentially giving rise to tax liability for the individual investor.

INDEX FUNDS

Index funds were created to track an index, such as the S&P 500. The goal is to buy and hold securities, only trading to keep the fund matched to the particular index. An index fund is like a mutual fund except that rather than the securities that comprise the fund being regularly traded to try and beat the market, an index fund is structured to mimic the market. Because an index fund avoids the trading necessary to manage the fund, the fees are usually considerably less than those associated with mutual funds. In addition, infrequent trading reduces the capital gains taxes on the fund. However, by the very nature of their structure, if the returns on the index the fund is following start to take a significant downturn, the manager of this fund has very little flexibility to avoid the loss.

EXCHANGE TRADED FUNDS

Exchanged Traded Funds (ETFs) are investment companies that are classi-

fied as open-end companies⁵ but differ from traditional open-end companies. Like a mutual fund, ETFs can provide diversification for a portfolio by investing in a more assorted range of securities than the individual investor would likely be able to do. An investor purchasing shares in an ETF is really purchasing an investment in the performance of the securities that comprise the fund. ETFs differ from mutual funds in that they typically trade on exchanges and are priced in real time.

ETFs do not sell shares directly to investors. Instead, each sponsor of an ETF issues large blocks (often of 50,000 shares or more) that are known as creation units.⁶ These units are then bought by an "authorized participant" – typically a market maker, specialist or institutional investor – which obtains shares of the underlying securities and places them in a trust. The authorized participant then splits up these creation units into ETF shares – each of which represents a legal claim to a tiny fraction of the assets in the creation unit – and then sells them on a secondary market where they become available to individual investors.⁷

ETFs have the advantages of generally lower costs and greater liquidity. ETFs do not charge fees for getting into or out of the fund (front end or back end). Additionally, because they are priced in real time during the trading day, the investor does not need to wait to the end of the trading day to determine the value. This allows an investor to liquidate a position or portion of a position like an equity security.

A disadvantage to ETFs include the inability to price the ETF share as precisely as the underlying securities, leading to the possibility that the ETF

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¹The Ohio Division of Securities (the "Division") does not recommend any particular investment or investment type. Information contained herein is for informational purposes only.

²<http://www.nasdaq.com/etfs/what-are-ETFs.aspx>.

³<http://www.investopedia.com/terms/m/mutualfund.asp>.

⁴Id.

⁵An open-end fund is one that issues shares as long as there are purchasers. See <http://www.investopedia.com/terms/o/open-endfund.asp>.

⁶See <http://www.sec.gov/answers/etf.htm>.

⁷<http://www.investinganswers.com/financial-dictionary/mutual-fundsetfs/exchange-traded-fund-efi-805>.

EXCHANGE TRADED FUNDS: COUSINS TO MUTUAL AND INDEX FUNDS (Continued)

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shares will be sold at either a discount or a premium. In addition, since the funds are not actively managed, some investors will perceive the funds as too risk-averse. Also, investment strategies that anticipate regular investments – e.g. a monthly purchase plan – will be paying commissions for each ETT trade.

The volatility of the August stock markets around the globe demonstrated a fundamental flaw in ETF investing. When the markets experienced steep declines that triggered halts in trading, a large number of ETFs traded at significant discounts from the value of their total holdings.⁸ Investors who sold during the ensuing panic experienced losses magnified by the discounts while purchasers benefited conversely. This loss of value put into question one of the supposed advantages of ETFs: the ease with which investors may move in and out of their ETF investments.

Leveraged ETFs use financial derivatives and debt to amplify the returns of an underlying index. These funds aim to keep a constant amount of leverage during the investment time frame, such as a 2:1 or 3:1 ratio. A leveraged ETF does not amplify the annual returns of an index; instead it follows the daily changes. Imagine, for example, a leveraged fund with a 2:1 ratio. This means that each dollar of investor capital used is matched with an additional dollar of invested debt. If one day the underlying index returns 1%, the fund will theoretically return 2%. The 2% return is theoretical, as management fees and transaction costs diminish the full effects of leverage. The 2:1 ratio works in the opposite direction as well. If the index drops 1%, your loss would then be 2%.⁹ In addition to the speculative nature of anticipating the direction of the market, leveraging increases the risk by the amount of the ratio.

Inverse ETFs are structured to obtain results in opposition (inverse) to the index they are following. An investor might buy shares in an inverse ETF if

they think the market is going to turn down. When they believe the market is going to turn around, they can sell the shares of the inverse ETF. Because buying an inverse ETF is not selling short, a margin account is not required. However, a turn in the positive direction can quickly erode any profit from correctly predicting the downturn.

There are various combinations, such as a leveraged inverse ETF, but the more esoteric or leveraged the investment vehicle, the greater the risk.¹⁰ If you buy an inverse ETF and the market associated with your fund rises, you will lose money. If the fund is leveraged, you could experience dramatic losses.¹¹

Before you decide to invest in these, or any other investment, remember the age-old rule: If you don't understand it you probably shouldn't be in it.

⁸See <http://www.etf.com/sections/features-and-news/mini-flash-crash-bites-some-etfs?nopaging=1>; See also <http://www.wsj.com/articles/stock-market-tumult-exposes-flaws-in-modern-markets-1440547138>

⁹See <http://www.investopedia.com/terms/l/leveraged-etf.asp>.

¹⁰See <http://www.sec.gov/investor/pubs/leveragedetfs-alert.htm>.

¹¹See http://etf.about.com/od/riskofetfs/tp/Five_ETF_Dsvntgs.htm; <http://www.investopedia.com/articles/mutualfund/07/inverse-etfs.asp>.

COMMENTS FROM COMMISSIONER ANDREA SEIDT (Continued)

(Continued from page 3)

Before I close, I would like to invite all subscribers to check out an upcoming investor education event hosted by our friends and regulatory partners at FINRA. I will be joining FINRA CEO Rick Ketchum, President of the FINRA Foundation Gerri Walsh, and special guest speaker Congressman Steve Stivers for a free Investor Forum to be held at the Hyatt Regency in Columbus on October 19. For registration information and more details, please visit the event page at <http://www.finra.org/columbus-investor-forum>. Education remains one of the strongest forms of investor protection so please spread the word to the investors in your area.

Did you know ...

- A new startup is launched every minute in the United States?
- Roughly 7% of all startup capital is derived from credit cards?
- 30 states now offer intrastate crowdfunding exemptions?

The Division is currently considering alternative finance and other proposals to give small businesses greater access to capital in Ohio, but we need your help to find the right path.

Please help us move forward by joining the Division's
CAPITAL FORMATION WORKING GROUP

Contact the working group Chair
Mark Heuerman, Mark.Heuerman@com.ohio.gov,
for information on how to join.



A to Z with L & E

A TO Z WITH L & E

Professional Designations: Meeting the Minimum Competency Requirements for Investment Adviser Representative Licensing....7

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This section of the Bulletin, the Licensing and Examination Section of the Division ("L & E"), discusses timely and important topics impacting our licensees. The goal is to cover a wide-range of issues – from "A to Z" – that are of greatest interest to you!

We welcome your suggestions for future topics.

OHIO DIVISION OF SECURITIES

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PROFESSIONAL DESIGNATIONS: MEETING THE MINIMUM COMPETENCY REQUIREMENTS FOR INVESTMENT ADVISER REPRESENTATIVE LICENSING

By Licensing Compliance Counsel Kelly Igoe

When a person applies with the Ohio Division of Securities (the "Division") to be a licensed Investment Adviser Representative (IAR), with a licensed Investment Adviser (IA) firm, it is a well-known fact that a series of numbered industry examinations are a condition to be licensed in Ohio. An IAR applicant must achieve a passing score on one of the various tests administered by FINRA or NASAA to satisfy the minimum competency requirements for licensure.

As an alternative, however, an applicant may qualify for licensure with the Division by providing verification that they are in good standing with the organization that issues credentials for the following designations:

- Certified Financial Planner;
- Chartered Financial Analyst;
- Chartered Investment Counselor;
- Chartered Financial Consultant; and
- Certified Public Accountant with a Personal Financial Specialist designation.¹

These designations are listed below with a quick synopsis of the programs. For more in-depth information, please visit the websites provided.

Certified Financial Planner (CFP)

This program requires that a participant complete college or university level coursework through a program registered with the CFP Board of Standards, Inc., and verify that you hold a bachelor's degree. In order to become certified, the program

has four parts: education, examination, experience, and ethics. The entire program can take up to 24 months to complete. For more information, visit:

www.cfp.net.

Chartered Financial Analyst (CFA) -

Unlike the CFP, the CFA does not require a bachelor's degree, but includes work experience as a pre-requisite for sitting for the exams. The self-study program takes several years to complete as participants must pass three six-hour exams. This program is administered by the CFA Institute. For more information and the cost of this program, visit: www.cfainstitute.org.

Chartered Investment Counselor (CIC)

This designation is sponsored by the Investment Adviser Association (IAA). A key educational component of the program is the requirement that candidates hold a Chartered Financial Analyst (CFA) designation, be employed by a member firm of the IAA, have five years of work experience, and be able to provide work and character references. More details and requirements are found at:

www.investmentadviser.org.

Chartered Financial Consultant (ChFC)

This designation has the most course work required and nine college level courses that must be completed in order to be a participant. The examination is nine closed-book, course specific, two hour examinations, and boasts study time at 400 hours. More information can be found at: www.chfchigheststandard.com.

(Continued on page 9)

¹See Ohio Administrative Code § 1301:6-3-16.1(B)(2).

PERMISSIVE AND PROHIBITED DESIGNATIONS AND CREDENTIALS

By Licensing Chief Anne Followell

As previously discussed, an Investment Adviser Representative can meet the minimum competency requirement for licensure by holding one of the enumerated professional designations. Unfortunately, some individuals may embellish their education or training with designations or credentials they have not earned, credentials that do not exist, or self-conferred credentials or degrees with no legitimate prerequisites.

This summer, the Securities and Exchange Commission (SEC) brought enforcement actions against two investment advisers for making false claims about their experience and industry awards, among other violations. The first case involved Todd M. Schoenberger of Lewes, Delaware.¹ Schoenberger attempted to form an unregistered private fund by soliciting investors through various channels. In soliciting investors, he “touted his appearances on cable news programs to bolster his credibility . . . , create around himself an aura of success, and entice investments in his scheme.”² In marketing materials, he represented that he had a B.A. degree in economics from the University of Maryland (which he did not), and that he had previously worked for a broker-dealer registered with the Commission (without disclosing that he had been terminated from the firm for misuse of company assets).³ The SEC found that Schoenberger willfully violated Section 206 (4) of the Advisers Act and Rule 206 (4)-8 by making “any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor

Anne M. Followell is the Licensing Chief for the Ohio Division of Securities. She joined the Division in October 2007, after working as a business litigation associate in private practice.

As Licensing Chief, she is responsible for reviewing the applications and disclosure reports of securities dealers, investment advisers, and their investment professionals, to ensure they meet the state’s licensing requirements and compliance standards. She also oversees the field examination program for on-site compliance inspections.



Anne represents the Division on the North American Securities Administrators Association (NASAA) CRD/IARD Steering Committee and serves as the Chair of the NASAA CRD/IARD Forms and Process Committee. She is a graduate of Miami University and the Ohio State University Moritz College of Law.

or prospective investor in the pooled investment vehicle.”⁴ In a Consent Order, Schoenberger agreed to pay \$65,000 in disgorgement of ill-gotten gains, plus interest. He also consented to a permanent bar from associating with any broker, dealer, or investment adviser, and from serving as an officer or director of a public company.

The second case was against Michael G. Thomas of Oil City, Pennsylvania.⁵ Thomas touted that he was named a “Top 25 Rising Business Star” by *Fortune Magazine*, as he solicited investors through e-mail blasts and on the website for the pooled investment vehicle he founded.⁶ The purported *Fortune Magazine* recognition does not exist, and the SEC found that Thomas, like Schoenberger, “willfully violated [the Advisor’s Act] . . . by making an untrue statement of a material fact . . . and engaging in any act, practice, or course of business that is fraudulent or deceptive with respect to any investor or prospective investor in a pooled investment vehicle.”⁷ To resolve the

matter, Thomas agreed to pay a \$25,000 penalty and consented to an order requiring him not to participate in the issuance, offer, or sale of certain securities for five years. He is also barred from associating with any broker, dealer, or investment adviser for at least five years.

Like many states, Ohio has adopted the NASAA Model Rule regarding the use of senior-specific designations. The rule appears at [O.A.C. 1301:6-3-44 \(J\)](#), and generally prohibits the use of a certification or professional designation indicating that a person has a special certification or training in advising or servicing senior citizens or retirees, unless the certification or designation is accredited by The American National Standards Institute, The National Commission for Certifying Agencies, or other federal accrediting body.⁸ Any senior-specific certification or designation that is not federally-accredited may only be used if the professional can verify that the designa-

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¹In the Matter of Todd M. Schoenberger, Investment Advisers Act of 1940, Release No. 4101 (June 3, 2015).

²Id. at p. 3.

³Id. at p. 5.

⁴Id. at p. 7.

⁵In the Matter of Michael G. Thomas, Investment Advisers Act of 1940, Release No. 4102 (June 3, 2015).

⁶Id. at pp. 3-4.

⁷Id. at p. 4.

⁸[O.A.C. § 1301:6-3-44](#).

PERMISSIVE AND PROHIBITED DESIGNATIONS AND CREDENTIALS
(Continued)

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tion is valid and has reasonable standards, as described in the rule.

Before investing, all investors should not only check the licensing status of the individual they are working with, but should also take steps to verify the individual's purported credentials, designations, and awards. For many designations, like the Certified Financial Planner, investors can go right to the designating body's website, e.g., www.cfp.net or www.cfainstitute.org, and verify if the individual is a member in good standing.⁹ Investors should not hesitate to ask the investment professional for details about their educational and professional background, including all advertised designations and credentials. The financial professional should be able to explain how they earned the designation and what they must do to maintain it. Investors can also contact the Division if they have questions about the background of the person they are looking to do business with.

For additional information and resources on this topic:

FINRA offers a free Professional Designation Online Tool, which can be used to “decode the letters that sometimes follow a financial professional’s name.” www.finra.org/investors/professional-designations.

SEC’s Office of Investor Education and Advocacy, “Investor Alert: Beware of False or Exaggerated Credentials” June 3, 2015, available at: http://www.sec.gov/oiea/investor-alerts-bulletins/ia_credentials.html

SEC’s Office of Investor Education and Advocacy and the North American Securities Administrators Association jointly issued an Investor Bulletin titled “Making Sense of Financial Professional Titles,” September 11, 2013, available at: <http://investor.gov/news-alerts/investor-bulletins/investor-bulletin-making-sense-financial-professional-titles>

⁹In *SEC v. Innovative Advisory Services, Inc., et al.*, Case No. 10-00423 JVS (RNBX)(C.D. Cal. 2010), the SEC brought a civil action against Richard H. Nickles and his three California companies for a \$3 million securities fraud. As part of the complaint, the SEC alleged Nickles held himself out as a Certified Financial Planner, when in fact, he was not. In April 2011, Nickles was permanently enjoined from further securities violations and his company was ordered to pay a civil penalty of \$725,000.

PROFESSIONAL DESIGNATIONS: REQUIREMENTS FOR INVESTMENT ADVISER REPRESENTATIVE LICENSING
(Continued)

(Continued from page 7)

Certified Public Accountant (CPA) with a Personal Financial Specialist (PFS) designation – Being a CPA is a respected mark of excellence for public accountants. The requirements for the CPA are set by each state board of accountancy. The basic requirements are the completion of a college or university program in accounting, passing the Uniform CPA examination, and meeting the experience requirements (www.nasba.org). Ohio has joined the National Association of State Boards of Accountancy, thus, application can be made to sit for the CPA exam through CPA Central (<https://cpacentral.nasba.org>). The Personal Financial Specialist credential is an additional award given by the American Institute of CPA’s and advertises that the status of CPA/PFS is more than a financial planner, but also a CPA with tax and financial planning expertise. To learn how to qualify to sit for this examination, go to www.aicpa.org.

Did you know ...

... the Ohio Division of Securities (the “Division”) licenses the Investment Officers working on behalf of the five state retirement systems (PERS, Police & Fire, STRS, SERS, and Highway Patrol)? The licensing requirements were enacted in June 2004 – together with other investment management reforms under Senate Bill 133 – and appear in R.C. 1707.162, 1707.163, and O.A.C. 1301:6-3-16.3. The requirements for licensure include: submitting fingerprint cards for a background check, meeting the minimum competency element, which can be accomplished by either passing an examination or earning appropriate credentials, and being of “good business repute.”

Similarly, the Division licenses the Chief Investment Officer for the Bureau of Worker’s Compensation (BWCCIO). This licensing requirement was enacted in September 2005, as part of House Bill 66, and requires an applicant for licensure to be a Chartered Financial Analyst (CFA), submit fingerprint cards for a background check, and be of “good business repute.” See R.C. 1707.164, 1707.165, and O.A.C. 1301:6-3-16.5.

Investment Officers renew their licenses with the Division annually, every fiscal year (July 1 – June 30).

Licensing Statistics	FY12	FY13	FY14	FY15
State Retirement System Investment Officers	83	78	77	80
Bureau of Worker's Compensation Chief Investment Officer	1	1	1	1



Enforcement Section Update

CRIMINAL CASES

PETER A. BECK - Case No. B1304 320
JANET S. COMBS – Case No. B1400 589
JOHN W. FUSSNER – Case No. B1304 320
VERNON “CHIP” DEMOIS – Case No. B1501 561
Hamilton County Court of Common Pleas, Ohio

Following a criminal referral by the Ohio Division of Securities and a criminal trial and conviction, Peter A. Beck was sentenced to four years of incarceration and remanded to custody on August 20, 2015 for 13 criminal counts, including three counts of theft, three securities violations and seven counts of perjury based on false statements he made under oath during a Division investigative hearing. On August 31, 2015, John W. Fussner was sentenced to three years of community control after pleading guilty to two counts of securities fraud. On the same day, Vernon “Chip” DeMois was also sentenced to three years community control and ordered to pay restitution in the amount of \$22,000 after entering a no contest plea to one count of engaging in the unlicensed sale of securities. Janet Combs previously entered a no contest plea to one count of receiving stolen property and was sentenced to five years of community control on January 29, 2015.

Peter A. Beck, John Fussner and Janet Combs were all indicted in a superseding indictment filed February 13, 2014, which included allegations that the defendants defrauded investors out of millions of dollars and then funneled investor funds to various accounts through Christopher Technologies, LLC, TML Consulting, and other related businesses. Instead of being used to fund technology and future development, investor funds were used to pay prior expenses and liabilities that were not disclosed to investors prior to investing in Christopher Technologies, LLC. Investor funds were also funneled through a local church where Combs was the pastor.

RUSSELL L. BOWERMASTER
Case No. 0215-001622
Butler County Court of Common Pleas, Ohio

Following a criminal referral by the Ohio Division of Securities and a grand jury indictment, Russell L. Bowermaster pleaded guilty on August 19, 2015 to four counts of theft, three counts of securities fraud and three counts of misrepresentations in the sale of securities. Bowermaster could face up to 24 years in prison if sentenced to the maximum term. The sentencing hearing is scheduled for October 22, 2015.

The conviction stems from the sale of securities by Bowermaster through his company, Biodontos, LLC, located in Dublin, Ohio. Four Ohio residents invested \$125,000 with Bowermaster and Biodontos, LLC in order to help develop technology related to the storage and use of stem cells. The investor funds were used for gambling at several casinos, credit card payments and other personal expenses. Bowermaster operated a dental office in Butler County, Ohio prior to retiring in 1992.

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ENFORCEMENT SECTION UPDATE

Criminal Cases 10, 12

Administrative Actions..... 11, 12

The Division’s Enforcement Section is a criminal justice agency authorized to investigate and report on all complaints and alleged violations of the Ohio Securities Act and related rules.

The Enforcement Section attorneys represent the Division in prosecutions and other matters arising from such complaints and alleged violations.

OHIO DIVISION OF SECURITIES

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ADMINISTRATIVE ACTIONS

Division Order No. 15-008
KENNETH F. DUNNAVANT, JR.
CRD No. 1837121
LAKESIDE FINANCIAL ADVISORS, LLC
CRD No. 149077
Sandusky, Ohio

On June 11, 2015, the Division revoked the Investment Adviser license of Lakeside Financial Advisors, LLC and the Investment Adviser Representative license of Kenneth F. Dunnavant, Jr. After a hearing conducted pursuant to *Goldman v. State Medical Board*, 110 Ohio App. 3d 124 (1996), the Division found that Dunnavant and Lakeside failed to respond to multiple requests to schedule an on-site examination and failed to update their ADV to provide for a new business address. The Division further found that Mr. Dunnavant failed to appear for testimony and failed to produce documents and records required pursuant to a subpoena issued by the Division. Dunnavant was indicted on unrelated criminal charges of theft and forgery in Case Number 2015 CR 0092 filed in the Erie County Court of Common Pleas on February 20, 2015, three months after the original Notice Order was issued by the Division in this matter.

Division Order No. 15-009
DARRIN B. FARROW
CRD No. 1995240
Rocky River, Ohio

On July 22, 2015, the Division issued a Cease and Desist and Suspension Order with Consent against Darrin B. Farrow, who effected six sales of membership interests in MAD Oregon, LLC, between March 9, 2015 and June 8, 2015 without disclosing those sales to his Investment Adviser firm, Royal Alliance Associates, Inc. Farrow is the Manager and an Executive Officer of MAD Oregon, LLC. The transactions were not recorded on the books or records of Royal Alliance. Farrow consented to a 45-day suspension.

Division Order Nos. 15-010 and 15-011
KEVIN K. ASHE
CRD No. 5770916
Worthington, Ohio

On July 31, 2015, the Division issued an Order Suspending the Securities Salesperson License of Kevin K. Ashe based on a finding that he failed to pay child support and failed to comply with a warrant or subpoena issued by the Franklin County Child Support Enforcement Agency ("FCCSEA"). On August 4, 2015, the Division issued an Order reinstating his securities salesperson license after receiving a notice from FCCSEA that Ashe was no longer in default on his child support obligations.

Division Order No. 15-012
THOMAS HENRY ROULSTON, III
CRD No. 1038010
THOMAS ROULSTON III INVESTMENT
PARTNERS, INC.
CRD No. 118822
ROULSTON BUYSIDE RESEARCH, LLC
Cleveland, Ohio

On September 1, 2015, the Division issued a Notice of Opportunity for Hearing and Notice of Intent to Suspend or Revoke the Ohio Investment Adviser and Investment Adviser Representative Licenses of Thomas Roulston III Investment Partners, Inc. and Thomas Roulston, III and a Notice of Intent to Issue a Cease and Desist Order against Thomas Henry Roulston, III and his companies, Thomas Roulston III Investment Partners, Inc. and Roulston Buyside Research, LLC based on allegations that the firm is insolvent. The Order further alleges that Roulston defrauded his clients by selling securities issued by Roulston Buyside Research without informing them that the funds would be funneled to Thomas Roulston III Investment Partners, Inc. to buttress his insolvent investment advisory business.

Division Order No. 15-013
CHELESTRA LIMITED D/B/A LBinary
Gibraltar

On September 12, 2015, the Division issued a Cease and Desist Order against Chelestra Limited d/b/a LBinary based on findings that, through its website www.lbinary.com, Chelestra acted as an unlicensed securities dealer and investment adviser by soliciting the sale of binary options in exchange for a fee and providing investment advice to investors who open an account online. The Division further found that Chelestra misrepresented material facts in the sale of securities, in part, by advertising returns up to 720% and engaged in fraudulent, manipulative and deceptive conduct by failing to inform investors of the high risk involved in binary options and by failing to provide proper disclosures about the nature and terms of their investments.

Division Order No. 15-015
AARON CHRISTOPHER GRIFFIN
ARMORED CAPITAL, LLC
Youngstown, Ohio

On September 5, 2015 the Division issued a Cease and Desist Order with Consent against Aaron Christopher Griffin and Armored Capital, LLC based on findings that they engaged in the solicitation and sale of unregistered securities through their website at www.armoredcapital.com. The Division found that Griffin and Armored Capital sold securities that offered returns based on purchasing, rehabilitating and selling distressed properties in the Youngstown, Ohio area.

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CRIMINAL CASES (Continued)

(Continued from page 10)

BERNARD MINNEYFIELD

Case No. 14 CR 6460

Franklin County Court of Common Pleas, Ohio

Following a criminal referral by the Ohio Division of Securities and a grand jury indictment, Bernard Minneyfield, a Gahanna resident, entered a guilty plea on September 22, 2015 to two counts of misrepresentations in the sale of securities. The amount of restitution will be determined at the sentencing hearing scheduled on November 13, 2015, where Minneyfield could be sentenced to up to four and a half years in prison.

Minneyfield solicited at least \$30,000 in 2009 and 2010 from two investors in M&M Capital Partners, LLC, located in Gahanna, by claiming that he would be able to provide large returns on their investments through day trading. Instead of using their investment funds for day trading, Minneyfield converted the money for his personal use. Minneyfield met both investors through a local church. Minneyfield was not licensed as a securities salesperson or investment adviser by the Division.

STEVEN P. MOORE

Case No. 14 CRI 10 0455

Delaware County Court of Common Pleas, Ohio

Following a criminal referral by the Ohio Division of Securities and a grand jury indictment, Steven P. Moore of New York City, a former Columbus, Ohio hedge fund manager for Moore & Company Capital Management, LLC, pleaded guilty to one count of fraud in the sale of securities, a felony of the fourth degree. Moore agreed to pay restitution in the amount of \$25,000.00 to an elderly victim he convinced to invest in his hedge fund.

Moore sold limited partnership interests in the Opportunity Fund, a hedge fund for which Moore & Company Capital Management, LLC was the general partner. The investment in the hedge fund was supposed to be used in the financial markets. The funds were used for purposes other than those presented to the elderly investor. Moore was sentenced on October 12, 2015. He received three years of community control and was ordered to pay \$25,000 in restitution and a fine of \$5,000.

PETER WILSON

Case No. CR-14-584064-A

Court of Common Pleas, Cuyahoga County, Ohio

Following a criminal referral by the Ohio Division of Securities and a grand jury indictment, Peter Wilson of Rocky River, Ohio pleaded guilty to one count of securities fraud and one count of aggravated theft and was sentenced on July 7,

2015 to five years of community control. Wilson paid \$30,000 in restitution to victims and was ordered to pay another \$80,000 in restitution as part of his sentence imposed by the Court.

The conviction and sentence are based on misrepresentations Wilson made to Ohio investors that their investment would be used to purchase an ownership interest in a spirituous liquor company. Instead, Wilson used investor money to fund tuition at a private university and for his own personal spending.

In 2005, prior to the indictment in this case, Wilson was permanently enjoined from trading in securities, with limited exception, by Judge Patricia Gaughan of the U. S. District Court, Northern District of Ohio after a complaint was filed by the United States Securities and Exchange Commission alleging securities fraud and other violations.

ADMINISTRATIVE ACTIONS (Continued)

(Continued from page 11)

Division Order No. 15-016

EDWARD I. CAMPBELL

ROSEWOOD CONSULTING, LLC

Baltimore, Ohio

On September 10, 2015 the Division issued a Cease and Desist Order against Edward I. Campbell and Rosewood Consulting, LLC based on findings that Campbell and Rosewood solicited and sold Chinese Reorganization Gold Loan Bonds and related investment contracts to two Ohio investors without proper licensure and registration from the Division. The Division further found that Campbell and Rosewood sold the securities through fraudulent and misleading statements on their website and LinkedIn pages, including allegedly false information about Campbell's background, quick and substantial returns on investment and guaranteed principal values. Neither Campbell nor Rosewood requested an administrative hearing in this matter.

Division Order No. 15-017

THE JAMES PIER COMPANY, INC.

CRD 160140

JAMES PIER

CRD 1723350

Fairview Park, Ohio

On September 14, 2015 the Division issued a Notice of Intent to Suspend or Revoke the Investment Adviser and Investment Adviser Representative Licenses of The James Pier Company and James Pier based on allegations that they repeatedly failed to respond to multiple examination requests issued by the Division.



SECURITIES EXCHANGE

CYBERSECURITY RISKS, REGULATION, AND RESOURCES

By: Shane B. Hansen - Partner, Carly Zagaroli - Associate, Paul Bratt - Summer Associate
WARNER NORCROSS & JUDD LLP

OHIO SECURITIES EXCHANGE

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OHIO SECURITIES EXCHANGE

The Ohio Securities Exchange provides a platform where views and opinions relating to the securities industry can be shared from sources outside the Division.

The Division encourages members of the securities community to submit articles pertaining to securities law and regulation in the state of Ohio.

If you are interested in submitting an article, please contact the Editor-In-Chief,

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OVERVIEW

Those convenient ‘clouds’ of electronically stored or accessed data and personal information also contain ‘lightning’ that can strike unprepared investment firms and their clients. Criminal enterprises behind these attacks have become more sophisticated and often involve domestic or foreign organized crime syndicates, foreign nationals and even foreign governments—no longer just techno-geeks and petty thieves.

A 2014 pilot survey by state securities regulators¹ found that 4.1% of state-registered investment advisers had experienced a cybersecurity incident and 1.1% had experienced theft, loss, or unauthorized exposure or misuse of confidential information. Cybersecurity experts (including cybersecurity consulting firms marketing their services) believe the “hit rate” is likely higher. With the U.S. government,² the Securities and Exchange Commission (SEC),³ the North American Securities Administrators Association (NASAA),⁴ the Financial Industry Regulatory Authority (FINRA),⁵ and news media sounding sirens of cyber threats, do not be caught unawares sleeping under a tree when the lightning strikes at your firm and your clients.

CONNECTIVITY IS CONVENIENT BUT RISKY

Today you need more than gates, guards, and guns to prevent criminals from getting away with the firm’s and client’s identities or cash. Email, computers, laptops, tablets,

internet-based information access or storage, smartphones, internet-connected hardware and related software, flash drives, wireless communications—all the modern conveniences—create ample opportunity for a tech-savvy intruder to monitor, gain access to, and misappropriate confidential information. Smartphone applications like “Swipe” and “Swift Key” include seemingly helpful features that “learn” and adapt to your (bad) typing habits by tracking your every key entry on their remote file servers—convenient, yes, but the person with access to that remote file server can potentially see every password and ID you type. Frequently, hi-tech platforms and data aggregators gather, store, and allow access to both clients’ and the firm’s own confidential personal information. Access to client information and emails can later be translated into highly convincing identity theft schemes. The days of physical computer tapes, CDs, DVDs, and manual data backups are largely gone—replaced by more reliable third-party “cloud” servers and systems. However, today’s remarkable connectivity and convenience through networks, the internet, and the digital cloud create cyber vulnerabilities.

Firms are susceptible to various kinds of cyber threats, some more serious than others. Unencrypted laptops, tablets, smart phones, and similar devices are easy targets if lost or mislaid, particularly if not password-protected. Unencrypted email is easily intercepted, especially when email addresses are stolen from other sources, such as big

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¹North American Securities Administrators Association, *Compilation of Results of a Pilot Survey of Cybersecurity Practices of Small and Mid-Sized Investment Adviser Firms* (September 2014), <http://www.nasaa.org/wp-content/uploads/2014/09/Cybersecurity-Report.pdf> (“NASAA Survey”).

²U.S. Computer Emergency Readiness Team (“US-CERT”), National Cybersecurity and Communications Integration Center (NCCIC), Department of Homeland Security, <https://www.us-cert.gov/about-us>.

³Cybersecurity Risk Alert, SEC, <http://www.sec.gov/ocie/announcement/Cybersecurity-Risk-Alert--Appendix--4.15.14.pdf>.

⁴NASAA Survey Finds Mid-Sized IAs Addressing Cybersecurity Risks, NASAA, <http://www.nasaa.org/32570/nasaa-survey-finds-mid-sized-ias-addressing-cybersecurity-risks/>.

⁵Customer Information Protection, FINRA, <http://www.finra.org/Industry/Issues/CustomerInformationProtection/>.



SHANE B. HANSEN is a partner and co-chairs the Funds and Investment Services Practice in the law firm of Warner Norcross & Judd LLP. His law practice concentrates in the area of financial services regulation, primarily involving federal and state securities and banking laws and related rules.

Mr. Hansen serves as the lead counsel and primary draftsman of H.R. 2274, the *Small Business Mergers, Acquisitions, and Sales Brokerage Simplification Act of 2013*. Mr. Hansen is a member of the Business Law Section Council, State Bar of Michigan (2014-present) and is a long-time active member of both the Section's Securities and Financial Institutions Committees. He is the immediate past chair of the Committee on State Regulation of Securities in the Business Law Section of the American Bar Association (2011-2014). He co-chairs its Subcommittee of Liaisons to Securities Administrators in the U.S. and Canada (2007-present). He is also an active member of the ABA's Committee on Federal Securities Regulation. Mr. Hansen graduated with honors from the University of Michigan Law School in 1982. He graduated with high honors from Albion College in 1979.

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box retailers. How often have you forgotten your password to personally access a website and simply clicked to have it emailed to you—are *you* the *only* person receiving it? Many consumer-grade file-sharing websites and systems are not designed with strong cybersecurity protections. These file-sharing systems may be simple and cheap—great for personal photo sharing—but may not be suitable for the type of confidential personal, financial, and business data transmitted and stored by financial services firms.

Malware, digital worms, and key-logging software are commonly spread through e-mail, spurious applications and program updates, Trojan horse file attachments, and visiting infected websites. Phishing emails continue to be a common attack strategy. There are cyber threats to the computer operating systems you use to conduct daily business—not just your own systems, but

also third-party systems and websites you rely upon to serve your clients. A “botnet”—short for robot network—is an accumulation of compromised computers (called “zombies”) manipulated by a central computer or “controller.” Botnets have the ability to overload web servers, to steal data, and may be difficult to detect. Distributed denial of service (DDoS) attacks can stall business operations for hours or even longer—your website or third-party websites you rely upon to monitor portfolios or enter trades. These attacks have been used to extort “ransom” from the web host in exchange for resumed operations. In the meantime, you may be unable to access or use the website.

CYBER-RELATED REGULATIONS

Assessing and planning for cybersecurity risks has become a high regulatory priority. On September 15, 2015, the SEC Office of Compliance Inspections and Examinations (“OCIE”) issued a

release, *Cybersecurity Examination Initiative*, summarizing its examination priorities, which will involve more testing to assess implementation of firm procedures and controls.⁶ OCIE’s focus will include: governance and risk assessment, access rights and controls, data loss prevention, vendor management, training, and incident response. The release includes a sample of OCIE’s requests for information and documents.

PRIVACY AND SAFEGUARDING RULES

Important privacy regulations derive from the Financial Services Modernization Act of 1999, more commonly called the Gramm-Leach-Bliley (GLB) Act.⁷ The GLB Act directed the SEC,⁸ the Federal Trade Commission (FTC),⁹ and the federal bank regulatory agencies to adopt consumer privacy regulations. The FTC does not examine state-registered investment advisers, but may respond to client complaints and referrals from state securities regulators.

SEC Regulation S-P, *Privacy of Consumer Financial Information*, applies to SEC-registered broker-dealers and investment advisers. Regulation S-P implemented sections of the GLB Act and the Fair Credit Reporting Act (FCRA) for entities registered with and regulated by the SEC. SEC Rule 30 (Safeguarding Rule) requires registrants to “adopt written policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information.”

State-registered investment advisers are covered by the FTC’s *Privacy of Consumer Financial Information* rule. The

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⁶Available at: <http://www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf>. See also FINRA Targeted Examination Letters-Cybersecurity, <http://www.finra.org/industry/regulation/guidance/targetedexaminationletters/p443219>.

⁷Title V of the Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999), 15 U.S.C. § 6801, *et seq.*

⁸SEC Regulation S-P, *Privacy of Consumer Financial Information*, 17 C.F.R. § 248 (2000).

⁹FTC, *Standards for Safeguarding Customer Information*, 16 C.F.R. Part 314, 67 FR 36493 (2002).

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FTC's rule is more rigorous than the SEC's Regulation S-P. Notably, it requires state-registered firms to "develop, implement, and maintain a *comprehensive information security program* that is written in one or more readily accessible parts and contains administrative, technical, and physical safeguards that are appropriate to your size and complexity, the nature and scope of your activities, and the sensitivity of any customer information at issue."

SEC – CFTC IDENTITY THEFT RED FLAGS RULES

As the name implies, the federal identity theft rules direct covered firms to take steps to prevent losses caused by identity theft through unauthorized account orders or access, including impersonations. The SEC and the Commodities Futures Trading Commission (CFTC) jointly adopted rules implementing identity theft red flags and guidelines under the Fair and Accurate Credit Transactions Act of 2003 (FACTA), which amended the Fair Credit Reporting Act (FCRA). The SEC's version is Regulation S-ID, Section 248.201, and the CFTC's version is Subpart C, Section 162.30, both titled *Duties Regarding the Detection, Prevention, and Mitigation of Identity Theft* (Red Flags Rules). The SEC-CFTC Red Flags Rules apply to SEC and CFTC registrants; the FTC's Red Flags Rule applies to state-registered investment advisers.

Generally, the Red Flags Rules require a covered financial institution to develop, implement, and administer a written identity theft prevention program. The

CARLY A. ZAGAROLI joined Warner Norcross & Judd LLP's Grand Rapids, Michigan office in September 2014. She received her law degree from the Michigan State University College of Law *summa cum laude* where she was a King Scholar. She also holds a bachelor of arts *magna cum laude* in sociology from Saint Mary's College in Indiana. Zagaroli has served as an extern in the 17th Circuit Court for the Hon. G. Patrick Hillary and the Hon. George J. Quist.



Paul Bratt interned as a Summer Associate in Warner Norcross & Judd LLP's Grand Rapids, Michigan office during the Summer of 2015. Paul is currently enrolled at the University of Michigan Law School.

program's purpose is to detect, prevent and mitigate identity theft in connection with the direct or indirect opening or maintenance of a covered account.¹⁰

FINRA CYBERSECURITY RULES AND GUIDANCE

FINRA's website provides cybersecurity guidance and resources for brokerage firms.¹¹ FINRA has provided guidance about cybersecurity issues, including risks related to wireless fidelity (Wi-Fi) and remote access networks.¹² Accordingly, a broker-dealer's written supervisory and control procedures must address compliance with the SEC's Safeguarding and Red Flags Rules under FINRA Rules 3110, 3120, and 3130.

Cybersecurity and identity theft prevention measures intersect in FINRA Rule 3110(c)(2). This rule requires brokerage firms to have policies and procedures to address safeguarding customer funds and securities; transmittals of funds (e.g., wires or checks, etc.) or securities from customers to third party accounts; from customer accounts to outside entities (e.g., banks, investment companies, etc.); from customer accounts to locations other than a customer's primary residence (e.g., post office box, in care

of accounts, alternate address, etc.); and between customers and registered representatives, including the hand-delivery of checks. Policies and procedures must also build controls around changes of customer account information, including address and investment objectives changes and validation of such changes. These are among the leading circumstances surrounding identity theft losses.¹³

STATE BREACH NOTIFICATION LAWS

Forty-seven states require security breach notifications.¹⁴ Firms must report identified data breaches to all affected customers and, typically, to government authorities. Requirements do vary significantly by state and are not preempted by federal law. Twenty-nine of those laws contain exceptions or safe harbors for firms that are subject to, and/or comply with federal privacy laws and related rules promulgated by their federal regulator. However, the SEC has not adopted breach notification requirements, so its rules likely do not preempt state laws. Forty-seven states have also enacted "security freeze" laws that allow customers to

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¹⁰See also *Fighting Identity Theft with the Red Flags Rule: A How-To Guide for Business*, FTC, May 2013, <http://www.business.ftc.gov/documents/bus23-fighting-identity-theft-red-flags-rule-how-guide-business>.

¹¹FINRA Customer Information Protection, <http://www.finra.org/Industry/Issues/CustomerInformationProtection/>; Firm Identity Theft, <http://www.finra.org/Industry/Issues/CustomerInformationProtection/p117442>.

¹²NASD Notice to Members 05-49, *Safeguarding Confidential Customer Infor-*

mation (2005), http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_014772.pdf.

¹³The FINRA report is available at http://www.finra.org/sites/default/files/p602363%20Report%20on%20Cybersecurity%20Practices_0.pdf.

¹⁴See National Conference of State Legislatures website for a list of states at: <http://www.ncsl.org/research/telecommunications-and-information-technology/security-breach-notification-laws.aspx>.

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freeze their credit reports in the event of a security breach. The national credit reporting agencies charge for security freezes, likely an expense of the firm whose cybersecurity was breached. Firms with clients in multiple states will be subject to multiple state laws with differing reporting obligations.

BUSINESS CONTINUITY PLANNING AND DISASTER PREPAREDNESS

Cyber-attacks on a firm or on a third-party vendor upon which the firm relies can have a devastating impact on normal operations and should therefore be among the risks addressed in business continuity and disaster recovery planning. For example, ransomware is a flavor of malware restricting access to the computer system that it infects. The infection is then accompanied by extortionate demands for access to be restored. Ransomware may encrypt files on the computer's hard drive, lock up the system, or simply threaten data erasure if the ransom is not promptly paid. Denial of service attacks are another form of business interruption. Cybersecurity risks intersect with recordkeeping requirements when books and records are stored or archived in the cloud. Specifically, if records are stored in electronic form it must be protected from alteration, loss, or destruction.¹⁵

CYBERSECURITY RESOURCES AND PLANNING

Commonly cited by cyber-industry experts, the National Institute of Standards and Technology (NIST), an agency of the U.S. Department of Commerce, released the first version of the *Framework for Improving Critical Infrastructure Cybersecurity* on February 12,

2014 (Framework).¹⁶ The Framework consists of voluntary standards, guidelines, and practices to promote the protection of critical infrastructure. The Framework is industry neutral, and therefore relevant to all types of businesses. The NIST's Computer Security Division published NISTIR 7621, *Small Business Information Security: The Fundamentals*, to help small businesses and small organizations implement the fundamental components of an effective information security program.

In addition, the Securities Industry and Financial Markets Association (SIFMA) published useful *Guidance for Small Firms*,¹⁷ including a *Small Firm Cybersecurity Checklist*. These resources are useful to all business models, not just broker-dealers. These resources will aid in your development of a firm-specific approach to cybersecurity risks as you develop policies, procedures, and a program to safeguard your clients' and firm's information.

So, how to get started? Each firm's circumstances will be different, so each cybersecurity risk assessment and each program will be different, but here are some basic suggestions:

Muster an internal team. Its members should include IT, operations, compliance, and front-line and back-office representatives. Involve senior management. Identify gaps in expertise—likely technology—and engage outside support. Keep records of the team's composition, meetings, and related activities.

Develop written cybersecurity and identity theft game plans. Written records are critical in demonstrating your team's efforts to regulators and courts. Set and update written priorities and progress reports.

The Red Flags Rules include specific guidance with helpful content.

FINRA created a template designed to help small firms develop and document their "red flags" program.

Start with the basics. Identify the technology you are using to remotely connect to email and client information, including technology allowing clients' remote access and assess its vulnerabilities—think about all office, home, and mobile devices. Install and update antivirus software, implement passwords and user IDs.

Revisit your plan periodically and when prompted by changes. When employees, representatives, and third-party vendors change, change log-ins and user access rights. New offices, new employees and representatives, new services, new vendors, and new technologies should trigger a reassessment of related cybersecurity risks.

Password management. Require and train all employees and representatives to use and periodically change passwords and user IDs on all electronic devices (e.g., computers, tablets, and other mobile devices).

Antivirus Software, Patches, and Encryption. Install and update antivirus software on all electronic devices. Check for application updates and promptly install security patches. Install encryption software on files, emails, and mobile electronic devices.

Vendors. Do your due diligence before contracting with cloud service providers. Beware of free cloud services for data storage, back-up, and file sharing.

Train and Educate. Train employees and representatives, and educate clients, on common cybersecurity risks and defensive strategies.

¹⁵For SEC-registered investment advisers, see Rule 204-2(g), 17 C.F.R. 275.204-3; state law imposes similar requirements on state-registered investment advisers. For broker-dealers, see SEC Rules 17a-3 and 17a-4, 17 C.F.R. 240.17a-3 *et seq.*

¹⁶Nat'l Inst. of Standards and Tech., *Framework for Improving Critical Infrastruc-*

ture Cybersecurity (February 12, 2014), <http://www.nist.gov/cyberframework/upload/cybersecurity-framework-021214-final.pdf>.

¹⁷Available at <http://www.sifma.org/issues/operations-and-technology/cybersecurity/guidance-for-small-firms/>.

ALTERNATIVE MUTUAL FUNDS

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WHAT ARE ALTERNATIVE INVESTMENTS?

In its simplest definition, alternative investments are investments that are not just long positions in traditional investments, which would include equities, fixed income, and cash.¹ They can also be defined as investments that follow nontraditional or complex trading strategies.² These are decidedly broad definitions and there is no consensus on a specific description.

Alternative Assets	• Not equities, fixed income, or cash
Alternative Strategies	• Use of hedging, leverage, derivatives, shorting

However, we can distinguish between alternative assets, such as commodities, and alternative strategies, such as long/short equity. Furthermore, it is important to observe that alternative investments can be accessed through a variety of vehicles, such as private funds and mutual funds.³ The table below highlights some alternative asset classes, strategies, and vehicles. This is not an exhaustive list and what is considered to be alternative can vary by source. This white paper will focus on alternative investment mutual funds.

An asset class is a group of securities that have similar financial characteristics, with the three primary ones being equi-

Alternative Assets	Alternative Strategies	Vehicles
<ul style="list-style-type: none"> • Currency • Commodities • Infrastructure • Private Equity • Real Estate • Volatility 	<ul style="list-style-type: none"> • Arbitrage • Bear Market • Event-Driven • Long/Short Equity • Market Neutral • Managed Futures • Global Macro • Long/Short Debt 	<ul style="list-style-type: none"> • Direct • ETFs/ETNs • Hedge Funds • Mutual Funds • Private Funds • SMAs • Variable annuity sub-accounts
<ul style="list-style-type: none"> • Multialternative 		

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ties, fixed income, and cash.^{4,5} However, what is considered nontraditional can change over time.

Alternative strategies can consist of all traditional assets, all alternative assets, or a mixture of both. What matters is the strategy. A long/short equity fund, for example, may consist entirely of stocks traded on the major US exchanges, but differ from a stock fund due to its ability to short. Some characteristics of alternative strategies include the (sometimes extensive) use of hedging, leveraging, derivatives, short selling, and opportunistic investing.

Morningstar, Lipper, and HFRI provide definitions by alternative asset and strategy.^{6,7,8}

WHY DO PEOPLE INVEST IN ALTERNATIVE INVESTMENTS?

According to a survey conducted jointly by Morningstar and Barron's, the top three reasons that institutions and advisors use alternative investments are diversification, better risk-adjusted returns, and absolute returns.⁹ Let's touch on each of these.

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¹Introduction to Alternative Investments, CAIA Association, Apr. 24, 2012.

²Alternative Funds Are Not Your Typical Mutual Funds, FINRA, <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/MutualFunds/P278033>.

³10 Myths Surrounding Alternative Investments, BlackRock, Jul. 2013. <http://www.blackrock.com/investing/literature/market-commentary/10-myths-surrounding-alternative-investments-commentary.pdf>.

⁴Asset Classes, TIAA-CREF Financial Services, https://www.tiaa-cref.org/public/advice-guidance/education/saving-for-retirement/basics/asset_classes?p=1331944007105.

⁵Asset Classes Explained, BlackRock, <http://www.blackrockinternational.com/individual/en-is/getting-started/understanding-investments/asset-classes-explained>.

⁶The Morningstar Category Classifications, Morningstar, Apr. 30, 2014, http://corporate.morningstar.com/us/documents/MethodologyDocuments/MethodologyPapers/InvestorCategory_Classifications.pdf.

⁷HFRI Strategy Definitions, Hedge Fund Research, <https://www.hedgefundresearch.com/?fuse=indices-str>.

⁸Lipper Global Classification, Lipper, Aug. 2014, http://www.lipperweb.com/docs/Research/Methodology/Lipper_Global_Classifications_Definitions2014.pdf.

⁹Morningstar Barron's Alternative Investment Survey 2013-2014, Morningstar, Jul. 22 2014, <http://corporate1.morningstar.com/US/Alternative-Investment-Survey/>.

ALTERNATIVE MUTUAL FUNDS (Continued)

(Continued from page 17)

One of the lessons of the last recession is that correlations among asset classes can increase in a financial crisis (in other words, the assets are more likely to go down at the same time), as shown in a study by BlackRock, which compares correlations for the last 15 years, and correlations during the “Great Recession.”¹⁰

A lower correlation among investments means that not all investments should go up or down in value at the same time, potentially resulting in less volatile returns for a properly allocated portfolio over a long period of time. This is what is referred to as diversification benefits and bears out for many (but not all) alternative assets and strategies in a simple study by NPH. However, correlation simply measures how much returns move in the same direction, not how desirable those returns are or how suitable those funds may be.

Correlation also says nothing about volatility or left-tail risk (the risk of a catastrophic loss). Some alternative strategies can reduce volatility and left-tail risk, which, along with a lower correlation, can lead to enhanced risk-adjusted returns at the portfolio level, as it bears out for some (but not all) assets and strategies in NPH’s simple study. However, it is absolutely critical to realize that the last three years have been very favorable for equity and bond markets alike, and lack any shocks like those experienced in the last recession or the potential shock of a sharp increase in interest rates. As such, these metrics would be more useful if the alternative funds had a long enough track record to cover a full market cycle. Additionally, lower risk metrics do not mean better returns. Nonetheless, some strategies, over a full market cycle, can have better risk-adjusted returns and benefit a properly allocated and suitable portfolio.

Absolute Strategies	Directional Strategies
<ul style="list-style-type: none"> • Arbitrage • Event-Driven • Market Neutral • Managed Futures 	<ul style="list-style-type: none"> • Bear Market • Long/Short Equity • Global Macro • Long/Short Debt
<ul style="list-style-type: none"> • Multialternative 	

Finally, let’s touch on absolute returns, which simply refers to returns that are independent of traditional asset classes, and is usually characterized by low correlation (neither highly positive nor highly negative). Some alternative strategies

are meant to provide absolute returns (generated regardless of the market direction) while others are meant to provide directional returns (generated by the anticipated direction of the market). Arbitrage is an example of an absolute strategy, which seeks to take advantage of the discrepancy between two prices and can produce positive returns even in a declining market. Long/short equity is an example of a directional strategy, which places bets on which securities will go up and which ones will go down. However, a fund that claims absolute returns will not necessarily achieve that result.

Mutual Fund Protections as compared to Hedge Funds



WHAT ARE THE RISKS AND LIMITATIONS?

As mentioned in the previous section, one of the main limitations of alternative mutual funds is a short track record for many of the strategies, which hampers performance analysis. Other limitations include derivative risk, short sale risk, and regulatory risk. Overall, alternative mutual funds have more complex strategies that may be more difficult for a client to understand and may actually increase, rather than decrease, risk (some alternative funds have had high correlation, higher volatility, or a higher negative skew, relative to equity and bond index funds).

Due to the short track record of many alternative mutual funds, it is not possible to fully analyze the return and risk characteristics of the funds and how they interact with traditional investments. Many alternative asset classes and strategies actually already exist in the hedge fund world. While the strategies may be similar, there are key differences. Mutual funds are regulated under the Investment Company Act of 1940, which limits their operations in ways that do not apply to unregistered hedge funds. The chart on the next page highlights some of the protections found in mutual funds.¹¹ These protections mean that hedge fund strategies cannot be fully

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¹⁰The New Diversification: Open Your Eyes to Alternatives, BlackRock, Apr. 2014. <http://www.blackrock.com/investing/literature/brochure/open-your-eyes-to-alternatives-conversation-with-chris-geczy.pdf>.

¹¹Alternative Funds Are Not Your Typical Mutual Funds, FINRA, supra.

ALTERNATIVE MUTUAL FUNDS (Continued)

(Continued from page 18)

implemented in a mutual fund structure and therefore may not be comparable.

While many alternative mutual funds seek to reduce risk, some may seek to enhance or magnify returns, be opportunistic, and take high-risk concentrated bets. This can result in higher volatility and higher left-tail risk. Additionally, some strategies may give the appearance of low risk for long periods of time, until they are exposed to an unanticipated stress that can cause a catastrophic loss in value. It also takes more effort to monitor complex strategies, derivatives, and sudden movements. A simple oversight can lead to a significant loss. While mutual funds have liquidity requirements, alternative mutual funds may have higher allocations to illiquid investments than traditional mutual funds.

The prospectus for each fund will go over specific risks. Commodity and managed futures funds have unique risks due to IRS' requirement that funds not derive more than 10% of gross income from commodity-linked securities in order to qualify as a registered investment company (RIC) for tax purposes. Commodity and managed futures funds get around this by creating a controlled foreign corporation and previously obtaining a private letter ruling (PLR) from the IRS. However, the IRS suspended such rulings in 2011. The Investment Act of 1940 also limits investments in master limited partnerships (MLPs) to no more than 25% of the fund's assets. Funds fully dedicated to MLPs get around this by forgoing RIC status and instead operating as a C-corporation, which negates many of the tax benefits typically associated with mutual funds.

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FEES

Below are average prospectus net expense ratios for the various alternative categories per Morningstar. Morningstar does not have separate categories for Arbitrage, Event Driven, Global Macro, or Long/Short Debt.

CONDUCTING DUE DILIGENCE

FINRA issued a notice on alternative mutual funds, in which it highlights some key points to keep in mind when conducting due diligence.¹²

(Continued on page 20)

Category	Avg. ex C, LW Share	Avg. C Share
Bear Market	1.95%	2.41%
Commodities Broad Basket	1.21%	2.10%
Commodities Precious Metals	1.78%	-
Long-Short Equity	1.74%	2.70%
Managed Futures	1.94%	2.72%
Market Neutral	1.67%	2.48%
Multialternative	1.92%	2.70%
Multicurrency	1.31%	2.00%
Nontraditional Bond	1.21%	2.09%
Real Estate	1.20%	2.05%

Source: Morningstar – Advisor Workstation
 Note: Average of the Prospectus Net Expense Ratio. The load-waived (LW) share class is omitted since it is the same as Class A. C-Share is separated out due to the high 12b-1 / shareholder fee, which skews the average.

¹²Id.

(Continued from page 19)

HOW MUCH OF A PORTFOLIO SHOULD BE ALLOCATED TO ALTERNATIVES?

There is no single answer to how much of a portfolio should be allocated to alternative investments. It depends on the goal (risk reduction or additional sources of alpha, for example), the composition of the existing portfolio, the composition of the proposed alternatives portfolio, and the client's profile.

In 2011, Morningstar compiled information on guidelines used by wirehouses. It concluded that the average range seemed to be around 15% to 20%.¹³ Suitable allocations can be as low as 0%, though, depending on the client's profile and other factors.

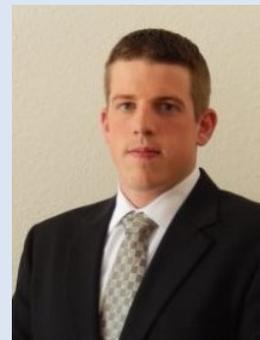
Other studies often point to the allocations used by large institutions. However, some institutions are very large and have infinite lives so that their allocations are not comparable to those of individuals.

When determining a client's potential exposure to alternative investments, always be mindful of the suitability considerations of the client and follow your firm's policies regarding the maximum amount of a client's portfolio that can be allocated to alternative investments.

FINAL THOUGHTS

The growth of offerings in the liquid alternatives space creates positive externalities for mutual fund investors. For one, the increasing product breadth allows investors to be more selective with their investment. Two, the increasing number of funds heightens competition among fund managers and fund companies, which in turn may lead to lower fees and increased quality in products over time. Third, increased offerings results in increased exposure, which may result in heightened scrutiny and due diligence within the space overall. This has already been seen with the launch of the SEC sweep exam of alternative mutual funds last year. However, just as there are benefits in growth, accelerated growth also has negative side effects. For instance, many of the funds that exist today have less than a 5 year track record and have yet to experience a major drawdown in the capital markets (as seen in 2008-2009). Furthermore, there is unknown risk surrounding whether these funds are being properly managed and whether they are operating within the regulatory guidelines outlined in the Investment Company Act of 1940, a concern of which is a major focus of the SEC sweep exam. Finally, as more and more product comes to market, standard definitions and the development of proper benchmarks for performance and risk analysis becomes more difficult.

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In summary, there are unknowns moving forward in the alternative mutual fund space. However, there are key takeaways for investors to be aware of, which have been outlined in this white paper and summarized as follows:

- Mutual funds that invest in traditional assets classes, but also seek to sell short, hedge, utilize leverage, and/or invest opportunistically may be considered alternative.
- Alternative mutual funds may be able to provide increased diversification, enhance risk adjusted returns, and/or earn positive returns in up and down markets.
- Mutual funds are regulated under the Investment Company Act of 1940, which limits their operations in ways that do not apply to unregistered hedge funds. As such, investors should be cognizant that mutual funds replicating hedge fund strategies will often vary in strategy execution (use of leverage, collateral, liquidity, etc.).
- Alternative mutual funds can be pricey relative to their traditional managed fund peers. It is common for alternative funds to have annual operating expenses of around 1.5 percent per year, and some funds are considerably more expensive.
- Portfolio allocation to alternative investments depends on the goal of the investor (risk reduction or additional sources of alpha, for example), the composition of the existing portfolio, the composition of the proposed alternatives portfolio, and the client's profile.

The National Planning Holdings Due Diligence department will continue to monitor the developments of the alternative mutual fund space and continue to provide education and resources as appropriate.