The Hidden Cost of Liquidity
Most investors gravitate toward owning liquid assets. But at what cost?

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President’s Letter
REISA is Headed UP!

By Mark Kosanke, Concorde Investment Services

Something new is always in the air at REISA! If you were present at the Spring Symposium, you know what a perfect blend of education, networking, and business happened. I heard nothing but stellar reports about the direction REISA is headed—UP! As part of that direction, we are beefing up our magazine—and the old F/y magazine has now become AI Quarterly.

AI Quarterly continues REISA’s commitment to turning out timely and useful articles of interest to our members, and grows with REISA’s expansion into more areas of the alternative, non-traded investment world. Not only are we growing up, we are also growing in terms of outward reach. Our expanded magazine will be in print and online and feature must-read articles about the industry, plus host many of REISA’s best practices and white papers. You can count on it for ideas to grow your business!

Not only has the quarterly publication grown, but in case you haven’t checked it out, our website has grown too. We are now posting past conference presentations along with archived copies of our magazine and other articles of interest, plus the new session syllabus tracker. For every session, you can now look up its syllabus (especially useful for continuing education reporting)—all the syllabi of this year’s events will be posted for your use.

Speaking even more of growth, our association boasts more than a 50 percent increase in membership in less than two years. Our ranks are now almost 2,000, and it’s a great mix too: about half are sponsors and affiliates, and about half are broker-dealers, reps and advisors. We’re the perfect mix for great education and networking opportunity.

To better serve our core groups, we have reclassified our membership categories. The Sponsor and Affiliate Firm categories remain the same. Our Associate Members (formerly just broker-dealers and RIAs) now include broker-dealers, RIAs, reps and advisors, each with their own subcategory. The old Individual category (which included some reps and advisors and also miscellaneous individuals) is going away—since reps and advisors are now included in Associate. The new Individual category will be Individual (Affiliate) and includes those individuals who are single-person firms (lawyers, accountants, third party due diligence, and others in solo practice). In terms of percentages, our new breakdown looks like this. However, something has NOT grown of which I, as a volunteer president, am very proud—our membership prices! Our rates are still the great value they’ve always been. Well, let me correct that. Since we have held the price constant and the program quality keeps getting better and better, the value has gotten even greater.

▲
Executive Director’s Letter

The Horse Races

By John Harrison, Executive Director, REISA

Explaining alternative investments to the uninstructed—at least the segment of them represented by REISA—is something we are all called to do on occasion. As part of my elevator speech about our industry when talking to those unfamiliar, I’ve hit upon an analogy which seems to help: the horse race. Try this out, poke holes, and let me know your thoughts.

When you go to the horse races (and by the way, the 2010 U.S. Census reports horse racing to still be in the top eight attended sporting event in the United States), you have two basic ways of participating: betting on a horse, or if you have the means, owning a horse. Now you most likely already sense where I’m going with this. Let’s rule out being a jockey or owning the racetrack for now.

Now you go to the races and decide to bet (a form of investing). Betting at the races depends on two things: the performance of the horses, and, more importantly for the winnings calculation, how everyone else bets. Thus, there is a type of “secondary market,” the pari-mutuel factor. The behavior of the betting pool determines your payout, given the horse you bet on performed as expected. This is analogous to the stock market, an exchange where the behavior of the investors controls the prices (and thus the cost or payout if sold).

There’s an alternative way to invest at the races: own part of a horse directly. I say part of the horse because horses are not cheap. Besides the initial purchase price (capital investment), they need a stable, care and feeding (by third party suppliers generally), and of course someone has to manage them (trainer and jockey). Thus, a horse can be owned by a group of investors. That group, the owner(s), makes money directly from the horse’s prize winnings, or purse. Nowadays (at least in the United States), horses who finish races get part of the purse. The higher they finish, the more they get. But by and large, they get something. Of course, when the horse is sold, there is a payoff too. Tax advantage also comes into play thankfully still in the real world (and once upon a time favorably for our horse analogy).

There are other phenomena around our industry which are parallel to the horse race analogy: track fees, regulatory burden, the vagaries of state legislation, etc. We can also take the analogy further with off-track (and online) betting, and how this may eventually shape the track’s fees (and thus earnings) and so on, but these are just more advanced nuances, not particularly useful in explaining non-traded alternatives to the uninstructed.

However, exploring an analogy such as this may give some insight on the interplay between traded and non-traded markets and their resulting life cycles. As we know from history, the non-traded investment was the original, and the traded markets were, well, secondary. Similarly, horse racing as a matter of simple prizes or winnings (direct investment) was around in ancient times more than a millennium before organized betting exchanges, which probably grew up about the same time as an early stock market was starting in 17th century Venice.

All analogies fall apart when overstretched, but try this one with the beginner listener who may be asking about non-traded alternatives. Not a sure thing, but a pretty safe bet.

September 2013 marked the beginning of a new era for capital formation and entrepreneurship in the United States. Under the new Rule 506(c) of Regulation D—a product of the JOBS Act of 2012—companies have the unprecedented opportunity to raise unlimited capital through the use of general solicitation, marketing, public advertising, and social media networking. Yet, over six months later, the number of Rule 506(c) offerings to hit the street have been relatively few and far between. Since September, only one in 10 companies surveyed indicate they plan to utilize the new exemption, according to a recent report in Fortune.

The reluctance of the alternative investment community to quickly embrace this new opportunity is somewhat surprising, considering the benefits offered by the new rule. Specifically, a company can accomplish the following under a Rule 506(c) offering: (i) raise an unlimited amount of money, (ii) from an unlimited number of accredited investors, (iii) with no federal or state registration (only a notice filing on Form D), (iv) with no specific disclosure requirements (other than applicable anti-fraud rules), and (v) with the ability to freely advertise, market, and promote the offering to the public.

Why the reluctance to jump on the Rule 506(c) bandwagon? There are several plausible reasons, starting with two of the conditions to the new safe-harbor exemption. First, all purchasers in a Rule 506(c) offering must be accredited investors (or the issuer reasonably believes they are all accredited investors at the time of investment—a subtle but important point in this context). Who or what counts as an “accredited investor” is defined under Rule 501(a) of Regulation D. For some sponsors, this limitation is a non-starter. There are, after all, fewer than 10 million accredited investors in the U.S. according to D issuers sponsoring Rule 506, accredited-only programs have been verifying accredited investor status for years (in some form or another), there seems to be significant confusion and discomfort with this new requirement and how to comply with it. Sponsors and registered representatives are reluctant to ask potential investors for too much personal financial information. Others are equally reluctant to incur added risk of liability by providing third-party certification of accredited investor status. For sponsors, fear of a blown exemption stemming from a non-accredited investor slipping through the cracks and being second-guessed on whether reasonable steps have been taken to verify an investor’s status as accredited appears to be a concern.

A related concern is the risk that an issuer that relies on Rule 506(c) but discovers an inadvertent violation during the course of an offering will not be able to fall back on another exemption under Regulation D or any other available exemption. Such a scenario would arguably require the issuer to stop the current offering and start from scratch at least six months later to avoid the risk of a new offering being integrated with—and tainted from—the definitive Rule 506(c) offering.

A fourth reason for the tepid response to the new rule is that the primary beneficiaries of Rule 506(c) are arguably startups, new sponsors, and smaller companies that lack the resources and infrastructure to comply with it. Conversely, more experienced Reg. D sponsors already have established broker-dealer selling groups and investor databases and, therefore, do not feel they need to publicly advertise their programs to raise capital. Furthermore, sponsors may not want to risk their existing selling group by marketing and selling directly to investors.

A fifth concern relates to current regulatory uncertainty. Almost as soon as the new Rule 506(c) became effective, the SEC proposed additional rules designed to better protect investors and impose more obligations on issuers (e.g., filing additional materials in advance for regulatory review. If such proposed rules are adopted, Rule 506(c) will be a less attractive option. This uncertainty has caused some to adopt a “wait and see” approach to Rule 506(c). Another concern relates to the type of investor likely to respond to a general solicitation. Sponsors desperate to raise capital might be willing to accept anyone with money to invest. An accredited investor is not necessarily a desirable investor. Qualifying potential investors who are products of a mass marketing campaign could prove to be challenging from an administrative and compliance perspective, and disastrous from a long-term strategic perspective. Finally, there is a natural reluctance to deviate from the status quo. For all the bravado and entrepreneurship espoused throughout the industry, most are reluctant to be innovators and advocates of significant change. Kudos to The Walton Group and Nelson Brothers Professional Real Estate for being among the first to promote Rule 506(c) offerings. So long as the industry promotes greater education, awareness, and compliance with the new rule, the above-stated concerns should dissipate in the coming years as Rule 506(c) gains wider acceptance among sponsors and investors. A
The Hidden Cost of Liquidity
How Alternatives Can Reward Long-Term Investors

By Kari Whitman, Franklin Square Capital Partners

The term liquidity refers to the ease with which an asset can be converted into cash. Assets or securities that can be easily bought and sold, such as bonds, public stocks and U.S. Treasuries, are considered liquid. Those that are more difficult to buy and sell, such as real estate, private debt and private equity, are said to be illiquid. Given investors’ natural bias for cash, most investors gravitate toward owning liquid assets. But at what cost?

Less Liquidity, More Potential Return

The financial crisis and persistent market volatility have intensified investor bias toward liquid securities. Unfortunately for investors, this increased demand has coincided with deteriorating yields for highly liquid assets in the public markets. Generally speaking, yields in more liquid assets have been decreasing due to a shortage of supply, while yields in less liquid parts of the market have been increasing due to a lack of demand. The result has been an increase in the illiquidity premium—that is, the difference in yield between liquid and less liquid securities. The mismatch between the demand for and supply of liquid securities creates an opportunity for those willing to employ a long-term alternative investment strategy.

As investors’ demand for liquidity has increased, so too has the relative cost of owning a fully liquid portfolio. The result is that the illiquidity premium is well above its historical average. The chart in Figure 1 illustrates the illiquidity premium in the high yield bond market from 1997–2012.

<table>
<thead>
<tr>
<th>Year</th>
<th>Spread Differential (1997–2012)</th>
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<tbody>
<tr>
<td>1997</td>
<td>-2.2%</td>
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<tr>
<td>2002</td>
<td>-2.2%</td>
</tr>
<tr>
<td>2007</td>
<td>0.8%</td>
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<td>2013</td>
<td>1.4%</td>
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What the data tells us: The yield premium for less liquid high yield bonds in December 2012 was 1.4 percent, considerably higher than the long-term average of 0.6 percent. Moreover, since the overall yield in high yield bonds has decreased so dramatically, with the Barclays High Yield Index ending 2012 at 6.1 percent, the spread differential due to liquidity represents a substantial component of an investor’s total return.

Illiquidity Premiums in the Senior Secured Loan Market

The illiquidity premium phenomenon extends beyond the high yield bond market. Senior secured loans, also known as bank loans, are a $1.2 trillion asset class that provides a form of debt financing to corporate borrowers. Although senior secured loans are used as a financing option by many public companies, they are more commonly found in the capital structures of private companies that lack access to public markets.

Figure 2 examines the spread differential between syndicated middle market senior secured loans (defined as loans to issuers with less than $50 million in EBITDA) and syndicated loans to large corporate borrowers (issuers with more than $50 million in EBITDA).
What the data tells us: Prior to the financial crisis in 2008, syndicated loans to middle market borrowers offered higher yields than syndicated loans to large corporate borrowers by an average of 0.67 percent, and since the financial crisis the spread differential has grown to an average of 2.89 percent.

The primary driver behind the middle market yield premium is liquidity. In response to regulatory changes, such as those required under Basel III and Dodd-Frank, large banks have generally re-focused their strategies to dedicate capital to only their largest and most profitable clients. Left behind are the private, middle market companies that historically relied on bank loan financing as their primary source of funding. To entice new lenders to fund this void, middle market borrowers have been forced to pay higher interest rates than larger corporate borrowers of similar credit quality. The higher yields available in the less liquid parts of the senior secured loan market create an opportunity for those willing to accept less liquidity in return for better risk-adjusted returns.

Why Endowments Invest in Alternatives

Alternative investments are often defined by what they are not—a traditional investment in publicly traded stocks or bonds. Alternatives can include both non-traditional assets, such as real estate, private equity or art, as well as non-traditional strategies, such as investing in illiquid securities. While individual investors have only recently begun to allocate a portion of their portfolios to alternative investments, institutional investors and endowments have been using alternatives for years. As of June 30, 2012, the average endowment allocated 54 percent of its total portfolio to alternative strategies.1 Yale’s endowment, widely considered the pioneer in alternative investing, allocates nearly 65 percent of its portfolio to liquid investments.2 The basic premise behind endowments’ relatively high and growing allocations to alternatives is their pursuit of enhanced risk-adjusted returns and their belief that illiquid securities can provide higher yields and less correlation to traditional markets. Figure 3 compares 10-year investment returns for endowments against the S&P 500 and an investment grade bond index.

The difference between investors’ realistic and potential returns illustrates the performance gap between short-term and long-term investment strategies. Portfolio managers are keenly aware of the risks posed to long-term investment strategies from clients managing to short-term trends, and portfolio managers are often deterred from making long-term investment decisions out of fear of experiencing short-term underperformance and capital withdrawals.3 The more liquidity investors have in their investment portfolio, the more likely they are to be focused on short-term performance, and the greater the challenge of portfolio managers to maintain a long-term investment strategy.

Options for the Long-Term Investor

Closed-end funds have access to permanent capital, thereby allowing their managers to pursue less liquid opportunities. Matching long-term investment capital with a long-term investment vehicle is critical to the success of an alternative investment strategy. The historical challenge with closed-end funds for the individual investor has been the volatility associated with their listed shares—closed-end fund shares often exhibit a high correlation to public market indices. Given that one of the objectives of an illiquid alternative investment strategy is to exhibit a low correlation to public markets, the volatility in listed closed-end fund returns can nullify the benefit of an illiquid alternative investment strategy.

Where Alternatives Fit for Individuals

Alternative investments are a clear driver of endowment performance. And while the investment horizon of the average individual is generally shorter than the average endowment, individual investors may still benefit from an allocation to long-term investments.

Today individual investors have access to alternatives through mutual funds, closed-end funds and business development companies (BDCs), among others. Each investment structure comes with its own benefits, risks, costs and liquidity. Among the most common investment vehicles for individual investors are traditional open-end mutual funds, which are typically low in cost and allow investors to redeem capital on a daily basis. One result of daily liquidity, however, is that mutual fund managers are forced to manage without a permanent capital base; when investors withdraw capital, a manager may be forced to sell assets, and when investors purchase fund units, the manager may be forced to buy assets, regardless of his or her opinion on relative value. If investors withdrew funds only when securities prices were high and invested only when securities prices were low, the job of a mutual fund portfolio manager would be relatively easy. In general, the opposite is true. On average, investors tend to sell losing positions and add to positions that have already appreciated in value. Figure 4 demonstrates this behavior by comparing the senior secured loan market index to the price of the Credit Suisse Leveraged Loan Index in 2011.4 The difference between investors’ realized and potential returns illustrates the performance gap between short-term and long-term investment strategies. Portfolio managers are keenly aware of the risks posed to long-term investment strategies from clients managing to short-term trends, and portfolio managers are often deterred from making long-term investment decisions out of fear of experiencing short-term underperformance and capital withdrawals.5 The more liquidity investors have in their investment portfolio, the more likely they are to be focused on short-term performance, and the greater the challenge of portfolio managers to maintain a long-term investment strategy.

Figure 2

Middle Market Loan Premium (March 2002–December 2012)

- Middle Market Discounted Spreads
- Large Corporate Discounted Spreads

Pre-crisis Post-crisis

Middle Market Spread Difference

Average Pre-crisis: 0.67%
Average Post-crisis: 2.89%

What the data tells us: Large endowments, which have over a 60 percent allocation to alternative investments, significantly outperformed both public equities and investment grade bonds over the past 10 years.

Figure 3

Average 10-Year Net Returns (June 2002–June 2012)

- S&P 500
- Barclays Aggregate Bond Index
- Endowments Under $25 Million
- Endowments Over $1 billion

5.3% 5.6% 5.7% 11% in Alternatives 7.6% 61% in Alternatives

...serious investors benefit by avoiding overpriced liquid securities and by embracing less liquid alternatives.”

— David Swenson, Chief Investment Officer, the Yale University Endowment

Figure 4

Mutual Fund Flows vs. Credit Suisse Leveraged Loan Index

- nullify the benefit of an illiquid alternative investment strategy.
Individual investors may benefit from an allocation to long-term investments.

Unlisted closed-end funds and BDCs are increasingly in popularity due to their ability to preserve the attributes of a fund’s underlying assets and still provide a permanent capital base. In an unlisted closed-end fund, or non-traded fund, there is typically no secondary trading market for the fund’s shares—individuals wishing to exit their investment can generally only do so through a limited tender offer process. By matching long-term capital with long-term strategies, portfolio managers of unlisted investment vehicles may have the flexibility to seek the higher returns available in the illiquid parts of the market and potentially improve risk-adjusted returns. As with any investment, unlisted funds and BDCs have risks, including limited liquidity, potential loss of principal and portfolio volatility. Investors should consult their financial advisors to understand these risks and how such investments might fit into their investment strategies.

Summary

The illiquidity premium has grown. Since the financial crisis, macroeconomic uncertainty and public market volatility have increased investors’ demand for liquid securities. At the same time, secondary market liquidity has deteriorated as many banks and broker dealers have deleveraged their balance sheets and reduced risk. The result has been the widening of the premium available to investors in less liquid securities.

Endowments favor alternatives for better risk-adjusted returns. Alternative investments are designed to provide access to non-traditional assets and strategies, one of which is investing in less liquid securities. Endowments and institutional investors have been using alternative investment strategies for years as a way to diversify their investment portfolios and capture the yield premium available in illiquid securities. A key to success for these managers has been to match their long-term investment strategy with long-term investor capital.

Unlisted closed-end funds and BDCs make illiquid alternatives accessible. With the unlisted closed-end fund structure, the interests of managers and investors are aligned: managers can invest in less liquid alternatives to drive returns, and investors can execute a long-term investment strategy without being subject to the daily share price volatility associated with the public markets. Investors should consult a financial advisor if they are interested in learning more about unlisted alternative investments.

In 1990, Congress created the EB-5 Visa Program in an effort to stimulate the U.S. economy. The program provides foreign nationals an opportunity to obtain U.S. permanent residency in exchange for their capital contributions. The EB-5 Visa requires a minimum $1,000,000 investment into a qualified U.S. business, which would create or preserve at least 10 full-time jobs for U.S. workers. The reduced investment amount of $500,000 is authorized if the business is located in a Targeted Employment Area, also known as a TEA. An area may be qualified as a TEA if, at the time of the investment, the area is suffering from high unemployment of at least 150 percent of the national average, or it is a rural area with a population of less than 20,000.

There are two paths to permanent residency through the EB-5 Visa Program—a Direct EB-5 Investment and an indirect Regional Center Investment. Each year, the government allocates a total of 10,000 EB-5 visas to foreign investors and their immediate family members; 3,000 of which are specifically set aside for investments in a TEA.
**Direct EB-5 Visa Program**

The Direct EB-5 Visa investment is the original immigrant investor program as created by Congress in 1990. In order to qualify for the visa, a foreign national must invest the required minimum amount into a business that would qualify as a “new commercial enterprise” or a “troubled business.”

Examples of direct EB-5 investments include franchised restaurants, day care centers, hotel chains, dry cleaners, or other small businesses that might interest the investor. The direct EB-5 investment path requires the foreign national to have a direct managerial role in the day-to-day operation of the business. Typically, the direct EB-5 is investment for investors wishing to start and manage their own business. These investors have the entrepreneurial spirit and desire to be fully engaged in the success (or failure) of their business. If the foreign national wishes to immigrate to the United States via the direct EB-5 investment route, they often seek advisory services from alternative investment professionals, as well as immigration attorneys in researching and selecting a business that would qualify for EB-5 visa purposes.

**Regional Center Program**

In 1993, Congress enacted the EB-5 Regional Center Pilot Program allowing passive investments through economic units known as Regional Centers. Public or private entities involved in promoting economic growth, may apply for a designation as a Regional Center with the United States Citizenship and Immigration Services (USCIS). Once approved, these entities may solicit funding for their investment ventures in the form of a private placement relying on the Regulation D exemption from registration with the SEC.

Regional Center projects vary in industries; investors can choose from investment opportunities in ski resorts, hotels, restaurants, hospitals, marinas, medical research facilities and much more. Since the introduction of the immigrant investor program, the Regional Center path has been the leading option for over 85 percent of foreign investors. For many, the burden of running a business in a foreign country is an overwhelming undertaking. Instead, the option of having an experienced management team in place may be a safer approach to their ultimate goal of obtaining permanent residency in the United States. The EB-5 Visa Program has attracted an increasing number of investors since its implementation. In 2012 alone, over 6,000 investors applied for the immigrant investor visa, and it is estimated that these foreign investors have contributed over $6.8 billion into the U.S. economy since 2005.

Once an investor obtains permanent residency, their contribution to the economy does not end solely with their EB-5 investment; they contribute by paying taxes, purchasing real estate, paying for their children’s education and investing in other assets. EB-5 industry experts agree, the EB-5 Visa is a win-win government program that creates jobs and stimulates the economy while providing a path to permanent residency for foreign nationals.

Trust is not the objective in an advisor-client relationship. Rather, trust is a byproduct of the other things you do, such as your behavior, your communication and the quality of your work. If gaining your clients’ trust is your objective, then the focus is on the wrong place: you. When your goal is to establish trust, it might be further to your agenda: “I have to get to trust me so they hire me, so they give me assets, so they buy my product or idea” and so on.

Consider this point of view instead: “I am going to show up relaxed, relaxed and professional, create a great client meeting experience, ask great questions, listen with empathy, well-organized, respect their time by not bragging about myself or my company or over-explaining financial concepts and ideas, and be selective about letting only right-fit people join my community of ideal clients. If, in the process of behaving this way, they trust me and hire me, fine. Not, that’s not okay.”

You may be concerned that relaxing or abandoning a more intense sales focus will diminish your results. Actually, the contrary is true. Which is more likely to attract successful people as clients: the relaxed trusted advisor or the intense salesperson? Relaxed doesn’t mean lacking in passion for helping people make smart choices about their money. It means that you don’t show up with what we used to call “commission breath.”

Relaxed advisors often have the trusted ideas for behaving in ways that create the byproduct of trust.

1. Look for right-fit people to join your client community versus going after anyone with money. Create an ideal client profile where personality is equally important to money for them to earn an invitation to join your client community. Notice the difference in how it feels to think of inviting people to do business with you versus thinking only of closing the deal.

2. Ask good questions about your clients’ values and goals. What’s important to them about you? Are your tangible goals that require money and planning to achieve? How much do you want to have for that goal? By when? What are two or three words that describe what you are thinking and feeling once you have achieved that goal? Does the idea of having a comprehensive financial plan that gives you a higher probability of achieving your goals and fulfilling your values appeal to you? Would you like to join our client community and have us do this work for you?

3. Listen with empathy. The tendency, especially during an initial client interview, is to think about what you are going to say next while they are answering your question. When you do this, you don’t really hear what they said. It’s difficult to be empathetic to things you weren’t mentally present to hear. The solution is to have your questions memorized so you don’t have to think about what you are going to ask next, thus allowing you to be fully present and a much more empathic listener.

4. Record your client meetings, especially the initial client interview. Have your clients sign permission to record. “I appreciate the investment of your time and effort you made to be here today. The fact that you have done so tells me that you must be serious about your money—is that true? (Pause for answer.) You’ll notice that I’ll ask many relevant questions, take copious notes, and I also record the meeting. (Refer to the recorder and pause.) The reason I record is because I’m very thorough. (Pause.) Do you know how you can watch a movie a second or third time and see things you missed the first time? (Long pause for response.) “Well, giving you advice about your money so you can achieve your goals is obviously much more important than a movie, so I want to make sure our advice is right for you. If we choose to work together, I’ll listen to this recording at least one more time to make sure to get it right.” (Pause.) Ask your first question.

5. Give advice with conviction. Salespeople tend to offer alternatives and let the prospect or client choose. Trusted Advisors gather all the information they need, consult with other experts where appropriate, and—with conviction—give the best advice for the client. There may be more than one way to achieve a goal, but there is only one best way. Find the best way and give advice with conviction.

6. Tell the truth, even if doing so jeopardizes the relationship. Serious and successful people don’t want to pay good money for a rubber-stamp, “yes-person” telling them only what they want to hear. It’s your job to tell the truth, especially when it’s what they need to hear and not what they want to hear.

7. Be inspiring. Focus on helping clients and prospective clients create a compelling vision for their future and become their bridge to make it happen. Being a future vision creator is much more trust-building than being a problem-solver.

8. Be a comprehensive financial professional. It’s interwoven that most financial advisors claim to be comprehensive, which implies “everything.” Do you really help your clients take care of everything related to their money? Check out www.blog.trustedadvisortoolkit.com for discussions about delivering truly comprehensive financial services.

9. Put the client first. It sounds almost silly, yet, there is a lot of discussion and controversy by regulators and industry leaders about the fiduciary standard. In all situations, under all circumstances, put your client’s needs ahead of your own. Isn’t that what you already do? The good news is that your competition needs somebody else to define integrity for them.

Keep in mind that these are not tactics to build trust. They are powerful behaviors of financial professionals who are very good at what they do and who genuinely care about helping people get their financial house in order, achieve their goals and fulfill their values. By behaving at this very high level of professionalism, your clients’ trust is the byproduct of that behavior.
Unconventional shale reservoirs are homogenous rock formations that span hundreds, if not thousands, of square miles deep below the surface of the earth. Shale has low permeability and porosity, which simply means that oil and gas is locked up tight and cannot naturally migrate to the surface through conventionally drilled wellbores. Over the past twenty years or so, technological advances including horizontal drilling and improvements in hydraulic fracturing have opened up production potential from shale formations across the United States. Using today’s technology, shale wells are drilled horizontally through the rock then are ‘frac’ed’ using a high-pressure injection of water, chemicals, and sand to create micro-fissures that allow the gas and oil to escape up the wellbore.

The game-changing impact of advancing technology is clearly evident in North Dakota’s Bakken Shale. Originally discovered in the 1950s, the Bakken’s production was a mere trickle before horizontal drilling and hydraulic fracturing began unlocking the shale’s estimated 7.38 billion barrels of recoverable oil reserves. Today, typical Bakken wells are drilled 1.75 miles vertically and 2 miles horizontally, providing wellbore exposure to over 10,000 feet of production potential. Each well undergoes up to 36 stages of hydraulic frac’ing using resin-coated sand or ceramic proppant to release hydrocarbons from the rock. Using these techniques, North Dakota has experienced a 177% increase in production since 2008 and now produces more than 1 million barrels of oil per day.

Achieving such a dramatic increase in production in just eight years has been a dynamic, technology-driven work in progress. Because of its homogenous nature, the Bakken holds oil in varying degrees throughout multiple producing formations, which include the Middle Bakken and the Three Forks, a separate shale formation located a few hundred feet under the Middle Bakken. Unlike in conventional fields that are dependent on geologic studies, seismic, and other geo-scientific methods for finding oil, operators in the Bakken simply drill, move the rig, and drill some more. In most cases, it is not a question of whether or not oil will be found. It is a matter of how much oil can be manufactured from the rock with as little investment as possible. When looked at this way, the Bakken is not merely a field—it is a factory.

In manufacturing, repetition is key to lowering unit costs and creating higher unit value. The same holds true in the Bakken. With over 7,000 wells already drilled, operators have a statistical set of repetitions they use to fine-tune drilling and completion techniques to help improve results. For example, operators have increased per well recovery potential from 245,000 barrels of oil (2006-2008) to 550,000 barrels of oil (2009 forward) by doubling the length of the horizontal leg and applying multi-stage fracture stimulation along the entire wellbore. The manufacturing learning curve is expected to continue to improve as an estimated 35,000 to 40,000 additional wells are drilled throughout the Bakken over the next two decades.
Pad drilling allows operators to move their drilling equipment into a single location where up to 24 wells (and potentially more) are drilled using the same rig, in a serial fashion. In 2011, additional manufacturing efficiencies came into play as operators began experimenting with drilling multiple wells per drilling spacing unit (DSU) using new pad drilling techniques. Pad drilling allows operators to move their drilling equipment into a single location where up to 24 wells (and potentially more) are drilled using the same rig, in a serial fashion. The first half of each well is drilled, the bit is changed, and the drilling of each well is completed. Hydraulic frac’ing is then completed in a similar fashion.

A significant operational efficiency gained by using pad drilling is the reduction in time needed to move the rig. Rigs are walked from one site to the next on hydraulic “feet” or slid from location to location on skids. It takes approximately eight hours to move the rig to the next well as compared to up to five days needed to completely dismantle the rig and truck it to the next drilling location. The reduction in downtime is just one of the reasons pad drilling is more economical than single-well drilling. Continental Resources, one of the largest operators in the Bakken, estimates that pad drilling will help save upwards of 10% in drilling costs per well.

On top of saving time and money during the drilling process, pad drilling is instrumental in efficient value creation, i.e. “proving up” the value of reserves in the underlying acreage. Value is created in the oilfield through aggressive in-fill drilling on acreage “held by production” (HBP). Held by production means a single well has been drilled and is producing on a specific DSU, which converts a time-sensitive net mineral lease (usually three to five years) to a lease held in perpetuity. With net mineral acreage (NMA) ownership, all reserves at all depths are owned. The unproduced reserves are money (value) in the ground just waiting to be produced. Thus, owning net mineral acreage can be more advantageous than simple wellbore rights where the owner is entitled to just his or her share of production on a single well. As the vast majority of prime acreage in the Bakken is now held by production, operators are free to systematically pursue in-fill pad drilling and risk weighted basis. Barrels that have been sold at the wellhead (proved-developed producing) and actual production results (if any) are based on numerous factors. There are no guarantees that any production or value creation will be achieved.

In the Bakken, a typical 1,280-acre DSU can support four Middle Bakken wells as well as multiple wells drilled in the four benches of the Three Forks. Pad drilling accelerates the value creation process as multiple wells targeting multiple production zones are drilled in close proximity from a single rig.

Just 10 years ago, reversing the United States’ decades-old oil production decline was practically a pipe dream. Today, production is on the rise throughout the country—driven by gains in shale plays unlocked by advancing technology. In fact, The U.S. Energy Information Administration’s Annual Energy Outlook for 2014 projects that U.S. crude oil output will continue to grow annually by about 800,000 barrels a day, nearing a record level not seen since 1970. Even as oil production from shale plays continues to climb, it is important to note that the unconventional oil development industry is still in its infancy. Advances in horizontal drilling and frac’ing techniques have and will continue to change the domestic energy landscape. In the Bakken, pad drilling, a manufacturing-style improvement, has positively influenced economics in just three short years. This is but one example. Energy analysts Wood Mackenzie Ltd. believes improved drilling techniques will help the Bakken boost output more than 70 percent to 1.7 million barrels a day by 2020.9 Further technological breakthroughs are expected to impact the learning curve in the Bakken and beyond—reducing costs while upping production capabilities, driving the United States closer to energy independence.
General Solicitation typically refers to the soliciting of investors to purchase securities. Prior to the passage of the JOBS Act in 2012, general solicitation was banned in connection with privately offered unregistered securities. Issuers were only permitted to offer such securities to investors with whom they had a pre-existing substantive relationship. Section 201(a) of the JOBS Act lifted the ban on general solicitation, but only with respect to accredited investors.

Reactions to the lifting of the ban on general solicitation from sponsors, financial advisors, and their broker-dealers have varied. REISA’s editorial committee followed up with the participants and audience attendees to get their thoughts on the subject and share with our readers.

One of the most important sessions at the recent REISA conference occurred on Tuesday morning, March 18. The panel discussed the impact of general solicitation and how the new rules have and would impact the industry.

Daniel Oschin Chief Operating Officer The Shopoff Group:

The non-traded securities industry has been in a constant state of flux. We face an onslaught of challenges that have dynamic effects, including ever shifting and often ambiguous regulations. At the 2013 REISA National Conference, to coincide with the new rules related to general solicitation under the Jobs Act, we provided an excellent panel of experts that forecasted what impact the new rules might have. Fast forward six months to the 2014 REISA Spring Symposium, where we brought back some of the previous panelists and added a few pioneer leaders. These innovative speakers represented what is happening right now with general solicitation, subscription and suitability management, online portals and advertising, and overall they provided a window to the future.

As the moderator of these sessions, I had some concerns about how the audience and other panelists, so long in an industry that has lived under strict rules that had become the norm, would react to these pioneers. It was inspiring and a testament to our industry to find that the mood, questions and responses were inquisitive, open-minded and demonstrated a willingness to carefully take steps forward towards what is likely going to be a reality for all of us.

Our association and its members are living in a fascinating period. We stand at an amazing moment in time when the old world is in the midst of a dramatic transformation into a digitally interactive, social media influenced, instant information whirlwind of technology that is challenging even our most fundamental concepts of communication, marketing, business and social processes. The financial services industry must and will adapt, walking the fine line between an aging population with intermittent adaptation to technology and a growing investors base of younger technology adapters, who don’t know any other way than the new way.
Reactions to the lifting of the ban on general solicitation from sponsors, financial advisors, and their broker-dealers have varied. REISA’s editorial committee followed up with the participants and audience attendees to get their thoughts on the subject and share with our readers.

Rick Murphy President Berthel Fisher & Company Financial Services:
I think the top two takeaways from the broker-dealer side are the bad actor [I hate that term] and portal funding issues. I feel bad actor disclosures have the biggest potential for future problems on Reg D issuers and broker-dealers. For the issuer, they face the fact that their offering could be considered an unregistered security in the event that they did not do more to review consent or final orders entered into between broker-dealers “BDs” and the States, SEC, courts, etc. This would require a rescission offer be made to all investors and possible sanctions and fines from the SEC or states which could put the investment at risk and consequently the investors’ money at risk.

For the BDs, the same holds true. We have to be able to confidently do our job in investigating the selling group members. We also should err on the side of caution when talking about our own disclosures. It would not bode well for a BD to take a more liberal view of an order only to find out that the regulators determine the exemption has been blown. This act, (intentional or not), would cause all selling agreement members to lose the reliance on the not good.

Portal funding I think will be here to stay, or at least until someone screws it up, which will invariably happen. It’s not if, it’s when. That will lead to increased regulation on that industry and how it acts in the future. As our mothers used to say, “It’s all fun and games until someone gets an eye poked out.” My takeaway is that we will see more of it. We should all use caution as we see what develops and how regulators oversee it. It is currently not a major threat but then again professional golfer and Masters Champion, Zach Johnson wasn’t even the best player on his division III college team in the 90s. However as of today, only two professional golfers in the world have won more times than Zach Johnson in the last six years; Tiger Woods and Phil Mickelson.

Cameron Hellewell General Counsel Orchard Securities
Today, the regulatory landscape for private offerings is much different than it was last year at this time. Significant changes have occurred that will impact the way we do business for years to come. For many of us in the securities industry, the natural reaction is to fear change, rather than accept it. However, the changes associated with the JOBS Act appear to be permanent, and those within our industry who embrace the changes will have a significant advantage over those who refuse to do so.

Over the years, I have been impressed with our industry’s ability to work together to find appropriate solutions for changes in regulations and other issues that impact our business. I am confident that, once again, the various constituencies in our industry will come together and effectively address these regulatory changes, and create industry best practices that will protect the interests of sponsors, broker-dealers, and registered representatives, as we work to effectively represent our respective clients.

John H. Grady President National Fund Advisors, LLC
I think that the session brought out a very interesting dynamic that exists between sponsors of offerings, who want to take advantage, to the extent practicable, of the revised rule (as it regards solicitation of investors for otherwise private offerings), and the broker-dealers who traditionally were a primary source of capital for such offerings. In a nutshell, since the prior SEC interpretations focused on there being a pre-existing relationship with the investor, clients of broker-dealers were highly eligible recipients of private offering opportunities.

With the changed rule, broker-dealer clients are still eligible but now there is a risk sharing that is somewhat unwanted, and may cause them to focus on only on offerings that are NOT advertised or the subject of solicitation, no matter what right the sponsor or issuer has to make such communications and to take in investors attracted thereby.

Will Febo Chief Operating Officer & Director Merriman Holdings, Inc.
As a broker-dealer, you should use technology to get closer to your clients as you start to deal with the generational shift. Be sure the technology partner you select understands all aspects of an offering, is sensitive to compliance and suitability, and associates with full service and compliant broker-dealers in the selling group. Some options include generic crowd funding sites, compliant web sites that allow sponsors/providers to go direct to the public and licensable technology platforms BDs can use for their own needs.

Tim Snodgrass President Axxess Capital Partners
It is sad to hear that some broker-dealer executives are ignoring the potential opportunities and threats to their firm as a result of the new rules regarding general solicitation. History is full of people who have ignored new ideas and rulings and then watched history pass them by. We ignore change at our own peril. Several years ago, some broker-dealers said they would never do a 1031 exchange and others doubted that NT REITS would never be a real investment option. Some executives get so concerned about protecting themselves; they can’t see the forest for the trees. As business leaders, we need to all remember to act like it by educating ourselves, be on the forefront of ideas, and not remain ignorant.

Darryl Steinhaus Partner DLA Piper LLP
The broker-dealers need to be aware that the general solicitation train is on the tracks and it is leaving. I believe the broker-dealers are looking at this as a negative, but they need to turn lemons into lemonade. The broker-dealers can advertise and can use this as a way to increase their client base and revenue. This is effectively no different than how broker-dealers have obtained clients for the last 30 years. The only difference is now they can advertise with specific products. If there is an attractive product, they can use this to bring new clients that they may never have had access to before.

With respect to the sponsors, this is a great opportunity to expand their investor base. The base in the past has been made up of broker-dealer and non-broker-dealer transactions. This is a way to bring non-broker dealer investors into the broker-dealer network. The fact that you are advertising does not mean that you are not using broker-dealers.

If a broker-dealer is complying with the current suitability standards, it should be easy for them to certify that their investors are accredited.

Conclusion
It is unclear whether the JOBS Act and amended Rule 506 will be the “game-changer” envisioned by the supporters of the act, but it is clear that the lifting of the ban on general solicitation will have a positive impact on small business capital formation. Amended Rule 506 should benefit broker-dealers who are well equipped to perform the screening of accredited investors. Naturally there has been an initial hesitancy by all parties, but they will either work this out or, if they resist, possibly miss future opportunities.
REISA’s Due Diligence Forum is intended as a drill down for Compliance and Due Diligence Officers.

Sessions will include:
- Advertising Deep Dive
- Audit Lessons Learned
- Oil & Gas PPM Review: What Are the Rules and Where Are the Landmines?
- A Practical Guide to Due Diligence
- Reg A+/Rule 506(c)
- Allocation and Concentration in REIT Valuation Metrics
- Arbitration Trends and Updates

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Designed for all industry professionals who sponsor, analyze, market, distribute or sell alternative investments.

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