



April 30, 2025

## An Alternative Reality: Regulatory Considerations in Light of the Increased “Retailization” of Alts

### EXECUTIVE SUMMARY

- Although the use of alternative investment products and wrappers in the retail space dates back decades, the past five years – and this past year in particular – have been marked by a noteworthy level of interest by both retail investors and industry alike.
- The combination of a general movement toward democratization of access to financial markets and instruments, along with evergreen competition realities for investment managers, appears to have contributed to this confluence of interests.
- Notwithstanding these interests and the potential opportunities alts products present, debate still exists about whether these perceived benefits bear evidentiary support and are worthwhile.
- Setting aside the debate regarding the potential investment merits of use of alts in retail investor portfolios, as investment managers pursue making alts products and vehicles available to a wider retail population, these pursuits should be informed by decades’ worth of regulatory guidance on this very topic . . . and even on specific alts and alt-related products.
- Such regulatory considerations include, but are not limited to: suitability, marketing, representative education, investor disclosures, operational and strategic complexity, sales practices, product legality, liquidity, performance, and third-party vendors, among others.
- With these regulatory and Compliance considerations in mind, investment managers will hopefully be able to navigate competitive demands and investor optionality, while also avoiding investor harm and regulatory missteps.

### INTRODUCTION

According to certain studies, the appetite of mainstream investors for alternative investments dates back to at least the early 2000’s. At that time, alternative assets such as real estate, private equity, and hedge funds accounted for 14% of pension investments outside of fixed income and cash. The past five years, however, have been particularly notable. By 2021, the aforementioned number had grown to 39%, and, between 2020-2023, alternative assets in the portfolios of high net worth individuals rose from 7.7% to 9.1% according to one study, and 94% of managers focused in this client segment expected to maintain or grow alternative asset positions throughout that time. That forecast appears to have proven itself out at least in certain contexts. For example, net assets in the interval and tender offer fund market increased by 25% between Q3 and Q4 2024, rising from \$130.6 billion to \$163.3 billion.

And yet, despite this prodigious retail appetite for alternative products, some posit that the attractive returns alts have been believed to offer are not worth the associated costs. According to one study, a diverse portfolio of alts costs 3-4% of asset value, underperformed their stock and bond market index counterparts by 2.6% per year over 16 years, and at the end of 2024 was worth 70% of what it would have been had it followed an indexing strategy. Additionally, and setting aside the debate on the investment merit of alts, the topic of alts in the retail space has received regulatory attention for almost a quarter century, and on a bipartisan basis.

Given the continued momentum surrounding alts in the retail space, taking a fresh and holistic look at how the topic has been treated by regulators in the past seems like a worthwhile exercise. Both at a general alts level and the level of specific alts products, regulators appear to have provided ample guidance to investment managers to at least put them on notice regarding the types of issues and considerations their Compliance programs should consider addressing. To those ends, this month's *Headspace* will address the following:

- ❖ The historic regulatory treatment and corresponding risk taxonomy applied to alts (*pp. 3-4*);
- ❖ The dimensions of suitability analyses, and points of particular salience for alts (*p. 5*); and
- ❖ SEC Marketing Rule implications (*p. 6*).

Now, let's dive into these "alternative realities" . . .

### **REGULATORY TREATMENT & RISK TAXONOMY**

**Whether from the NASD, FINRA, the SEC, NASAA, and even the FCA, regulators seem to have touched upon the types of risks alts can present to retail investors in a variety of forms relatively consistently over the past 20 years: enforcement actions, exam findings, risk alerts, bulletins, speeches, collective statements, media appearances, and investor education.**

Regulators themselves acknowledge that there is not a legal definition for what constitutes an "alternative" or "alt." Instead, there appears to be general acceptance that, unless a product is a stock, bond, traditional mutual fund, cash, or other customary investment instrument, it falls into the industry vernacular of being an "alt." The "alt" universe is actually quite vast, encompassing products such as crypto, private credit, private placements, liquid alts, reverse convertibles, distressed debt, REITs, PPNs, buffer ETFs, 1031's, "cat" bonds, geared ETPs, and a host of other spiffily named instruments and vehicles. Although this universe is quite large by some measures, regulatory attention to their use generally appears to have been more tactical over the past 20 years, with certain types of products eliciting guidance on their use and features specifically. Based on a review of this body of regulatory treatment, the risk taxonomy in the table below comes to the fore, regardless of which specific alt may have been the focus of regulatory attention. This taxonomy should form the basis for how an investment manager's Compliance program may need to account for the manager's use of alts in their given business model.

## ALTS REGULATORY RISK TAXONOMY

CATEGORY	CONSIDERATIONS
1. Legality	<ul style="list-style-type: none"> <li>▶ Is the product legal? Is it subject to regulation, and if so, does it comply?</li> <li>▶ Is the offering legal? Do those offering it need to be licensed, and if so, are they?</li> <li>▶ Is the product subject to regulation at all?</li> </ul>
2. Suitability	<ul style="list-style-type: none"> <li>▶ Has the investment adviser understood the terms, features, and risks of the products? Has sufficient initial and ongoing product diligence been conducted?</li> <li>▶ Has the customer's investment profile been understood and mapped to the product's features?</li> <li>▶ Has the investment adviser evaluated regulator-issued suitability guidance specific to the product?</li> <li>▶ Is the product restricted to only eligible accounts or investor types?</li> <li>▶ Are suitability determinations documented?</li> <li>▶ Is there a clear research process?</li> </ul>
3. Education	<ul style="list-style-type: none"> <li>▶ Have those offering or managing the product been adequately trained on its features, operations, risks, and suitability requirements (including how to assess reasonable alternatives)?</li> <li>▶ Have customers been adequately educated on the products features, operations, and risks?</li> </ul>
4. Operational & Strategy Complexity	<ul style="list-style-type: none"> <li>▶ Do investors, and the investment professionals who offer and manage them, appreciate how they work?</li> <li>▶ Is the product difficult to understand?</li> <li>▶ Is the payout structure understandable?</li> </ul>
5. Investor Autonomy	<ul style="list-style-type: none"> <li>▶ Will investors be able to access and trade in the product without the assistance of a financial professional?</li> </ul>
6. Sales Practices	<ul style="list-style-type: none"> <li>▶ Does the nature of the product require or warrant heightened supervision and surveillance?</li> </ul>
7. Advertising	<ul style="list-style-type: none"> <li>▶ Do communications with the public regarding the product contain fair and balanced information?</li> <li>▶ Are such communications subject to heightened review and oversight?</li> </ul>
8. Performance	<ul style="list-style-type: none"> <li>▶ Does the product offer the potential for higher returns, and is accompanied by higher degrees of risk?</li> <li>▶ How much experience does the manager have managing or offering the product or strategy?</li> <li>▶ Do performance returns correlate to known factors associated with the investment manager's strategy?</li> </ul>
9. Liquidity	<ul style="list-style-type: none"> <li>▶ Is the product difficult to sell-out of?</li> </ul>

### ALTS REGULATORY RISK TAXONOMY (continued)

<u>CATEGORY</u>	<u>CONSIDERATIONS</u>
10. Third-Party Vendors	<ul style="list-style-type: none"> <li>▶ Has adequate due diligence been performed on third-party vendors supporting the product?</li> <li>▶ What is the experience and familiarity of the third-party vendors with the product?</li> <li>▶ Does the vendor have the infrastructure to support the product or strategy?</li> <li>▶ Does the vendor have conflicts of interest, such as being an affiliate?</li> </ul>
11. Theft/Loss	<ul style="list-style-type: none"> <li>▶ Primarily for digital assets, are there substantial risks of theft or loss?</li> </ul>
12. Costs & Taxes	<ul style="list-style-type: none"> <li>▶ How do the costs of the product compare to more traditional peers?</li> <li>▶ Does the product contain unique tax features or implications?</li> </ul>
13. Disclosures	<ul style="list-style-type: none"> <li>▶ Do investors, and the investment professionals who offer and manage them, appreciate how they work?</li> <li>▶ Is the product difficult to understand?</li> <li>▶ Is the payout structure understandable?</li> </ul>
14. Policies & Procedures	<ul style="list-style-type: none"> <li>▶ Does the investment manager have policies &amp; procedures in place to address the foregoing?</li> </ul>

### THE DIMENSIONS OF SUITABILITY

**Although all of the factors in the above table are important, the topic of suitability warrants its own attention. Although all investment advisers owe their clients a duty to act in their best interests, often times, how an investment manager determines whether a particular recommendation meets that standard may not be supported by a process that is as systematic or documented as it perhaps should be.**

In the context of alts, the topic of suitability becomes acutely important given the regulatory risk considerations discussed above. When recommending alts to clients or prospective investors, investment managers should be mindful of all the dimensions of suitability, both through the lens of product and customer due diligence. Additionally, particular focus should be given to evaluating reasonably available investment alternatives, special or unusual features of the alts product, the customer's level of financial sophistication, and

the customer's liquidity needs. The table below outlines the dimensions of suitability that have been discussed by regulators over the past number of years:

### SUITABILITY FRAMEWORK

<u>PRODUCT</u>	<u>CUSTOMER</u>
▶ Potential risks (e.g. liquidity, volatility, margin call terms, early repayment of debt underlying a securitized product, potential losses, etc.)	▶ Investment objectives/goals (e.g. long-term growth, short-term savings, income, preservation of capital, tax advantage, market segment exposure, etc.)
▶ Potential rewards (e.g. expected returns, expected payout rates, etc.)	▶ Current income
▶ Commissions, markups/markdowns, and other transaction costs	▶ Financial needs
▶ Other fees that may impact return (e.g. 12b-1, revenue sharing, TA fees, administrative and service fees, etc.)	▶ Risk tolerance
▶ Trading costs (at strategy level)	▶ Marital status
▶ Exit costs (e.g. deferred sales charges, redemption fees, other liquidation costs, etc.)	▶ Investment experience
▶ Likely impact of costs over investor's time horizon	▶ Tax status
▶ Reasonably available alternatives	▶ Financial sophistication
▶ Affiliated or proprietary nature of product	▶ Age
▶ Special or unique features (e.g. tax advantages, guaranteed payments, etc.)	▶ Liquidity needs
▶ Role of product in the context of the client's actual or anticipated portfolio	▶ Investment time horizon
▶ Tax considerations	▶ Decision autonomy preferences

### THE SEC MARKETING RULE

**The discussion of alts with prospective investors also raises more tailored implications under the SEC's Marketing Rule. Although alts do not necessarily invoke any new categories or**

particularly novel applications of the Rule, attention should be given to how the less common features of alts can make the process for creating, approving, and distributing marketing materials more nuanced.

In the context of alts, the following components of the Marketing Rule are of particular note: unsubstantiated claims, fair & balanced treatment, performance claims, third-party ratings, and Compliance approval processes. The table below identifies ways in which investment managers may wish to think through each of the aforementioned categories when creating an alts-centric advertisement:

### ALTS & MARKETING RULE CONSIDERATIONS

<u>TOPIC</u>	<u>CONSIDERATIONS</u>
Unsubstantiated Claims	<ul style="list-style-type: none"> <li>▶ Has the investment manager overstated or exaggerated the level of due diligence performed on the product or strategy?</li> <li>▶ Has the investment manager overstated or exaggerated its research process?</li> <li>▶ Has the investment manager overstated or exaggerated the qualifications and experience of its personnel?</li> </ul>
Fair & Balanced	<ul style="list-style-type: none"> <li>▶ Has the investment manager given fair and balanced treatment when discussing the product's potential benefits (e.g. discussing how while interval funds may offer greater access to private credit, there are corresponding liquidity considerations tied to the vehicle)?</li> <li>▶ Has the investment manager clearly and prominently stated such other considerations?</li> <li>▶ Has the investment manager given fair and balanced treatment when giving alts advice generally (e.g. while alts have potential benefits, they also can carry various risks and complexities)?</li> <li>▶ Is the investment manager providing alts marketing to an audience that is wider than may be appropriate for the particular strategies or products being discussed?</li> </ul>
Performance	<ul style="list-style-type: none"> <li>▶ Is the investment manager presenting any of the following forms of performance without required corresponding disclosures: gross, extracted, hypothetical, predecessor?</li> <li>▶ Is the investment manager presenting performance over the requisite periods (e.g. 1-5-10)?</li> <li>▶ For hypothetical performance, is its use limited to an audience whose financial scenario and investment objectives make the hypothetical performance relevant (e.g. are alts even a potentially viable product or strategy for the client or prospective investor)?</li> </ul>
Third-Party Ratings	<ul style="list-style-type: none"> <li>▶ Do the investment manager's marketing materials contain references to any third-party ratings or awards that lack applicable disclosures (e.g. disclosing the date the rating was given, whether the investment manager provided compensation in connection with obtaining the rating, etc.)?</li> </ul>
Compliance Approval	<ul style="list-style-type: none"> <li>▶ Does the investment manager require Compliance approval of alts marketing prior to use?</li> <li>▶ If the investment manager does not require Compliance approval of alts marketing prior to use, what is Compliance's back-testing process?</li> <li>▶ Does Compliance conduct monitoring for use of any unapproved or non-compliant advertising materials?</li> </ul>

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## PARTING THOUGHTS

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With the current administration, the regulatory environment for alts appears that it be more amenable to mainstream alts use compared to prior years. However, that shouldn't be taken to mean the SEC will take a laissez faire approach to investor protection in this space. Indeed, Jay Clayton – an independent and whose nomination for serving as U.S. Attorney for the Southern District of New York – has consistently spoken of both democratizing ordinary investor access to products that traditionally have only been available to institutional and sophisticated investors, while concurrently being clear that such access should be accompanied by appropriate protections and standards. Similarly, although the current administration is aggressively pursuing the expanded use of crypto and crypto markets, the SEC appears to be going about it deliberately with its series of crypto roundtables. Accordingly, investment managers shouldn't run headlong into the alts waters without first testing those waters against a well-established body of regulatory guidance and positions. While the past performance of regulators is by no means a guarantee of future regulatory returns, it can at least prompt investment managers to make more risk-informed decisions when it comes to their use and employment of alts – both for the benefit of managers, but more importantly, investors.

Thanks for reading . . .

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