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ATTORNEYS & COUNSELORS

Independent Underwriting— The Rubber Meets The Road (Again) with SEC Regulation BI

For decades, FINRA has given implicit direction to broker-dealers (BDs) that they must independently analyze and make a determination as to the prospective financial performance of private placement investments and other nontraded securities. Those BDs who continue to utilize third-party “reports” of REITs, DSTs, oil and gas drilling, and other investments, which simply do a “stress test” of the sponsor’s numbers or provide generic sub-market or asset class data are placing their firms and their clients’ hard-earned dollars at significant risk. SEC Regulation Best Interest (Reg BI) has codified this mandate.

NTM 03-71 requires that the BD independently determine “the creditworthiness and value of any underlying collateral.” NTM 10-22 requires that the BD conduct a reasonable investigation concerning: 1) the business prospects of the issuer; 2) the assets held by or to be acquired by the issuer; and 3) the claims being made. FINRA mandates that reasonable basis suitability includes “analyzing management’s assumptions upon which any business forecast is based.”

In the context of a commercial real estate asset, analyzing the value of the collateral and assets to be acquired mandates a direct analysis of the offering’s asset(s) against the same asset class comparables in the same submarket. It requires that the BD compare the acquisition price and offering cost to investors against the historical NOI of the asset. “Claims being made” in, and the “business prospects” of, the offering would obviously include the comparison of the asset’s current and prospective rental rates, expenses, concessions, vacancy numbers and financing costs against not only market metrics but state macroeconomic and MSA trends. Post-acquisition real estate tax valuation and reassessment, 10-year capital improvement schedules and reserves, and NOI short of out-year master lease payments are just a few of the examples uncovered with independent 10-year Argus modeling on real market data.

Reg BI not only requires the above exercise in independent underwriting, but it requires that the BD be able to compare its own financial analysis of a particular product with its underwriting of other, competing products in making a best interest investment recommendation. For example, if a product is more expensive than comparable products, or if a BD receives higher compensation for selling a particular product as compared to other products

with comparable features, the BD needs to be able to produce underwriting models created by its law firm or consultant that show the superior IRR, debt service/master lease coverage and/or exit valuation differentials.

In summary, FINRA has always required independent underwriting of non-standard assets, and now the SEC has mandated that a BD should be able to demonstrate its reasoning in concluding that a higher-priced or more remunerative product or strategy is in fact in the customer’s best interest. That is done by utilizing a third-party firm that can direct the BD as to which of many alternative DSTs, Opportunity Zone, oil drilling or REIT portfolios have a greater underwritten IRR and a higher likely return of capital than others, especially when lower cost alternative products or BD compensation structures are available.

ASSET CLASSES ANALYZED:

Mick Law PC provides reliable, industry-leading independent due diligence analysis on an ever-widening scope of alternative investments, including, among others:

Real Estate

- Delaware Statutory Trusts (DSTs)
- Qualified Opportunity Zones (QOZ)
- REITs (Public Non-Traded, Reg D and Reg A+)
- Development Projects
- Conservation-Oriented Real Estate

Oil & Gas, Energy

- Drilling Partnerships
- Royalty Programs
- Leasebank

Additional Alternative Classes

- Private Equity: Funds and Direct Investments
- Business Development Companies (BDCs)
- Interval Funds
- Liquid Alternatives / 40 Act Funds
- Life Settlements

Contact us to discuss how we can customize an affordable and effective due diligence solution that fits your needs.

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