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The Role of Asset-Level Due Diligence in Meeting SEC Reg. BI's Diligence, Skill, and Care Obligation

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The Financial Industry Regulatory Authority, Inc. ("**FINRA**") released its *Risk Monitoring and Examination Priorities Letter* on January 9, 2020, which identified about a dozen examination focus points for this year. Among the examination focus points, it comes as no surprise that Regulation Best Interest ("**Reg. BI**") landed at the top of the list. This article summarizes FINRA's examination priorities relating to Reg. BI and the importance of undertaking asset-level due diligence in respect to Reg. BI's duty of care obligation.

The U.S. Securities and Exchange Commission ("**SEC**") adopted Reg. BI on June 5, 2019. Reg BI establishes a "**best interest**" standard of conduct for broker-dealers and associated persons when they make securities recommendations to retail customers. The best interest obligation is comprised of four components that include: (i) a disclosure obligation about the recommendation and relationship of the broker-dealer and retail customer; (ii) a duty of diligence, skill, and care in making the recommendation; (iii) a duty to disclose and mitigate conflicts of interest; and (iv) a duty to adopt policies designed to facilitate a broker-dealer's compliance with the disclosure, duty of care, and conflict requirements of the rule. While noting the SEC's initial contemplation of a fiduciary duty rule for broker-dealers, the commentary to Reg. BI clarifies the SEC's preference for a best interest rule that espouses disclosure, product skill and knowledge, and conflicts mitigation based upon the transactional nature of the broker-dealer business model.

For decades, FINRA has given implicit direction to broker-dealers that they must conduct rigorous due diligence relating to non-traded securities (e.g, RN 03-71, RN 10-22), which include independent confirmations of a product sponsor's claims and representations stated in private placement memoranda and other offering materials. Most recently Reg. BI's duty of diligence, skill, and care was added to FINRA's due diligence mandates, which require a broker-dealer to understand the "**risks, rewards, and costs**" of its securities recommendations in order to have a reasonable basis to believe that the recommendation concerning a securities purchase will serve the best interest of the retail consumer. This "duty of care" obligation of Reg. BI requires an understanding of a security's risks, rewards, and costs in connection with the client's profile <u>in an effort to determine if the recommendation favors the broker-dealer's interests over that of the client</u>.

To fulfill the duty of care obligation, a broker-dealer must consider a security's risk, rewards, and costs within the context of what reasonable alternative products offer. While product costs must be considered, the obligation does not always require the lowest cost alternative to be chosen but the higher cost product must be justified (for example, the underwritten economics are better).

From an underwriting perspective, the assets of low-cost products can sometimes be located in challenged markets where the sponsor's ability to perform is stressed or a lower up-front cost product might have a lower preferred return or a higher sponsor carried interest. While an analysis of reasonable alternatives is required, the obligation does not require broker-dealers to identify every product alternative available or to select "one best" product within an alternative investment class. *Most importantly, however, a broker-dealer may not use a limited product menu to justify recommending a product that does not satisfy the best interest obligation.* Hence, the product's prospects for economic success and the client's willingness and capacity to tolerate the risks must be considered alongside the fairness of the broker-dealer's and product sponsor's compensation (i.e., thereby justifying rigorous asset-level due diligence in an effort to determine if the product can produce a reasonable return on investment given the risks).

Within its 2020 exam priorities letter, the SEC mentioned a list of factors that FINRA may take into consideration in determining if a broker-dealer has achieved Reg. BI compliance after the rule's implementation date (June 30, 2020). Of the nine factors, two specifically touch upon the duty of care obligation, which include the following points of inquiry:

- Does the firm consider the risks, rewards, and costs of a product being recommended to a client?; and
- Does the firm consider reasonably available alternatives to the recommendation?

In our view, Reg. BI is where "**the rubber meets the road**" on the due diligence front when it comes to reviewing alternative investments such as REITs, DSTs, oil/gas, and other non-traded securities, and this observation rings true when it comes to using resources and analytics tools in a way that will further one's grasp of the risks and rewards of product choices. Unfortunately, asset-level analysis among broker-dealers and consulting attorneys and firms has come in a variety of shapes and sizes, from 1) those that engage in an independent economic valuation of an asset, to 2) those that "stress test" the sponsor's internal pro forma, to 3) a cursory review of generic sub-market data, to 4) a complete reliance upon the sponsor's colorful marketing slicks and internal pro formas. The first-mentioned of these alternatives is what we believe Reg. BI is wanting broker-dealers to accomplish.

In the context of a commercial real estate asset, a consideration of the asset's ability to perform under various economic conditions mandates an analysis of the offering's asset(s) against the same asset class comparables in the same submarket. In terms of product rewards/costs, broker-dealers should compare the acquisition price and offering cost to investors against the historical net operating income ("**NOI**") of the asset. The risks/rewards of an 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 and submarket metrics but state macroeconomic and MSA trends. In terms of a risk/reward assessment, an "as important" factor to the on-going cash flows of a property would be the capability of the property to return capital to investors in 6-8 years and how the market trends of an area align with that objective. This is where independence in real estate underwriting is needed.

In the energy space, FINRA 10-22 mandates that the broker-dealer obtain, with respect to energy development and exploration programs, expert opinions from engineers, geologists and others to determine suitability of the investment prior to making a recommendation. From a best practices perspective, and to appropriate identify the rewards and costs of an energy project as Reg. BI requires, the obligation of care means engaging a petroleum engineer who is intimately familiar with a particular shale play or basin to: (i) determine the quality of the reserves; (ii) model the production on NYMEX strip; (iii) factor the costs of production; (iv) create a model at the asset level, and then (v) factor in partnership splits and carried interest to determine the financial return to the investor. In terms of identifying the risks of the subject program as Reg. BI requires, the guidance of independent technical experts is almost always necessary in helping us understand (i) whether the oil/gas project is proven or exploratory in nature, and (ii) what the most significant operational challenges are (e.g., water production/disposal, pipeline constraints in an area). In terms of costs, the guidance of technical experts is also necessary to help broker-dealers to understand the nature of what drilling and operating costs are reasonable and whether or not a project operator is taking advantage of the investors.

Taking it a step further, Reg. BI not only requires the aforementioned exercises in underwriting, but 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 real estate or oil/gas product is more expensive than its comparable products in terms of mark-ups, management fees, or carried interests, it might be difficult for the broker-dealer to argue that the product is in the best interest of the customer. Similarly, the fact that a broker receives higher compensation for selling a particular product as compared to other products with comparable features indicates that the broker might be placing its interest ahead of its customer. *On the other hand, if a broker-dealer can show, through independent asset level economic analysis, the reasonable prospects for a higher return on capital were present despite the higher commissions or higher sponsor compensation, it would appear that the broker-dealer would be in a much better position to defend its recommendations on the basis of Reg. BI.*

Where a broker-dealer has a limited product menu or most definitely proprietary products, we believe it would behoove the broker-dealer to have the deals analyzed with a rigorous independent asset level review to ensure that the assets are viable and have the capability to deliver a reasonable return on investment under conservative economic conditions.

While Reg. BI gave the broker-dealer community a year to figure out a path to compliance, the grace period wanes each day. In respect to complying with the duty of care, a highly prudent step in our view would be to take a hard look at the quality of your asset-level underwriting practices and resources. This is the path to truly and objectively understanding the risks and rewards of a product offering and whether the product can deliver a return to your clients that is more competitive than other available products if higher broker-dealer compensation is involved.