

# MICK QUARTERLY

*Alts. News Bulletin*



## Today's News

In this Edition, we provide an overview of the SEC's Regulation Best Interest (Reg BI) as it applies to the sales of non-traded equity and debt products, and in doing so, we explain the importance of having independent asset-level underwriting in the due diligence process. We will provide you with a real estate sector report covering the U.S. MultiFamily Sector. Finally, we'll conclude with announcements of industry events.

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# SEC Reg BI's Diligence, Skill, and 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.

*Historical Background:* For decades, FINRA has given implicit direction to broker-dealers that they must conduct rigorous due diligence relating to non-traded securities (e.g., Notice 03-71, Notice 10-22), which include independent confirmations of a product sponsor’s claims and representations stated in private placement memoranda and other offering materials. In 2020, 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 in an effort to determine if the recommendation favors the broker-dealer’s interests over that of the client.

*Role of Due Diligence:* **To fulfill the duty of care obligation under Reg BI, 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 (e.g., 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).

*Western International Securities:* The first seminal case in which a brokerage firm was alleged to have violated Reg BI was SEC v. *Western International Securities, Inc.* (Dist. Court, CD California 2022), a case involving \$13.3 million in "L-Bond" sales to several retail investors who were elderly, had moderate risk tolerances, and were living on fixed incomes. The L-Bonds were sold through Reg. D offerings and paid interest of 5.5-8.5% depending upon the product maturity dates.

The actionable sales occurred from July 2020 through 2021 and after the bond issuer had undergone a material change in its core business activities. Prior to the sales of the L-Bonds (2018 and prior), the bond issuer (GWG

Holdings, Inc., or “**GWG**”) had been engaged in the business of acquisition life insurance policies in secondary market transactions. Upon acquiring control of GWG’s business through a series of transactions occurring in 2018-2019, Beneficient Company Group changed GWG’s core business activities to include issuing loans and other liquidity products to customers holding illiquid alternative investments.

Short of providing a full case analysis, the defendants, which included a broker-dealer firm and several of its registered representatives, were alleged to have violated Reg BI on several grounds, including their failures to: (i) appropriately conduct ongoing due diligence to understand the effect of a fundamental business change upon the L-Bond’s risk, and (ii) to update rep-oriented on-line product education to encompass the change to the bond issuer’s core activities. In addition to its failure to update its due diligence and rep-education resources, the defendant advisors were alleged to have violated Reg BI by failing to consider comparable fixed income products that could have been offered to the investors instead of the L-Bonds.

Although the content/analysis of the case opinion focuses more on the failure of updating due diligence and rep-oriented product education, the failures of certain of the defendant advisors to conduct adequate comparable product analysis were noted by the court in multiple instances. As such, the illustrates that the Securities and Exchange Commission will examine a broker-dealer’s comparative product analysis when considering Reg BI compliance matters.

*MICK Thoughts:* Reg BI is now 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**. An incredibly helpful exercise allowing BDs to balance risk/reward is to underwrite not only the costs of a program but also its underlying

assets in a manner that enables one to understand a program's reward potential in light of its risks. Unfortunately, asset-level analysis among broker-dealers and consulting firms have come in a variety of shapes and sizes, from (i) those that engage in an independent economic valuation of an asset, to (ii) those that "stress test" the sponsor's internal pro forma, to (iii) a cursory review of generic sub-market data, to (iv) 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 appropriately 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.

*Reg BI not only requires the aforementioned exercises in 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 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. The review should consider how the costs and sponsor compensation of the product

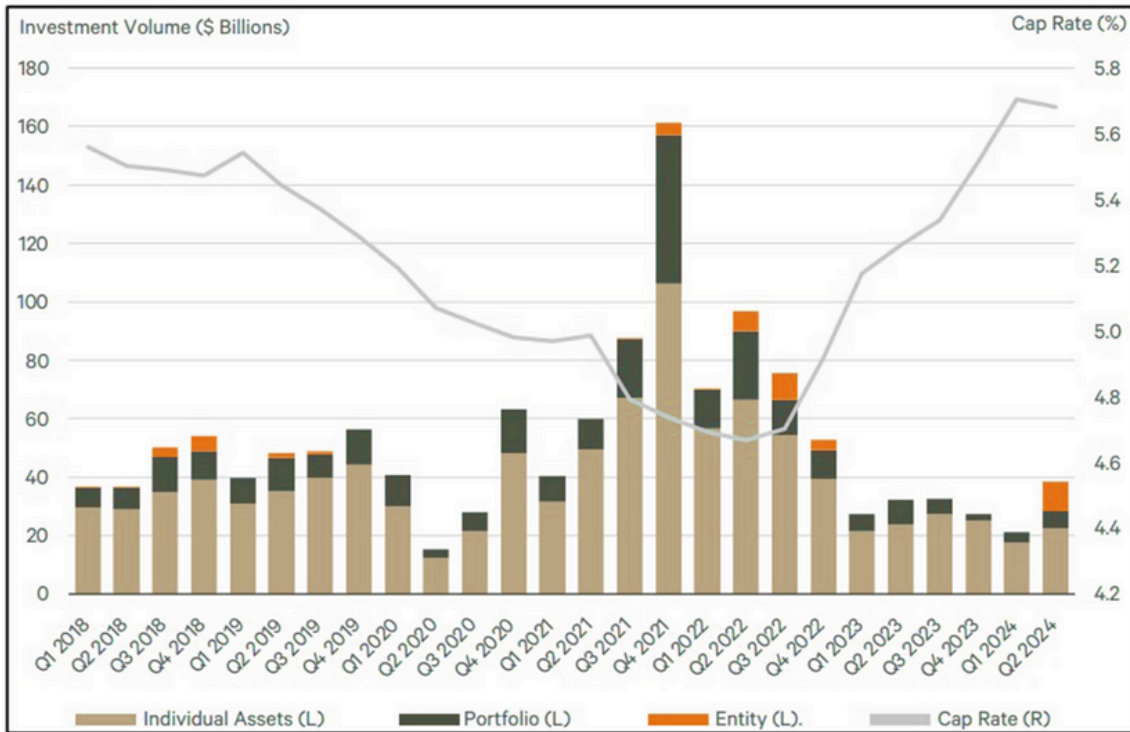
fares against products with similar features and underlying sector strategies. In terms of measuring risk/reward, an independent examination of the underlying program assets in terms of return potential and business execution risk would be appropriate.

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. On a final note, we recommend that you review “Practice Tips to Satisfy the Care Obligation of Due Diligence for BDs Under Regulation Best Interest,” which was written by Miriam Lefkowitz, JD, and published by the National Society of Compliance Professionals (Sept. 2020). The article provides good practical guidance on how FINRA firms should consider designing their due diligence programs to comply with Reg BI. The article provides helpful practice tips on due diligence information gathering, as well as tips for using third party reports. Ms. Lefkowitz is a Bates Consulting and Testifying Expert with more than 25 years of professional experience in broker-dealer and investment adviser securities regulations and compliance. She has also seen the other side of the industry, having served as an enforcement attorney for the SEC. A full copy of the article reprint can be provided upon request.

## Multifamily Investment Market

According to CBRE, multifamily investment continues to remain depressed. The total multifamily investment sales for 2023 were \$117.5 billion, approximately 40% of the 2022 multifamily investment sales of \$294.8 billion, and 35% of the 2021 record multifamily investment of \$335.3 billion. The decline continued in the first half of 2024. The rolling-four-quarter (“R4Q”) investment volume as of June 30, 2024 was \$119.1 billion, the

second-lowest R4Q total since the third quarter of 2014; second only to the R4Q ending March 31, 2024. Multifamily investment still accounts for the largest share of total commercial real estate investment activity at 43% over the R4Q ending June 30, 2024. A summary of multifamily investment from 2009 to present can be found below:



According to CBRE, the average multifamily going-in capitalization rate, or “cap rate,” held steady at 5.7% in the second quarter of 2024. Since the Federal Reserve (the “Fed”) began increasing interest rates in the second quarter of 2022 (prior to the more recent rate cut in Q3 2024), the national average multifamily cap rate has increased by 100 basis points. Over the same period, the cap rate among prime<sup>1</sup> markets has increased 170 basis points, but declined by four basis points during the second quarter of 2024. The average multifamily cap rate exceeds the pre-pandemic (2018-2019) cap rate by approximately 75 basis points.

According to CBRE’s Q2 Prime Multifamily Underwriting Survey,

<sup>1</sup> The top 15 multifamily markets in the country, as determined by CBRE



underwriting assumptions for multifamily assets are nearing their peak. The narrow spread between going-in and exit capitalization rates continued a decline that lasted for eight consecutive quarters, from the 4th quarter of 2021 to the 4th quarter of 2023. The overall average exist cap rate for prime multifamily assets is not expected to fall below the going-in rate before pricing recovery begins in earnest.

The Fed's ongoing efforts to combat inflation have caused debt to become more expensive and less available, precipitating a cap rate rise across all asset classes. Fed Chair Jerome Powell has been clear that the Fed wants to achieve maximum employment and inflation at the rate of 2% over the longer term. After reaching a high of 9.1% in June 2022, inflation has recently begun to wane. The latest CPI report, published September 11, 2024, showed consumer prices increased 2.5% in the 12 months ended August 2024, the smallest 12-month increase since February 2021. Nevertheless, with short term rates still 400 to 500 basis points above the level found during early 2022, many investors have reset expectations, resulting in less aggressive bidding and higher cap rate expectations. After a series of successive increases that led to the highest federal funds rate in two decades (recorded July 2023), the Fed just recently voted to decrease the federal funds rate by 50 basis points to a range of 4.75% and 5.0%. According to the Fed, "[it] has gained greater confidence that inflation is moving sustainably toward 2 percent, and judges that the risks to achieving its employment and inflation goals are roughly in balance."

## Upcoming Events Calendar

### **2024 Mick Law Real Estate Symposium**

October 20-22 at the Westin  
Tempe Hotel, Tempe AZ

### **The National Due Diligence Alliance**

November 22-24 at The St.  
Regis, Houston, TX