

# ALTERNATIVE PRODUCTS, SELLING AND DEFENDING FROM THE PERSPECTIVE OF THE BROKER DEALER, THE E & O CARRIER, THE LEGAL DEFENSE TEAM AND THE EXPERTS

Sherri Cooke, CEO and Founder of AI Insight

David Baugh, Co-Managing Partner, Kaufman Dolowich & Voluck

Karl Marquardt, Principal, Bressler Amery Ross

Jay Rosen, Chairman Emeritus, Capital Forensics, Inc.

Greg Curley, Senior Litigation Counsel, Advisor Group

Lilian Morvay, CEO, IBDC-RIAC



## THE BROKER-DEALER'S PERSPECTIVE

- What is adequate due diligence?
  - Obtain and review all offering documents and receive and review all subsequently issued product documents.
  - Review audited financials and all subsequent financial reports.
  - Arrange for meetings/calls with the product sponsor or, if feasible, personal meetings.
  - Create a well documented file about the specific product and the rep should create a file for the clients that are investing in the product.



## WHAT IS APPROPRIATE CLIENT DUE DILIGENCE?

- Is the client an accredited investor?
- Does the client exhibit an understanding of the risks associated with investing in the alternative products?
- Does the rep exhibit an understanding of the alternative products?
- Did the client sign disclosure forms regarding risks and information about the product before the investment?
- Did the broker-dealer take into consideration the age of the client before allowing the client to invest in alternative products?



# THE ISSUE OF CONCENTRATION LIMITS

- Most States' Blue-Sky laws limit the amount an individual may invest in alternative products.
  - Track and update all blue-sky laws regularly.
- Should broker-dealers articulate specific concentration limits in their WSPs?
  - Most broker-dealers specifically reference concentration limits in their WSPs. If and when exceptions to the concentration limits are made, they must be well documented with sound reasoning for the exceptions.
- Does your E & O policy impose concentration limits for the sale of alternative products?
  - Review your E & O policy carefully with the assistance of your insurance broker. Insurance carriers not only impose concentration limits, they may also limit the amount of the insurance limits that may be available to pay for claims involving alternative products.
- Should a broker-dealer have lower concentration limits for senior investors?



# Why • How • What

## WHY?

- In today's regulatory-centric environment, Broker Dealers, RIAs and advisors need confidence to offer complex product lines to remain competitive.

## HOW?

- Conduct thorough, independent analysis on alternative investment offerings and implement compliance documentation process.

## WHAT?

- Presentation of alternative investment offerings in a consistent and transparent manner must be demonstrated to regulators.



# Meeting regulatory requirements and mitigating risk

## **Present offerings based on factual understanding**

- Extensive database of PPM and prospectus-based information within the Program Summary provides key points at the offering-level.

## **Conduct ongoing due diligence through entire fund lifecycle**

- Review alternative investment trends and historical market data to help monitor and make informed decisions.



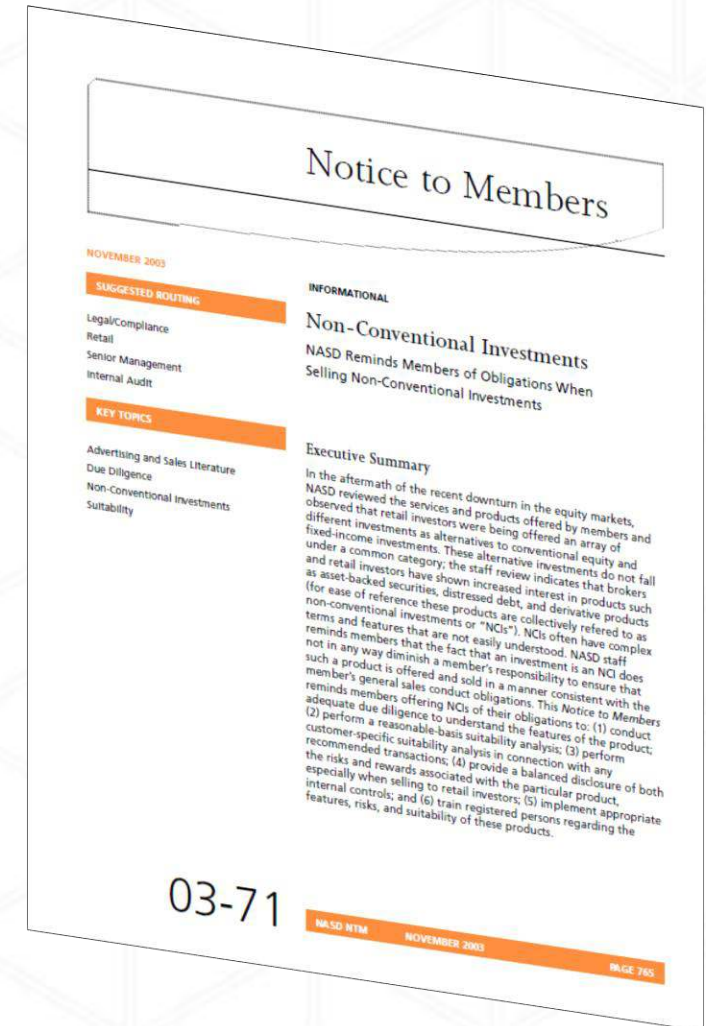
# Two-Part Suitability Test

## Due Diligence / Reasonable-Basis Suitability

Conduct due diligence on the investment product and ensure that it is suitable for some investors

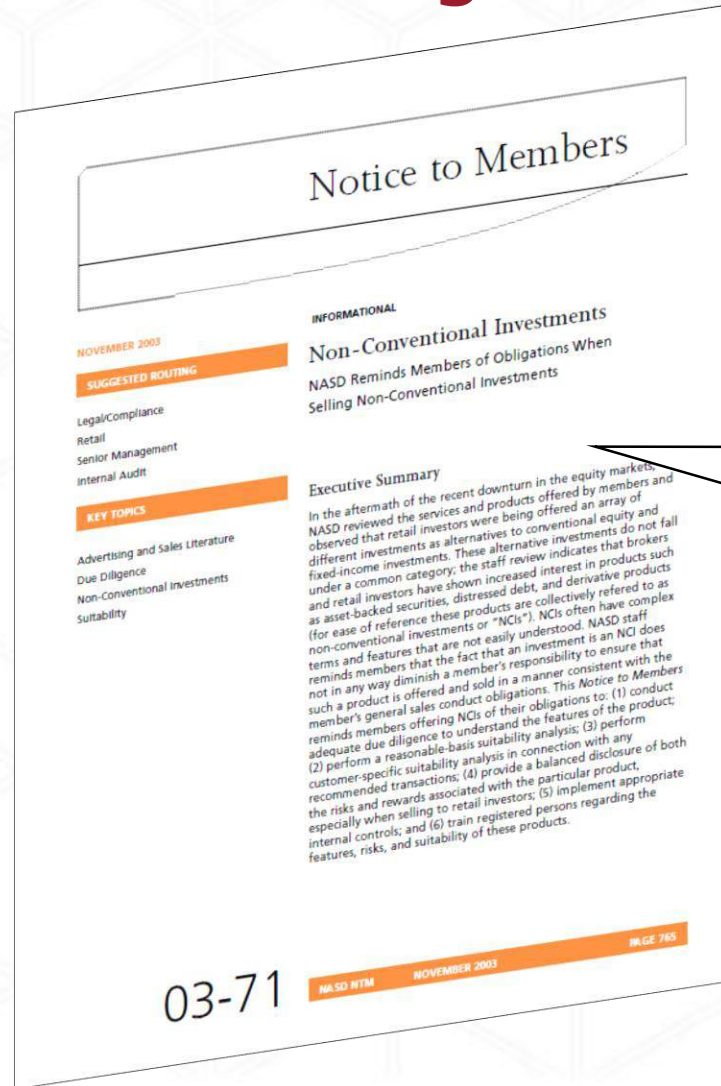
## Customer-Specific Suitability

Undertaken on a customer-by-customer basis in light of that customer's specific circumstances





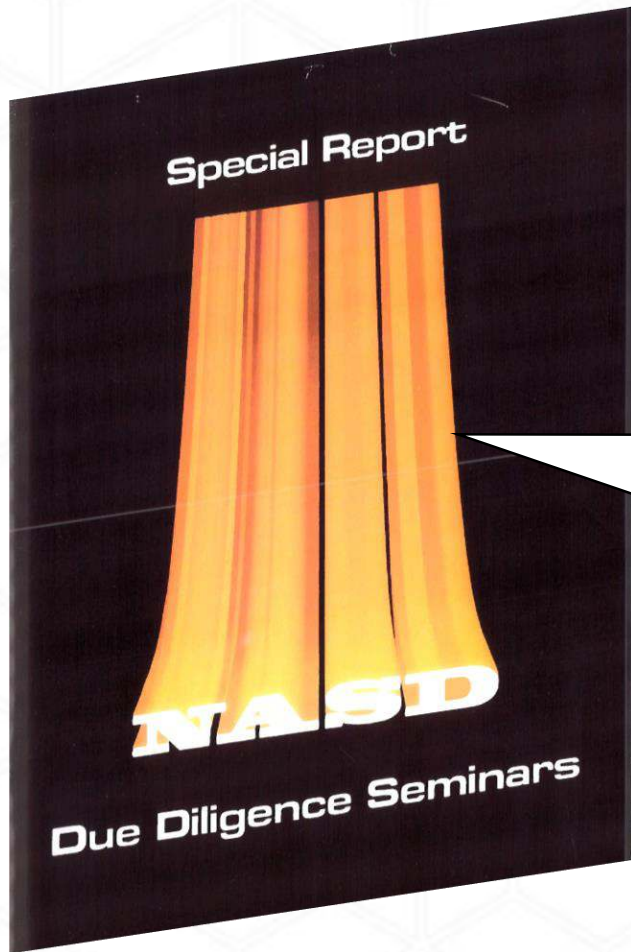
# The Due Diligence Standard: “Reasonable” Investigation



“Performing appropriate due diligence is crucial to a member’s obligation to undertake the required reasonable-basis suitability analysis.”



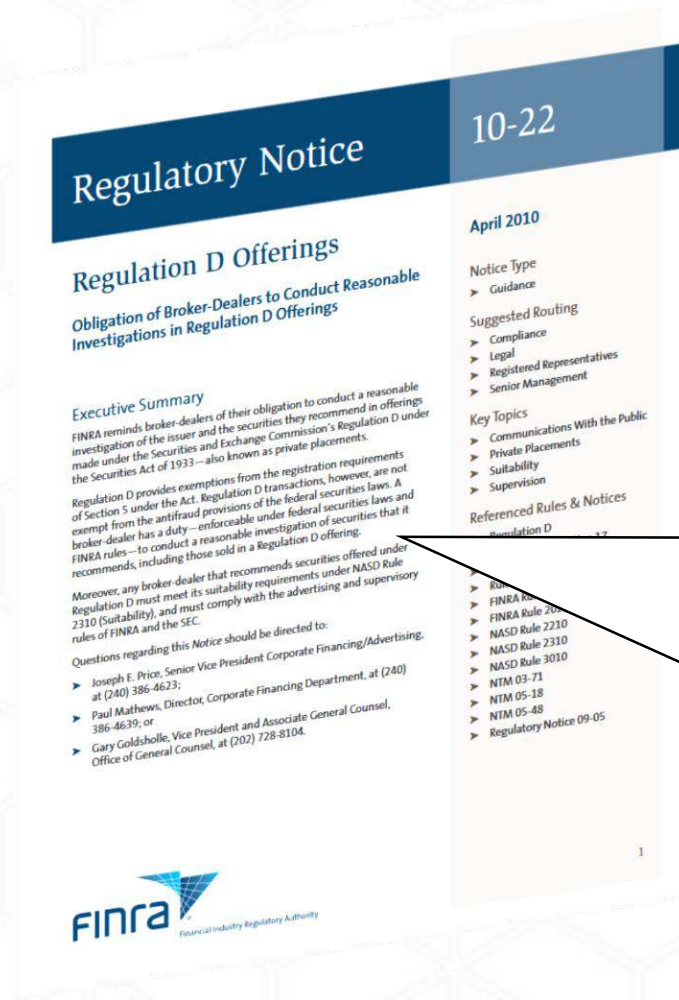
# What is “Reasonable” Investigation?



“The standard of reasonableness under Section 11 [of the Securities Act of 1933] is, in a sense, a ‘standard of the street.’ In considering whether an underwriter has conducted a reasonable investigation, therefore, one must realize that the standard is not an absolute standard that never changes.”



# What is “Reasonable” Investigation?



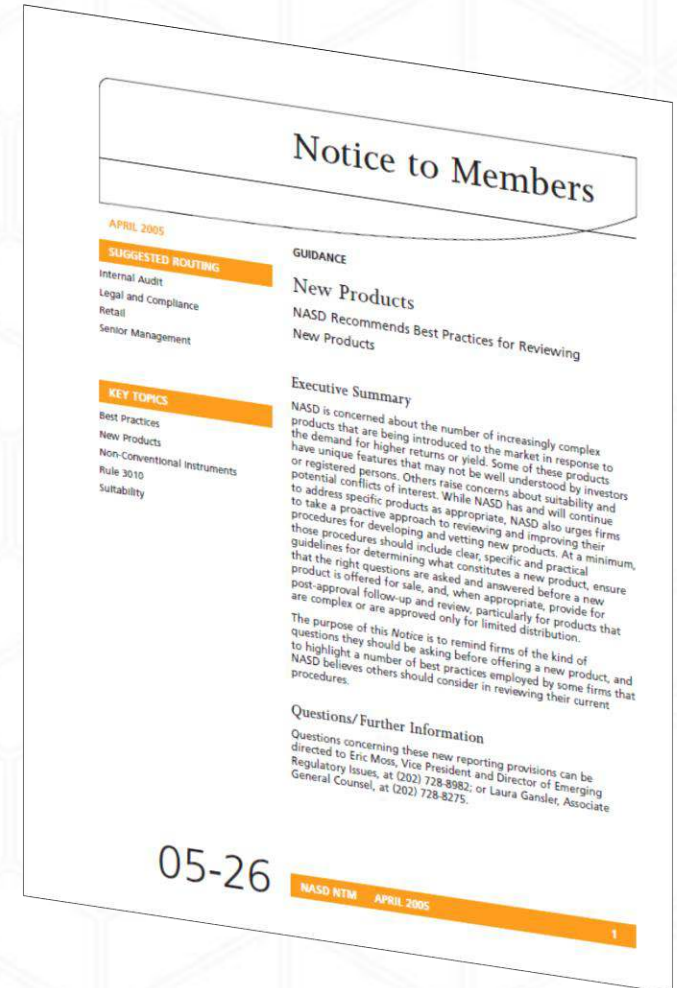
“There are *no iron clad rules* as to what a broker must do to meet his responsibility.”

“The amount and nature of the investigation required depends, among other factors, upon the nature of the recommendation, the role of the broker in the transaction, its knowledge and relationship to the issuer, and the size and stability of the issuer.”



# "Reasonable" Investigation: Due Diligence Best Practices

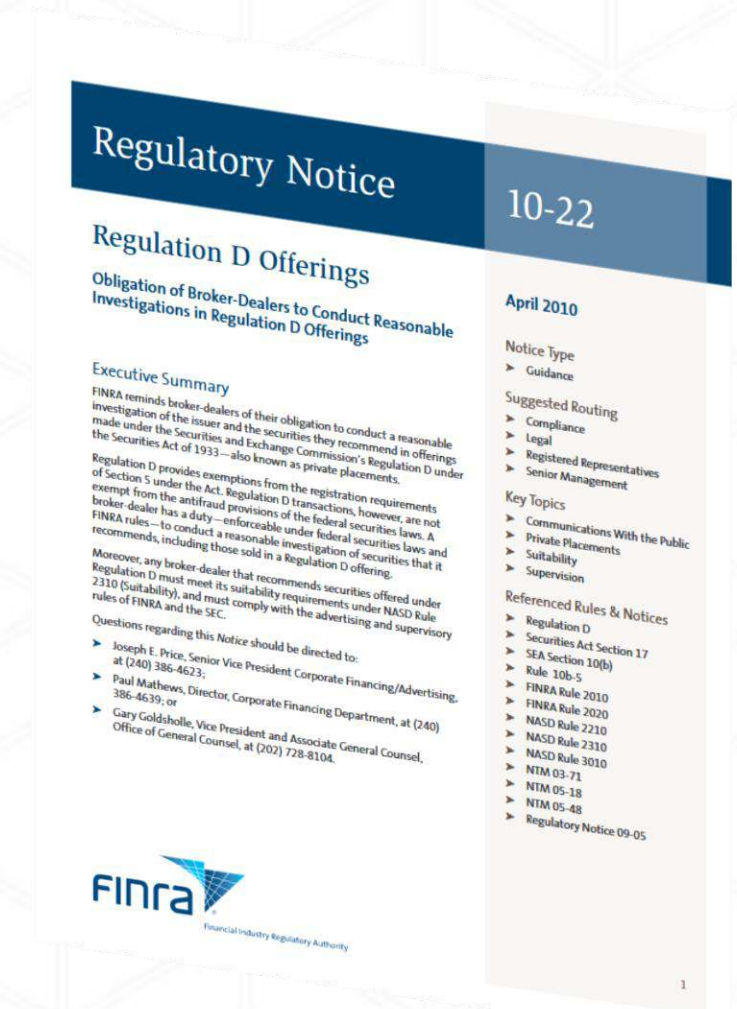
- Involve legal and compliance personnel at the outset
- Consider hiring a third-party vendor to handle due diligence
- Determine which customers can be permitted to purchase the product (e.g., "speculative" risk tolerance and minimum net worth)
- Ensure that adequate training for reps is required





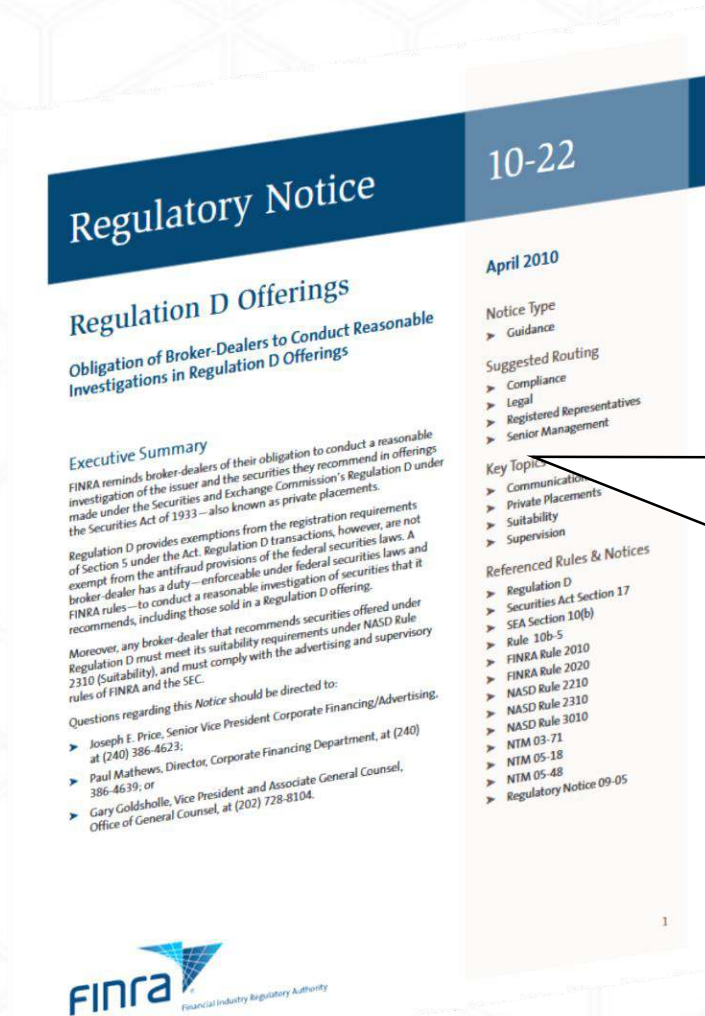
# Due Diligence – Nuts and Bolts

- ✓ Examine two years of issuer's audited financial statements and tax returns
- ✓ Review prior financing rounds (if any) and examine performance and use of funds
- ✓ Review issuer's contracts and finances – review business plans and revenue projections
- ✓ Review issuer's management – including background checks and compensation history
- ✓ Research issuer's industry, prospects for that industry, and any current/anticipated regulatory restrictions
- ✓ On-site visit of issuer's facilities
- ✓ Review status of issuer's intellectual property
- ✓ Review issuer's litigation and UCC history
- ✓ Maintain due diligence file demonstrating your review/analyses





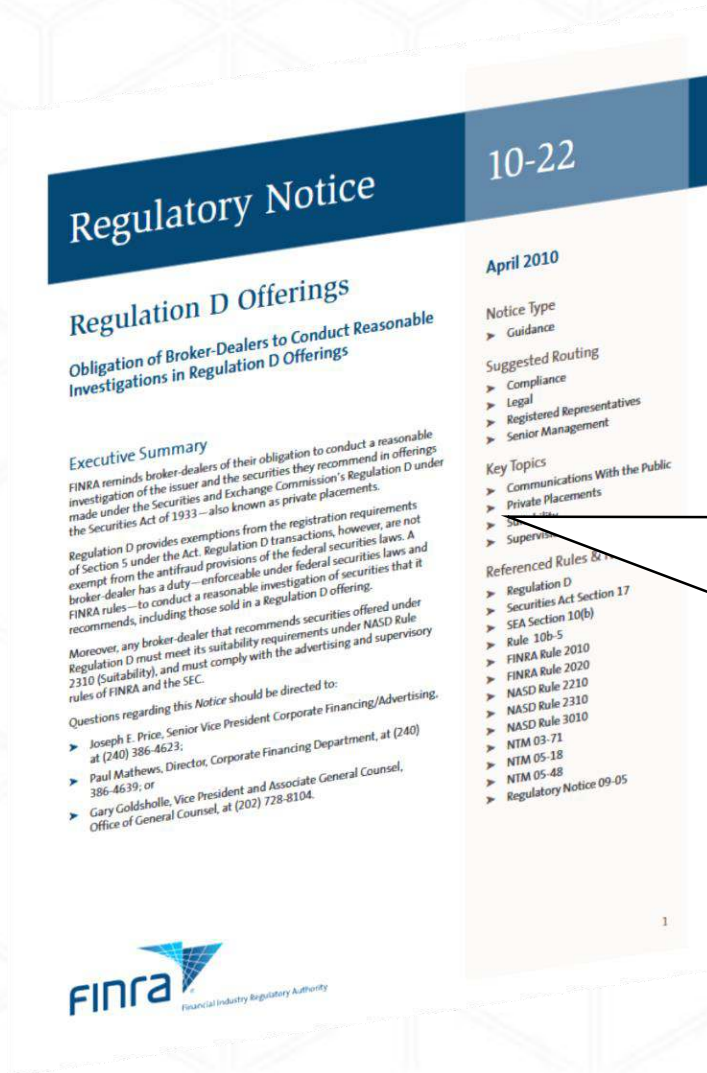
# Review the Sales Literature



“Sales literature concerning a private placement that a BD distributes will be deemed to be a communication by the BD *whether or not the BD assisted in its preparation.*”



# "Reasonable" Independent Investigation



"The use of counsel or experts does not necessarily complete the BD's investigation responsibilities, insofar as a review of the counsel's or expert's report may identify issues that require further investigation by the BD."



# “Reasonable” Ongoing Due Diligence



- Post introduction to market – track customer complaints
- Determine whether offering proceeds are being used consistently with the offering memorandum (*i.e.*, prevent “style drift”)
- Determine whether market conditions have materially altered the disclosed risks of the product



# “Unreasonable” Due Diligence

## Selected Examination Findings

FINRA has observed instances where some firms’ reasonable diligence was not sufficient in scope or depth to be considered a “reasonable investigation of the issuer and the securities.”

### ► No Reasonable Diligence

- Failure to conduct additional research for new Reg D offerings from the same issuer
- Failure to independently verify information included offering documents

### ► Overreliance on Third Parties


- Failure to independently evaluate due diligence reporting provided by third parties

### ► Potentially Conflicted Third-Party Due Diligence

- Failure to consider conflicts of interest between third-party due diligence and the issuer







**Conducting due  
diligence won't  
eliminate your  
litigation exposure**

**If a product fails –  
your due diligence  
will be assessed  
using hindsight bias  
and claims of  
“missed” red flags**



# Preparing an Alternative Products Claim for Arbitration

## Essential Documents from the BD's Due Diligence File

- ✓ Written Supervisory Policies – BD's due diligence, suitability and supervisory WSPs – gather and review documents that evidence the firm's adherence
- ✓ Product approval process – third party vendor report – including all supporting documentation reviewed by vendor, documented independent internal follow-up on any “red flags” identified during due diligence, new products committee minutes
- ✓ Client-facing materials – one pagers, PPMs – including drafts, subscription agreements, e-mails
- ✓ Training program for reps – materials used and documents evidencing completion by reps
- ✓ Ongoing monitoring – what did the BD do when/if there was a material change to the risks disclosed in the selling documents
- ✓ Expert witness – retain and consult with an expert witness regarding the above



# Defending an Alternative Product Suitability Case

- Understand the Product
- Evaluate the Customer
- Assess Your Client
- Review the Documentation



# What are the Stated Benefits and Risks of the Alternative Product and What is its Current Status?

- What are the underlying assets of the Alternative Product?
- What was the state of that market sector at time of offering?
- Is it a Reg D Offering?
- When and how are investors to receive distributions and/or return of initial investment?
- Is investment performing as predicted?
  - If not, why?



# Quantitative Suitability Under FINRA Rule 2111

- Customer Specific Suitability Requires a Quantitative Suitability Analysis
  - Focuses on the overall handling of the account - is the investment suitable in light of not only stated investment objectives and risk tolerance, but in the context of entire investor portfolio?
  - Factors that must be considered under Rule 2111
    - Age
    - Other Investments
    - Financial situation and needs
    - Tax Status
    - Investment Objectives
    - Investment Experience
    - Investment Time Horizon
    - Liquidity Needs
    - Risk Tolerance
    - "Any other information the customer may disclose in connection with such recommendation"



# Scenarios of Suitability Claims Involving Alternative Investments

- Overalllocation

- The most common claim for suitability relating to alternative products is the argument that a customer's portfolio was overallocated in alternative products
- Brokers often argue that a client did not want "market exposure."
  - Alternative products, most often, though are still subject to market forces, e.g. price of oil, softening of real estate market
- A broker recommends three alternative investments in different sectors: real estate, healthcare, oil & gas.
  - While the client's portfolio is then "diversified" in different sectors, most of his or her assets are now in illiquid.
  - The lack of diversification problem becomes bigger if more than one product recommended is issued by the same sponsor.
- An overallocation into alternative investments also instantly raises the question whether the broker was just after a large upfront commission.



# The “Income vs. Distribution” Pitch

- Sometimes a broker will recommend (and justify the recommendation of) an alternative product based upon an investor’s stated desire for “income.”
- Oftentimes, though, the income generated from an alternative product is actually a distribution, which may deplete the principal value of the investment
- The customer (and broker) may not understand that when the investment matures, it is not expected that the investor will then be returned his or her principal investment amount.
- If the broker does not understand how the product is designed, the investment may not fall within the parameters of the client’s needs, and therefore be unsuitable.



# Liquidity Issues

- Does the alternative product have a definitive end date for dissolution/payout?
- How old are the customers?
  - If near retirement, what is the customer's other anticipated retirement income?
- Do customers have other liquid assets in case of unanticipated life event?
  - Job loss
  - Death in the family, etc.



# Misrepresentations Regarding The Features of Investment

- Brokers sometimes describe alternative products as more “safe and secure” than stocks or equities because the alternative product is “secured” by an underlying asset (oil wells, hospitals, etc.)
- However, most alternative products carry a significant amount of risk, and certain investments may even be completely speculative, e.g. medical receivables, drilling rights.



# Strongest Defense - Documentation

- Do you have a well documented file and an informed broker?
- Broker Documentation might include:
  - Documentation of training on specific product
  - Review of due diligence file
  - Compliance manual sections delineating limits on amount of customer's portfolio may be dedicated to alternative products
  - Specific explanation justifying recommendation to client with back-up documentation
- Client Documentation might include:
  - Alternative Investment Form
  - Subscription Agreement
  - Written statement attesting to reason why client is interested in product and affirming understanding of risks of product



## Changes to FINRA Arbitration Panel Rules

- On January 31, 2011, the S.E.C. approved a rule change to provide customers in cases that proceed with three arbitrators the option to choose whether their case would be decided by three public arbitrators.
- On September 18, 2013, the SEC approved a modification to the rule. FINRA would provide all parties with lists of 10 chair-qualified public arbitrators, 10 public arbitrators, and 10 non-public arbitrators. FINRA would permit the parties to strike four arbitrators on the chair-qualified public list and on the public list. However, any party could select an all-public arbitration panel by striking all of the arbitrators on the non-public list.
- On January 1, 2017, FINRA's expansion to 15 public arbitrators began.



## What Do These Changes Mean For Respondents?

- With the likelihood of three public arbitrators, many of whom are new to FINRA, it is critical that Counsel and Firms do greater due diligence in ranking their prospective panelists. Arbitrator selection is more important than ever.
- Retaining an Expert early in the process helps to identify weaknesses and exposure that may exist. This will help Counsel create a defense around these issues.
- Because there are at least two and often three public Arbitrators (non-industry experienced), it is important that an Expert is retained, who is qualified and able to educate the Panel.



## Characteristics of a Successful Expert

A Successful Qualitative Expert Must:

- Generate the respect of a panel
- Be experienced in cross-examination
- Have comprehensive product knowledge
- Know the industry standards and rules
- Communicate relevant industry standards and best practices, effectively
- Know the importance of listening and evaluating every aspect (words, actions, etc.) of both the arbitrators, witnesses and Counsel
- Be able to demonstrate their wisdom and expertise in a concise manner.

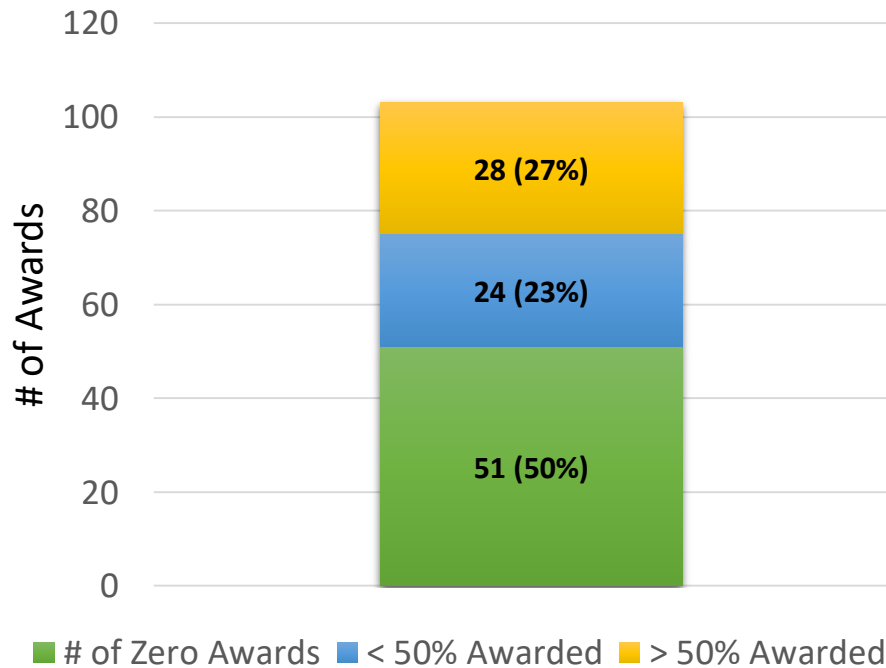






# FINRA Awards Analysis – Alternative Investments January, 2011 through May, 2019

Count by \$ Awarded



FINRA Awards Analysis - By Product

Investment Type (as described in the Award)	# of Awards Decided by Arbitrators	# of Zero Awards	# of Awards with < 50% Awarded	# of Awards with > 50% Awarded	Cases w/ Unspecified Damage Requests	Awards in Unspecified Damage Cases
Alternative Investments	13	6	3	4	-	-
Commodities	11	6	5	0	-	-
Derivatives	11	4	4	2	1	1
Hedge Funds	30	13	5	10	2	0
Managed Futures	5	3	1	1	-	-
Non-Traded REITs	41	21	8	10	2	0
Private Equities	5	4	0	1	-	-

1. One-hundred and three (103) awards were captured using the following search criteria: Alternative Investment, Commodities, Derivative, Hedge Fund, Managed Futures, REITs (non traded, illiquid, non public, non exchange, non registered), Private Equities
2. A single award may reference multiple products.



# THANK YOU FOR JOINING US

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# PANELISTS' CONTACT INFORMATION

**Sherri Cooke, CEO and Founder of AI Insight**

**Office: 877-794-9448 ext. 708 | Direct: 614-505-1005 Email: [scooke@aiinsight.com](mailto:scooke@aiinsight.com) | [www.aiinsight.com](http://www.aiinsight.com)**

**David Baugh, Co-Managing Partner, Kaufman Dolowich & Voluck**

**Cell: [847-710-5807](tel:847-710-5807) Main: [312-759-1400](tel:312-759-1400) Email: [dbaugh@kdvlaw.com](mailto:dbaugh@kdvlaw.com) [www.kdvlaw.com](http://www.kdvlaw.com)**

**Karl Marquardt, Principal, Bressler Amery Ross**

**P: 212.809.3794 | C: 201.417.0498 Email: [KMarquardt@bressler.com](mailto:KMarquardt@bressler.com) | [www.bressler.com](http://www.bressler.com)**

**Jay Rosen, Chairman Emeritus, Capital Forensics, Inc.**

**T.847-392-0900 C.847-561-6007 Email: [Jay@CapitalForensics.com](mailto:Jay@CapitalForensics.com) [www.capitalforensics.com](http://www.capitalforensics.com)**

**Greg Curley, Senior Litigation Counsel, Advisor Group**

**Office: 212-551-5723 | Email: [gcurley@advisorgroup.com](mailto:gcurley@advisorgroup.com)**

**Lilian Morvay, Founder and CEO, Independent Broker Dealer Consortium**

**Cell: 203-249-1712 Email: [Lilian@IBDCconsulting.com](mailto:Lilian@IBDCconsulting.com) [www.IBDCconsulting.com](http://www.IBDCconsulting.com)**