

Consider NASD NTM 05-48: Who Should Perform a Broker-Dealer's TIC Due Diligence?

With the explosive growth of the tenant-in-common ("TIC") market together with the requirement of the National Association of Securities Dealers, Inc. ("NASD") that a broker-dealer conduct adequate due diligence, broker-dealers have the daunting task of finding sufficient resources to satisfy their due diligence obligation. While outsourcing has become an increasingly popular option, there are several factors to be considered in selecting an outsourcing option, including the requirements of NASD Notice to Members 05-48.

Due Diligence Overview

To assess who should perform a broker-dealer's TIC due diligence, a broker-dealer should consider (i) why the firm conducts due diligence and (ii) the appropriate scope of a TIC due diligence review.

Broker-dealers conduct due diligence investigations prior to offering or selling securities for several reasons. For business purposes, due diligence assists broker-dealers in detecting and avoiding transactions with an unfavorable risk-reward profile. Legally, due diligence offers a number of potential benefits, including: (i) providing a defense to possible liability under state and federal laws that allow investor redress for material misstatements in or omissions from offering disclosure, (ii) allowing broker-dealers to gain sufficient knowledge of a transaction to perform an effective product-based suitability determination and (iii) complying with the NASD requirements.

NASD Notice to Members 05-18 ("NTM 05-18") expressly instructs members to conduct due diligence of a TIC offering. NASD believes it is inappropriate for members to simply rely on representations made by the sponsor of a TIC offering in an offering document and recommends performance of a reasonable investigation to ensure that an offering document does not contain false or misleading information.

Independence

Understanding what constitutes adequate due diligence requires an analysis of applicable legal precedent and regulatory policy as well as an understanding of

the business aspects of the proposed offering. The ultimate goal of any due diligence investigation is to evaluate the offering disclosure to ensure the offering document does not contain false or misleading information and contains all information necessary in light of the circumstances. Since the offering document reflects the statements of the sponsor, it is logical that both legal precedent and regulatory statements make it clear that it is inappropriate in conducting due diligence for broker-dealers to simply rely upon statements made by a sponsor - independent verification is paramount to adequate due diligence. A corollary to this concept is the principle that a broker-dealer's due diligence should be performed by its agent, not the agent of the sponsor. Thus, a broker-dealer should question whether a firm hired by the sponsor as its agent truly provides the requisite "independent" investigation.

However, "independent" does not always mean "adversarial," especially where the sponsor embraces the due diligence process. This is because while a law firm, such as our firm, retained by a broker-dealer has an ethical and legal responsibility to act in the best interests of its broker-dealer client, the sponsor benefits from the process since complete and accurate disclosure protects not only the broker-dealer, but also the sponsor, from potential liability.

Multi-Disciplinary Approach

Legal precedent and regulatory policy make it clear that a due diligence investigation should include verification of all facts material to an investor. Material facts generally are all facts a prudent investor would want to know before investing. For a TIC transaction, this requires a legal, business, and financial evaluation of the transaction. On the legal side, an understanding of real estate law, finance law, securities law and tax law are minimum requirements for evaluating the offering and related disclosure. On the financial and business side, an understanding of real estate markets, financial projections, and valuation concepts is critical. Thus, a broker-dealer should consider its ability to put each of these, and any other necessary disciplines, into play in developing its due diligence program.

Outsourcing

In establishing its due diligence program, a broker-dealer certainly can perform all work in-house by hiring personnel with the necessary expertise. However, given the cost of maintaining such an in-house staff, a broker-dealer may consider outsourcing some of its due diligence process to third parties. In addition to ensuring that these third parties are independent agents of the broker-dealer, a broker-dealer should comply with the requirements of NASD NTM 05-48. While NTM 05-48 sets forth many requirements, an overall theme is that the broker-dealer needs to determine that the third-party provider is

competent and should monitor performance of the provider's work to make sure that the work is being conducted appropriately. Thus, reliance on a third party to conduct due diligence requires an understanding of which aspects of the overall due diligence investigation the third party is performing, and a determination whether the third party is qualified to perform such duties.

For example, while a broker-dealer's need to evaluate legal aspects of title or loan documents could be outsourced to an appropriately experienced attorney, it would be questionable to outsource legal analysis of such matters to a non-attorney. Similarly, outsourcing of financial statement or financial projection analysis would seem to be better suited for an individual, such as a CPA or MBA, experienced in financial analysis. That individual may or may not have the requisite expertise in evaluating the adequacy of related offering disclosure, however, which requires experience with, and knowledge of federal securities laws.

Where does Snyder Kearney Fit In?

Snyder Kearney has assembled a strong, multi-disciplinary team to assist broker-dealers in conducting due diligence. Our staff of seasoned securities and transaction attorneys includes a former SEC branch chief, three MBAs, a CPA, an LLM in taxation and an LLM in securities law. Our attorneys have reviewed hundreds of TIC transactions and have been involved in real estate due diligence and other aspects of real estate securities offerings since the 1980s.

We believe that a critical component of a broker-dealer's due diligence process is an evaluation of legal aspects of the offering and the adequacy of offering disclosure by the broker-dealer's legal counsel - counsel that understands all pertinent aspects of the transaction. Our goal is to provide broker-dealers an effective outsourcing option to assist them in their due diligence of TIC offerings.