

XALT RIA FORUM 2019

INVESTOR SUITABILITY & TRANSACTION COMPLIANCE BEST PRACTICES



AGENDA

1

A Case Study

2

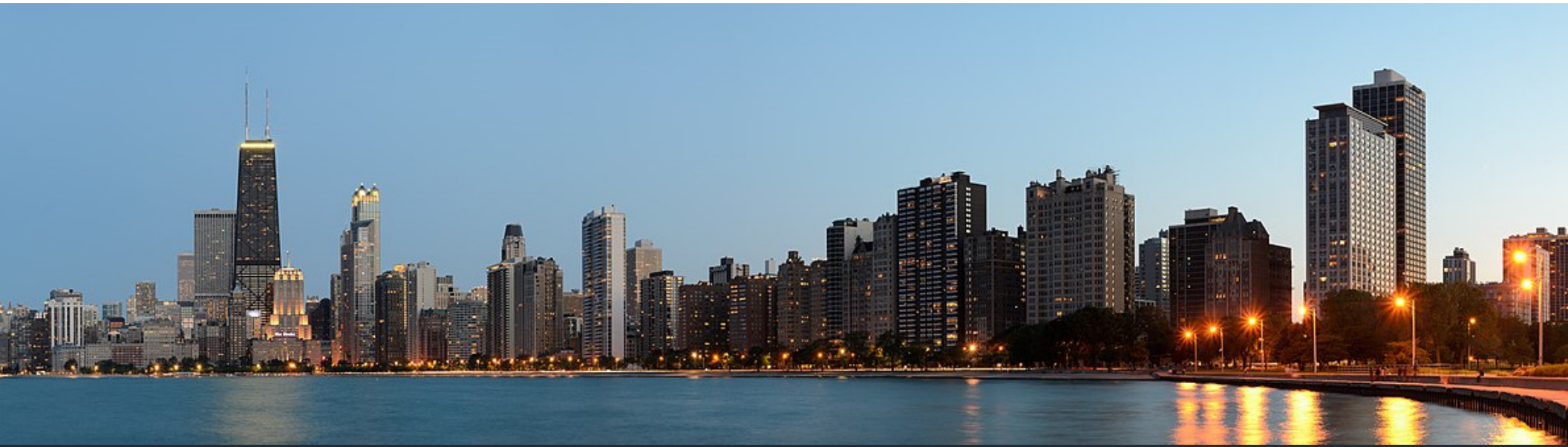
Investor Suitability Guidelines

3

Key State Issues

4

Key Transactional Documents



A CASE STUDY (ON WHAT NOT TO DO)

BACKGROUND

March 2014, LPL was fined \$950,000 for supervisory failures related to sales of alternative investments.

“In order to sell alternative investments, an advisory firm must tailor its supervisory system to these products. LPL exposed customers to unacceptable risks by not having an adequate system in place that could accurately review whether a transaction complies with suitability requirements imposed by the states, the product issuers, and the firm itself and it failed to train its registered representatives to apply all the suitability guidelines appropriately.”

- Brad Bennett, FINRA Chief of Enforcement

KEY FINDINGS

Alternative Investment Form:

- ☐ Did not have accurate definitions of net worth
- ☐ Concentration rules on AI Form did not match WSPs

KEY FINDINGS

Investment Review Process:

- ☐ Did not look back for fluctuations in net worth
- ☐ Did not verify customer's financial information to ensure suitability and prevent over-concentration
- ☐ Did not utilize current state suitability standards
- ☐ Did not ensure most recent sub docs were used

KEY FINDINGS

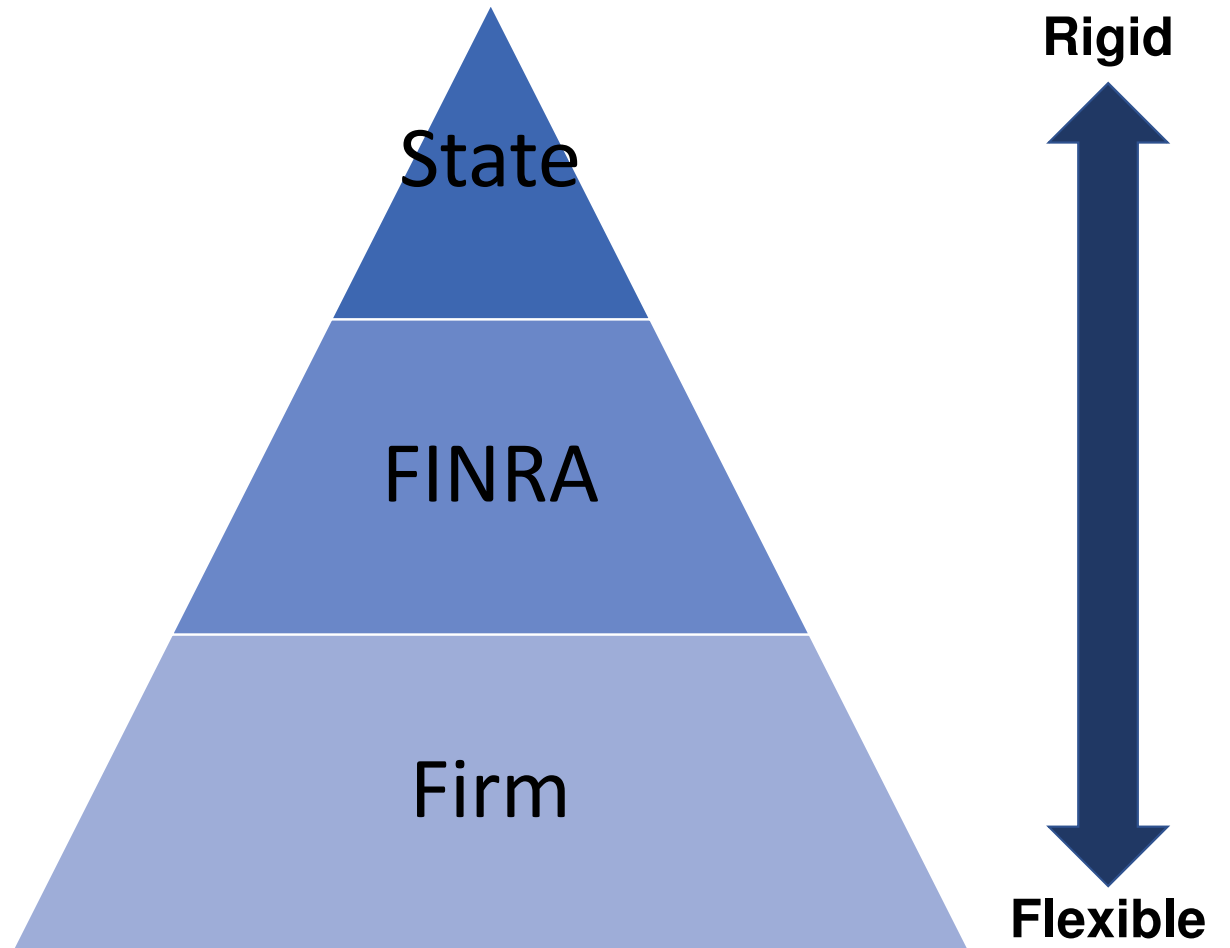
Written Supervisory Procedures:

- ☐ Provided no guidance on how to handle state regulatory rules
- ☐ Did not provide correct definitions of net worth
- ☐ Did not outline specific steps compliance should take when reviewing alternative investment for suitability



ESTABLISHING INVESTOR SUITABILITY POLICIES

SUITABILITY LAYERS





KEY STATE ISSUES

DRIP
PROGRAMS
PROHIBITED

Iowa
Kansas
Kentucky
Maine
Massachusetts
Michigan

Missouri
Nebraska
New Mexico
Ohio
Oregon
Pennsylvania

MASSACHUSETTS & OHIO

An investor's aggregate investment in any non-traded REIT shares, shares of an affiliate, and in other non-traded real estate investment programs may not exceed ten percent **(10%)** of his or her liquid net worth.

“Liquid Net Worth”: The portion of net worth (total assets exclusive of home, home furnishings, and automobiles minus total liabilities) that is comprised of cash, cash equivalents, and readily marketable securities that can be converted to cash under ordinary and routine business conditions within 10 calendar days.

Note: Investors cannot participate in the DRIP feature that reinvests distributions into subsequent affiliated programs

NEW JERSEY

A New Jersey investor must have either:

- a) a minimum liquid net worth of \$100,000 and an annual gross income of \$85,000, or
- b) a minimum liquid net worth of \$350,000.

In addition, a New Jersey investor's total investment in a non-traded REIT offering and in other non-traded REIT's shall not exceed **10%** of his or her liquid net worth.

“Liquid Net Worth”: A portion of net worth (total assets exclusive of home, home furnishings and automobiles, minus total liabilities) that is comprised of cash, cash equivalents and readily marketable securities.

MAINE

The Maine Office of Securities recommends that an investor's aggregate investment in any non-traded REIT offering and similar direct participation investments should not exceed **10%** of the investor's liquid net worth.

“Liquid Net Worth”: That portion of net worth that consists of cash, cash equivalents and readily marketable securities.

Note: Maine investors cannot participate in the DRIP feature that reinvests distributions into subsequent affiliated programs.

KANSAS

Investors should invest no more than **10%** of their liquid net worth, in the aggregate, in any real estate investment trust(s).

“Liquid Net Worth”: that portion of net worth (total assets minus total liabilities) that is comprised of cash, cash equivalents and readily marketable securities.

INTERNAL PROCEDURES CHECKLIST

- ☐ How will you check potential investment against state rules?
- ☐ How will you insure you have the latest state rules?
- ☐ How will you monitor other states for new rules as they come up?



KEY TRANSACTIONAL DOCUMENTS

FEE AGREEMENT

- ☐ Describe non-liquid investment management program
- ☐ Suitability Requirements
- ☐ Fee Schedule
- ☐ How to bill?
- ☐ Conflict of Interests

NEW CLIENT FORM

- ☐ Net Worth Definitions / Calculations
- ☐ Income Definition / Calculation
- ☐ Accredited Investor Attestation
- ☐ Authority to Conduct Background Check
- ☐ Financial Experience with Alternatives
- ☐ Household-Level Objectives / Risk Tolerance

NEW ACCOUNT FORM

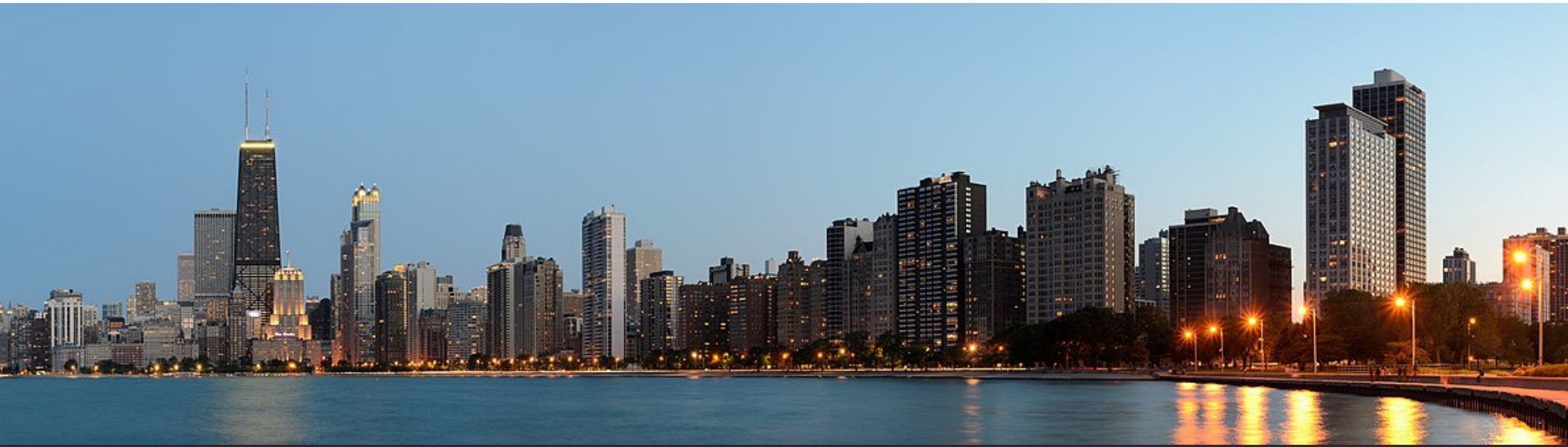
- ☐ Acceptable Account-Level Risk Tolerance
- ☐ Account-Level Liquidity Needs
- ☐ Account-Level Time Horizon

RISK TOLERANCE QUESTIONNAIRE

- ☐ Time Horizon
- ☐ Cash Distribution Needs
- ☐ Acceptable Amounts of Illiquidity
- ☐ Other Relevant Constraints

PROSPECTUS RECEIPT

- ☐ Prospectus Date
- ☐ Prospectus Number
- ☐ Delivery Method
- ☐ Date of Delivery



TRANSACTION CHECKLIST

TRANSACTION CHECKLIST PART 1

- ☐ Calculate Household Net Worth, Investable Net Worth, Liquid Net Worth based on Firm's definition
- ☐ Calculate Net Worth and Liquid Net Worth based on rules of State in which customer domiciles
- ☐ Calculate customer's prior investment into (a) similar program, (b) sponsor, and (c) all alternatives

TRANSACTION CHECKLIST PART 2

- ☐ Calculate Household Net Worth, Investable Net Worth, Liquid Net Worth based on Firm's definition
- ☐ Calculate Net Worth and Liquid Net Worth based on rules of State in which customer domiciles
- ☐ Calculate customer's prior investment into (a) similar program, (b) sponsor, and (c) all alternatives

TRANSACTION CHECKLIST PART 3

- ☐ Attest (i.e., document) customer can bear risk of loss
- ☐ Confirm whether customer's state of domicile has unique suitability requirements
- ☐ Confirm whether customer meets suitability standards as outlined in the prospectus

TRANSACTION CHECKLIST PART 4

- ☐ Confirm whether investment meets firm's program, sponsor, age-based, and global concentration guidelines
- ☐ Confirm client has sufficient liquidity per firm's guidelines
- ☐ Confirm client's time horizon matches or is longer than the hold is reasonably expected to be

TRANSACTION CHECKLIST PART 5

- ☐ Document whether less complex products are available / were considered
- ☐ Confirm that the program does not exceed customer's preference for non-liquid (per risk tolerance questionnaire)
- ☐ Complete (if needed) switch authorization



PURCHASE AUTHORIZATION

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- ☐ Received Offering Materials
- ☐ Reliance Solely on Offering Materials
- ☐ Belief of Appropriateness
- ☐ Potential for Price Volatility
- ☐ Valuation and Market Value may not Match
- ☐ Investment is Illiquid

PURCHASE AUTHORIZATION

- ☐ Redemption Program, if any, may close
- ☐ Program may not achieve goals
- ☐ Nothing is guaranteed
- ☐ Distributions may include return of principal
- ☐ May be subject to UBTI
- ☐ Different tax treatments