

November 11, 2011

*Via PDF email: [pubcom@finra.org](mailto:pubcom@finra.org)*

Ms. Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 K Street, NW Washington, DC 20006-1506

**Re: FINRA Regulatory Notice 11-44**

Dear Ms. Asquith,

The Investment Program Association (the “IPA”) appreciates the opportunity to comment on Regulatory Notice 11-44 published by the Financial Industry Regulatory Authority, Inc. (“FINRA”) on September 29, 2011. The Notice seeks comments to FINRA’s proposal to modify NASD Rule 2340 (the “Proposed Amendment”). Rule 2340 governs reporting of per share estimated values on customer account statements. The IPA is a national trade association comprised of members engaged in sponsoring, selling or providing services relating to alternative investments including, among other things, non-listed REITs and other types of direct participation programs (“DPPs”).

**The Proposal**

The Proposed Amendment is described in FINRA Regulatory Notice 11-44 (“RN 11-44”). We understand that FINRA is proposing the changes in an effort to, among other things, assist investors in understanding the value and relative performance of non-listed REITs and DPPs over time. If adopted, the Proposed Amendment would modify existing NASD Rule 2340. This rule generally requires each general securities member firm to send account statements to customers at least quarterly. NASD Rule 2340(c), in particular, requires the member firm to include an estimated value for any non-listed REIT or DPP held in a customer’s account developed from information that is as of a date no more than 18 months prior to the date that the statement is issued. FINRA Regulatory Notice 09-09 (“RN 09-09”) states that during the offering period, member firms may report an estimated value based on the offering price of the shares until 18 months after the conclusion of the offering.

The Proposed Amendment would revise NASD Rule 2340 by:

- requiring member firms to deduct, during the offering period, all “organization and offering expenses,” including issuer expenses (“O&O Expenses”), from the gross offering price resulting in a “net value” for purposes of customer account statement reporting;
- limiting the time period during which member firms may use the offering price on customer account statements;<sup>1</sup>
- requiring estimated per share valuations after the offering period to be determined and reported sooner than the rules and RN 09-09 currently require; and
- prohibiting member firms from using a per share estimated value if the firm knows, or has reason to know, that the estimated value is unreliable.

### **Discussion**

The IPA shares and supports FINRA’s interest in disclosure that furthers an investor’s understanding of the value and performance of the investments. SEC, “blue sky” and FINRA rules and regulations impose significant disclosure obligations on offerings conducted by non-listed REITs and DPPs. For example, the prospectuses for offerings of non-listed REITs and DPPs clearly disclose all of the O&O Expenses, including selling commissions, to be paid in connection with the offering. In fact, FINRA requires these disclosures to be made assuming the highest possible selling commissions and dealer manager fees. This information is typically discussed at length under the estimated use of offering proceeds, management compensation and plan of distribution sections of the prospectus. Moreover, the cover page of the prospectus clearly sets forth, in tabular format, the price to the public, selling commissions, dealer manager fee and net proceeds before other expenses so that a prospective investor is able to clearly understand the net amount available to be invested.

During and after the offering period, SEC rules and interpretations also require extensive disclosure regarding the nature of each property acquired, including the purchase price and capitalization rate as well as information regarding significant tenants, lease rates and expirations, audited financial statements for all “significant” acquisitions, and extensive disclosure regarding the amounts and sources of distributions paid to investors. All of these disclosure requirements are designed to provide investors and others such as due diligence firms or other analysts, with the information that can be used to evaluate an investment in a non-listed REIT or DPP. Further, RN 09-09 and new SEC interpretations regarding disclosure of estimated share values reported after the end of the offering period provide investors with additional knowledge of an entity’s performance after it has completed its initial capital raising phase. Through the comment and review process, the SEC has begun requiring additional extensive disclosure regarding the

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<sup>1</sup> The initial offering period is defined in your notice and by Securities Act Rule 415 as lasting up to three years plus an additional 180 day carryover period.

methods used by non-listed REITs and DPPs to estimate share value, including disclosure of all key assumptions and the range of values arrived at in the process of estimating value.

Presently, a member firm is not required to report an estimated value based on any metric other than the offering price until the issuer has completed its primary public offering or offerings. Most issuers typically engage in both an initial offering and a follow-on offering. Thus, the period before a member firm reports an estimated value not based on the offering price can be quite long. The IPA understands that this period may be too long. The IPA supports FINRA's desire to shorten this timeframe and, subject to further understanding of the interplay between follow-on offerings and the ability of non-listed REITs and DPPs to achieve their objectives, including providing a liquidity event or events to their investors, would support a shorter period of time during which a customer account statement may report a value based on the offering price.

The IPA does not, however, believe that the changes in the Proposed Amendment that would require the reporting of a "net value" on the customer account statement during the initial offering period will further an investor's understanding of an investment in a non-listed REIT or DPP and should not be adopted. Also, if one of the objectives of the Proposed Amendment is to change the commission structure associated with the sale of non-listed REITs and DPPs, we do not believe the Proposed Amendment should be used for that purpose.

***I. The customer account statement value should be equal to the gross offering price during the initial offering period.***

In raising capital, non-listed REITs and DPPs have generally used a fixed pricing method, typically \$10.00 per share. This offering price has been selected because it provides a transparent and easily understood manner for determining the number of shares to be issued to an investor and calculating returns. The fixed offering price is also consistent with the fact that each non-listed REIT or DPP typically starts as a "blind pool," raises money and invests proceeds in assets over a period of time. During an offering period, capital is raised, subsequently deployed, income grows with the growth of the program's portfolio, and the underlying asset values themselves may go up or down. An important component of this process is a follow-on offering. A follow-on offering typically commences immediately after the initial offering expires or is terminated. Because many member firms do not actually begin their due diligence investigation and sign selling agreements until sometime after the initial offering is declared effective, most non-listed REITs and DPPs receive the bulk of their offering proceeds during the last few months of the initial offering period and during the follow-on offering. The amount of capital raised largely influences whether the non-listed REIT or DPP will have the necessary size to effect a successful liquidity event such as a listing, merger or sale of the portfolio for an attractive return to investors.

Needless to say, the ultimate value of a security is impacted by many variables, including an issuer's policy regarding leverage, the nature of the assets purchased by the issuer, the quality of the issuer's management, as well as other macro and micro economic factors. The IPA believes that many of the SEC's disclosure rules and initiatives result in investors receiving information

regarding many of these variables so that the investors may understand the value and relative performance of their investment, particularly during the offering period or periods.

With respect to an illiquid security such as a non-listed REIT or DPP, FINRA acknowledges that the estimated value “may be derived from several sources.” FINRA goes on to note that an “appraisal of the issuer’s assets and operations will assist investors in understanding the value and relative performance” of the entity over time. The IPA agrees with FINRA’s assessment.

Unfortunately, FINRA goes on to state that “in the earlier stages of an offering,” as the issuer accumulates assets, “the net offering price can be a suitable alternative, particularly since an appraisal would involve recently acquired assets and cash that is yet to be invested during the ramp-up period” (emphasis added). FINRA does not, however, cite any recognized authority for estimating the value of a security in this manner. Despite the lack of any such authority, FINRA proposes to amend Rule 2340 to require that, during the offering period, all per share estimated values reflect a deduction of all O&O Expenses, resulting in what FINRA calls a “net value” for customer account statement purposes.

The IPA does not believe this approach furthers an investor’s ability to understand an investment in the non-listed REIT or DPP and the relative performance of the investment over time. The calculation of “net value” is not based on any new information or analysis. We believe the change, if adopted, will likely confuse investors and may have the unintended consequence of negatively impacting capital formation in the United States.

A. Transparency

If the Proposed Amendment is adopted, member firms will be required to report an artificial price that may confuse investors into thinking the “net value” is a real value. Existing disclosure, contained on the cover page of each prospectus and in the risk factors of the prospectus, among other places, clearly explains the initial offering price and related O&O Expenses, including selling commissions. Reducing the offering price by the amount of O&O Expenses simply results in a smaller number. Reporting this “net value” on a customer account statement could very well confuse investors into thinking that the “value” of their investment had immediately dropped, causing investor consternation, frustration with their registered representatives and a reluctance to invest in this type of security. All of this despite the fact that all investors had been provided with transparent disclosure, cleared by the SEC and various state regulatory authorities, disclosing the offering price, and more importantly, the fees and expenses associated with the offering and the net proceeds to be realized by the issuer.

Using a “net value” as proposed by FINRA also runs the risk of creating other issues or consequences that FINRA should further consider and evaluate. In addition to understanding the impact that the Proposed Amendment would have on follow-on offerings and the ability to effect a successful liquidity event, the Proposed Amendment could have far reaching negative consequences. For example, all offerings of shares through “distribution reinvestment plans” or “DRPs” are priced at a “discount” to the gross offering price. The “net value” approach taken by the Proposed Amendment will, at a minimum, create a question of whether investors are or are not purchasing at a discount and may result in negative tax consequences, albeit unintended, for

these DRP programs. The Proposed Amendment is unclear as to whether O&O Expenses would be subtracted only on shares sold in the primary offering on which commissions are paid or must be allocated across all shares that may be offered such as DRP shares. Not everyone participates in DRP programs and existing FINRA rules prohibit sales loads on these shares. Thus, it seems the likely outcome would be to allocate these costs only to the shares issued in the primary offering and thus investors who do participate in the DRP will end up believing they have paid a premium, not a discount, for DRP shares which would likely reduce the proceeds raised through DRPs. Also, a statement of “net value” will cause confusion regarding redemption programs. Most non-listed REIT and DPP programs provide share redemption programs, in which the redemption price is equal to a percentage of the gross offering price (typically between 90% and 100% of the offering price). If the Proposed Amendment is adopted, in many cases, the stated redemption price will be higher than the reported “net value” during the pendency of the offering, suggesting that the redemption would in fact result in a profit to the investors and possibly resulting in “a run on the bank.” The more funds that an issuer must use to fulfill redemption requests, the less it will have to purchase properties.

There are other issues as well that raise concerns that merit further study and review. For example:

(a) In calculating “net value,” the requirement that issuers deduct variable, as opposed to fixed, O&O Expenses is problematic. Under FINRA and state regulations, these variable expenses can be as much as an additional 5% of the gross offering proceeds even if they are generally much less. For example, under the Proposed Amendment, it is not clear whether the amount of O&O Expenses reflected on the customer account statement should be equal to the maximum 15% of gross offering proceeds at the outset of the offering and then reduced as more shares are sold or whether the member firm should use an estimated percentage assuming the maximum amount of proceeds are sold. The Proposed Amendment also does not address how offerings with caps on O&O Expenses are to be treated and, in particular, the treatment of O&O Expenses that may exceed the cap as is often the case in the early stages of an offering.

(b) The Proposed Amendment does not make clear whether O&O Expenses that are charged after the date as of which a post-offering estimated value for the program shares is published should be included in any net value that is reported on a customer account statement during the offering.

(c) The Proposed Amendment does not make clear whether member firms must include any particular disclosure to their customers in respect of distribution and yield percentages based on the gross offering price versus the figures reported on customer statements. Using something other than the \$10.00 offering price will eliminate the current uniformity of approach which will be a step backward from the goal of enhancing investor understanding.

(d) The Proposed Amendment does not address whether member firms may report, in the case of an issuer that voluntarily reprices its shares during the pendency of a follow-on offering, this new price as the estimated value for the remainder

of the offering, whether member firms must require the issuer to publish a new estimated value on an annual basis and whether member firms must continue to deduct O&O Expenses throughout the term of the follow-on offering.

(e) Current rules do not require a member firm to ascribe a customer account statement value to non-listed REITs and DPPs that are privately offered. The Proposed Amendment could be read to require them to do so and should be revised to make it clear that the Proposed Amendment does not impact the treatment of, or apply to, privately offered non-listed REITs or DPPs.

(f) Footnote 10 of the Proposed Amendment states that issuers that deduct O&O Expenses from income or assets must still reduce the gross offering price for these costs. It is not clear why costs which are funded from income should nevertheless be subtracted from the gross offering price for customer account statement purposes. In addition, if this footnote is intended to capture deferred commissions during the initial offering period, there would be no uniform way of calculating these commissions because the amount that would be paid during the offering period depends on when investors purchase shares, which occurs over a period of time.

(g) The difference in the mandatory prohibition on providing a per share estimated value in Proposed Rule 2340(c)(2)(A) and the permissive approach in Proposed Rule 2340(c)(2)(B) is not clear. If the annual report does not contain a per share estimated value that complies with Proposed Rule 2340(c)(1)(B) or (C), it would seem a member “knows or has reason to know” the value is unreliable and would therefore be required, not merely permitted, to refrain from providing the value. The Proposed Amendment should make clear that FINRA member firms will have the option of not including an estimated value on customer statements when the member reasonably believes that it cannot rely or make any such estimate. Further, the Proposed Amendment should provide greater clarity on when a member firm will be deemed to “know or have reason to know.” The Proposed Amendment should also make clear that member firms are not required to conduct an independent analysis of the estimated value.

Rather than require reporting of a “net value,” the IPA believes that FINRA can achieve its objectives by requiring delivery of a customer purchase confirmation that reflects the gross per share offering price, the selling commissions paid in connection with the sale as well as the net offering proceeds realized by the issuer. The IPA does not believe it makes sense to show either due diligence costs or issuer costs on this separate document. As noted above, these costs are variable during the offering period.

The investor purchase confirmation would function together with the issuer’s prospectus and would best assist FINRA in achieving its objectives because it would ensure that each investor is provided with information regarding the offering price of the shares in connection with the purchase along with the selling commissions and the net proceeds realized by the issuer.

**B. Unintended Economic Consequences**

There is ample evidence that the U.S. is losing its competitiveness in capital formation with a growing percentage of this important economic driver moving overseas. Regulation that could exacerbate this trend in these difficult times should be carefully considered before being implemented. Non-listed REITs, in particular, serve an important role in both providing investors with a method to diversify their portfolio and in providing capital to the commercial real estate industry (\$5 to \$10 billion annually) which in turn impacts real estate value and performance as well as job creation.

In the decade preceding the decline in real estate values that began abruptly in 2008, real estate values generally increased in all major categories each year. During this period, in accordance with then prevailing regulations, the vast majority of members of the IPA maintained the fixed offering price in their valuations and they appeared as such on client statements issued from FINRA member firms. This underscores the longstanding consistency of approach the industry has taken.

The Proposed Amendment could negatively impact the amount of capital raised by non-listed REITs and DPPs to the detriment of the U.S. economy. As noted above, the Proposed Amendment is especially problematic for follow-on offerings which could impact the ability of non-listed REITs or DPPs to raise adequate capital in order to achieve their investment objectives. Careful study and analysis is needed to understand these potential impacts.

**II. *Changes in customer account statement reporting rules should not be used to change commission practices.***

As noted above, an underlying objective of the Proposed Amendment may be to create greater competition regarding selling commissions and to ultimately reduce the amount of these commissions paid in connection with public offerings by non-listed REITs and DPPs. The need for changes to the commission structure used in the sale of non-listed REITs and DPPs is beyond the scope of this letter. We do not believe, however, that changes to commissions arrangements should be a motivating factor underlying the Proposed Amendment. The selling commissions currently paid in these offerings conform to existing FINRA limits. We believe that market forces should dictate the outcome on this issue.

**III. *The IPA supports more frequent estimates of share value.***

As noted above, the IPA agrees with FINRA that the present 18 month post offering timeframe set out in RN 09-09 is too long. The IPA supports more frequent estimates of share value which may very likely impact the issuer's business decisions such as distribution coverage and perhaps selling commissions. The IPA, however, urges FINRA to study the impact that a shorter timeframe may have on follow-on offerings and the ability of non-listed REITs and DPPs to achieve their objectives.

The IPA also believes that the timeline should be tied to the completion of the offering and not the filing of an annual report by the issuer. This latter approach leaves too much room for unintended results and “management” of the offering termination.

Further, the Proposed Amendment should make clear that no change in the published estimated value is required for customer account statement purposes until the time that the issuer publishes an estimated per share value. Until this is clarified, member firms will seemingly have an untenable level of uncertainty as to whether they will be entitled to rely on the offering price during the offering period and in periods between annual estimated valuations. While there are notional fluctuations in value during these periods, day-to-day perfection cannot be achieved and disclosure must be sufficient to keep investors informed that such fluctuations can occur during these periods.

#### ***IV. Transition issues.***

The non-listed REIT and DPP industry and member firms have operated under the historical paradigm described herein for many years. The Proposed Amendment contains no considerations of transitioning to its new methodologies, many of which will be highly disruptive to the industry and its investors. As an example, under current regulations, non-listed REITs and DPPs in offering are currently reported on customer statements at their gross offering prices. The consequences of suddenly changing this paradigm may unfairly impact these non-listed REITs and DPPs and may result in other unintended consequences such as the impact on follow-on offerings. A sudden change of this magnitude bears further study by FINRA. At the least it seems that FINRA, if it were to adopt new methodologies along the lines of those described in the Proposed Amendment, should provide that the effectiveness of the new rule be set at a reasonable time into the future after they are finalized and officially adopted, both so that FINRA member firms can prepare their customers for the effect of the new rules, but also so that existing programs are not prejudiced, new programs can incorporate the new rules into their structures and that all industry participants can create compliant systems. A reasonable timeframe for this delayed effectiveness may be eighteen months.

Thank you for your consideration of these very important concerns.

Respectfully submitted,



Martel Day  
Chairman