



**Direct Participation Programs  
Limited Representative  
Qualification Examination  
(Test Series 22)**

**Study Outline**

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## Introduction

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The FINRA Direct Participation Programs Limited Representative (Series 22) Qualification Examination (hereinafter called “DPP”) is designed to test a candidate's knowledge of the products, rules and statutory provisions applicable to this category of registration. By passing the DPP examination, a candidate becomes a Series 22 Limited Registered Representative. The DPP Registered Representative can participate in the purchase and sale of certain direct participation programs offered (see Section 1.1-Direct Participation Programs Investment Entities and Section 2.0 - Types of Direct Participation Programs). Section 1.2 lists securities that cannot be sold by the DPP Registered Representative--either because these securities are registered under the Investment Company Act of 1940 or the trades take place on the secondary market.

This study outline has been prepared to assist FINRA member firms in preparing candidates to sit for the Series 22 examination. It may be used to structure or prepare training materials, develop lecture notes and seminar programs, and as a training aid for candidates themselves. This outline and the examination are divided into six topical sections listed below, along with the percentage of each section’s representation in the overall examination.

<b>Section</b>	<b>Description</b>	<b>Number of Questions</b>
1	Investment Entities for Direct Participation Programs	12
2	Types of Direct Participation Programs	11
3	Offering Practices Applicable to Direct Participation Programs	14
4	Tax Issues Applicable to Direct Participation Programs	20
5	Regulation of Direct Participation Programs	32
6	Factors to Consider in Evaluating Direct Participation Programs	11
<b>Total</b>		<b>100</b>

The Series 22 examination is composed of 100 multiple-choice questions covering all of the material in the following outline in accordance with the subject matter distribution shown above. Candidates will be allowed 135 minutes to complete the examination. A candidate must correctly answer 70 percent of the questions to receive a passing grade.

At the completion of the examination, each candidate will receive an informational breakdown of their performance on each section and their overall score. The examination is a closed-book test and candidates will not be permitted to use any reference material

during their testing session. Scratch paper and a basic electronic calculator will be provided by the test center administrator. Severe penalties are imposed on candidates who cheat on securities industry qualification examinations.

Examination questions are updated regularly to reflect the most current interpretations of the rules and regulations. Questions on new rules will be added to the pool of questions for this examination within a reasonable period of their effective dates.

At the end of this outline are four sample questions written in the various formats used in the actual Series 22 examination. The samples do not mirror the difficulty level of actual test questions or the subject matter distribution of the test itself. Their use is merely to familiarize the candidate with the style of multiple-choice questions used in the Series 22 examination.

Information about qualifications exams may be found at <http://www.finra.org/Industry/Compliance/Registration/QualificationsExams/RegisteredREPs/Qualifications/index.htm>

Please Note: Candidates are responsible for keeping abreast of changes made to the applicable rules and regulations, as the examination is updated when new rules are introduced and/or amended.

The following reference materials may be used in preparing for the examination.

## REFERENCE MATERIALS

### **Blue Sky Practice for Public and Private Direct Participation Offerings**

Peter M. Fass and Derek A. Wittner  
610 Opperman Drive  
St. Paul, MN 55123  
[www.westgroup.com](http://www.westgroup.com)

### **Federal Securities Law Reporter**

Vol. 1 - Securities Act – Vol. 2 – Exchange Act  
Commerce Clearing House, Inc.  
4025 W. Peterson Avenue  
Chicago, IL 60646

### **Federal Taxation of Partnerships and Partners,**

W.S. McKee, W.F. Nelson and R.L. Whitmire  
Warren, Gorham & Lamont, Inc.  
Boston, MA 02111

### **FINRA Publications available through**

[www.finra.org](http://www.finra.org):  
FINRA/NASD Rules  
FINRA Notices

### **Guide to Limited Liability Companies,**

CCH Incorporated  
P.O. Box 5490  
Chicago, IL 60680  
[www.cch.com](http://www.cch.com)

### **Investment Limited Partnerships Handbook**

R. J. Haft and P. M. Fass  
Clark Boardman Callaghan  
155 Pfingsten Road  
Deerfield, IL 60015  
[www.west.thomson.com](http://www.west.thomson.com)

### **Limited Liability Company Handbook**

M. A. Sargent and W.D. Schwidetzky  
610 Opperman Drive  
St. Paul, MN 55123  
[www.west.thomson.com](http://www.west.thomson.com)

### **Oil and Gas: Federal Income Taxation (2005)**

Patrick A. Hennessee, Ph.D., CPA  
CCH Incorporated  
P.O. Box 5490  
Chicago, IL 60680  
[www.cch.com](http://www.cch.com)

### **2005 Federal Tax Course**

Aspen Panel Publishers  
1185 Avenue of the Americas  
New York, NY 10036  
<http://tax.cchgroup.com/Aspen>

### **Resales of Restricted Securities**

J. William Hicks  
West Group  
620 Opperman Drive  
St. Paul, MN 55164  
[www.westgroup.com](http://www.westgroup.com)

### **Securities Act Handbook**

Aspen Publishers  
111Eighth Avenue  
New York, NY 10011  
[www.aspenpublishers.com](http://www.aspenpublishers.com)

### **Securities Law Handbook, 2005 ed.**

H.S. Bloomenthal  
Clark Boardman Callaghan  
610 Opperman Drive  
St. Paul, MN 55164  
[www.west.thomson.com](http://www.west.thomson.com)

### **Tax Advantaged Securities Handbook**

R. J. Haft and Peter M. Fass  
West Group  
610 Opperman Drive  
St. Paul, MN 55164  
[www.westgroup.com](http://www.westgroup.com)

## 1.0

### INVESTMENT ENTITIES FOR DIRECT PARTICIPATION PROGRAMS

#### 1.1 Investment Entities

##### 1.1.1 Limited Partnerships (LP)

- 1.1.1.1 Limited liability
- 1.1.1.2 Consequences of the pass through tax provision
- 1.1.1.3 Filing of limited partnership organizational documents in the states - usually called the certificate of limited partnership
  - 1.1.1.3.1 Contains name, address, purpose, date of formation and names of general partner(s) and in some states the names, addresses, and amount of capital contribution of the general and limited partners
  - 1.1.1.3.2 Required to create a limited partnership
  - 1.1.1.3.3 Required for amendments to information contained in Section 1.1.1.3.1 above
- 1.1.1.4 Agreement of limited partnership--the contract between the general partner(s) and limited partners to conduct the business of the limited partnership
  - 1.1.1.4.1 Lists the date of formation, name, place of business, purpose and date of termination
  - 1.1.1.4.2 Specifies the types of partners, each individual partner, the capital contribution of each partner and the provisions in the event a partner defaults on a capital contribution
    - Types of partners--general, limited, original limited, special limited
    - Name, address, capital contribution and percent interest in limited partnership are usually listed on separate exhibit
    - Capital contributions can be made at one time, staged over a defined period or are subject to being called under specified circumstances
    - Default of partner's obligation to contribute can lead to dilution of interest or dismissal from limited partnership

- 1.1.1.4.3 Allocates operating income and loss, capital gain and loss, operating cash distributions and capital cash distributions among the partners
  - Disproportionate allocation of income, loss, gain and cash distribution among the partners
  - Preferred cash distribution
  - Cumulative cash distribution
  - Subordinated distribution
- 1.1.1.4.4 General partner(s)--rights and obligations
  - 1.1.1.4.4.1 Exclusive power and authority to manage the partnership
  - 1.1.1.4.4.2 Usual duties
    - Execute all agreements, contracts and certificates to operate partnership
    - Borrow funds
    - Purchase liability and casualty insurance
    - Employ agents, attorneys, accountants and contractors
    - Pay all expenses
    - Act as tax matters partner
    - Sell or dispose of partnership assets
    - Act as attorney-in-fact for limited partners
  - 1.1.1.4.4.3 Usual limitations on powers of general partner(s) without approval of limited partners
    - Admission of new general partner(s)
    - Substitution of existing general partner(s)
    - Change the purpose of the partnership
    - Sale of all or substantially all the assets of the partnership
    - Refinancing in certain situations
  - 1.1.1.4.4.4 Compensation of general partner(s)
    - Only as specified in partnership agreement
    - Affiliate can be compensated but only at competitive rates
  - 1.1.1.4.4.5 General partner liability
  - 1.1.1.4.4.6 General partner indemnification
  - 1.1.1.4.4.7 Right to compete with partnership
  - 1.1.1.4.4.8 Fiduciary responsibility to limited partners

- 1.1.1.4.5                    Limited partners' rights
  - Amend partnership agreement
  - Vote to lift restrictions on power of general partner(s) (see Section 1.1.1.4.4.3)
  - Receive periodic reports
  - Inspect and copy books and records
  - Vote to continue partnership upon death, bankruptcy or incompetency of sole remaining general partner
  - Remove general partner(s) if provided in partnership agreement
  
- 1.1.1.4.6                    Limited partners' obligations
  - Pay capital contribution
  - Potential liability for unpaid capital contributions and distributions received, in event of default
  
- 1.1.1.4.7                    Transfer of interest in limited partnership
  - 1.1.1.4.7.1                    General partner(s)
    - Need approval of limited partners
    - Opinion of counsel that partnership will not be terminated or taxed as corporation
    - Bankruptcy, death or incompetence
  
  - 1.1.1.4.7.2                    Limited Partners
    - Opinion of counsel that partnership will not be terminated or taxed as a corporation
    - General partner(s) approval
    - Restrictions usually on transfer to non-family
    - General partner(s) right of first refusal
  
- 1.1.1.4.8                    Dissolution and liquidation of a limited partnership
  - 1.1.1.4.8.1                    Events causing dissolution
    - Withdrawal of last general partner
    - Vote of partners
    - Sale of all the assets of the partnership
    - Approval of general partner(s) and required number of limited partners
    - Expiration of term of partnership
  
  - 1.1.1.4.8.2                    Liquidation
    - Payment of expenses and liabilities of partnership
    - Distribution to partners in accord with terms of partnership agreement
    - Filing of termination certificates

## **1.1.2 Limited Liability Companies (LLC)**

- 1.1.2.1 Advantages
  - Receive same pass through tax advantages as a limited partnership
  - Have limited liability attributes of corporations
  - Allows disproportionate allocation of income, loss, gain and cash distribution
- 1.1.2.2 Organization filings of LLC--usually called the Articles of Organization
  - 1.1.2.2.1 Contains name, address, date of formation and termination and names of members (a minimum of two required) and may contain other provisions from operating agreement
  - 1.1.2.2.2 Required to create LLC
  - 1.1.2.2.3 Required for amendments to information contained in Section 1.1.2.2.1
- 1.1.2.3 Operating Agreement of LLC--the contract among the members to conduct the business of the LLC
  - 1.1.2.3.1 Lists date of formation, name, place of business, purpose and date of termination
  - 1.1.2.3.2 Specifies duties of members (may create Managing Member(s)) and their capital contributions
  - 1.1.2.3.3 Specifies duties and responsibilities of members
  - 1.1.2.3.4 Allocates operating income and loss, capital gain and loss, operating cash distributions and capital cash distributions among members
    - 1.1.2.3.4.1 Disproportional allocations
    - 1.1.2.3.4.2 Preferred cash distributions
    - 1.1.2.3.4.3 Cumulative cash distributions
    - 1.1.2.3.4.4 Subordinated distributions
  - 1.1.2.3.5 Rights of members
    - Elect managing members
    - Amend operating agreement
    - Vote on LLC matters as provided in the operating agreement

Approve transfers of membership interests unanimously  
Consent to dissolve the LLC

- 1.1.2.3.6 Rights and powers of managing member(s)
  - Exclusive power to manage the affairs of the LLC
  - Term of office specified in operating agreement
  - Duties similar to general partner(s) in limited partnership
  - Limitation of powers similar to general partner(s) in limited partnership
- 1.1.2.3.7 Liabilities of members including managing member(s) are only for promises of contributions and services to the LLC; not liable for debts and obligations of the LLC
- 1.1.2.3.8 Transfer of member's ownership in the LLC
- 1.1.2.3.9 Indemnification of managing members
- 1.1.2.3.10 Dissolution of the LLC
  - 1.1.2.3.10.1 Events causing dissolution
    - Consent of all members
    - Expiration of term of the LLC
  - 1.1.2.3.10.2 Liquidation
    - Payment of expenses and liabilities of the LLC
    - Distributions to members
  - 1.1.2.3.10.3 Filing of certificate of dissolution
- 1.1.3 S Corporations**
  - 1.1.3.1 Requirements for eligibility
    - Limited number of shareholders
    - Must be a domestic, eligible corporation
    - Shareholders must be individuals, certain estates, trusts, or tax exempt organizations
  - 1.1.3.2 Election of tax year
  - 1.1.3.3 Generally a tax pass-through entity
    - No disproportionate allocation
    - No negative capital account
  - 1.1.3.4 Termination of S Corporation election

Revoking the election  
Ceasing to qualify as an S corporation  
Violating the passive investment income restrictions  
Restrictions against re-establishing S corporation

**1.1.4 General Partnerships**

- 1.1.4.1 Liabilities of general partners
- 1.1.4.2 Partnership subject to technical dissolution by reason of death or legal disability of a partner even though the partnership may be continue
- 1.1.4.3 Passive interests are treated as securities

**1.1.5 Joint ventures**

- 1.1.5.1 Liabilities of venturers
- 1.1.5.2 Co-venturers join together for a specific project
- 1.1.5.3 Joint venture is terminated upon completion of project
- 1.1.5.4 In some jurisdictions, a corporation may not be a partner, but may take a position as a joint venturer
- 1.1.5.5 Passive interests are treated as securities

**1.1.6 Grantor trusts**

- 1.1.6.1 Generally used for equipment leasing programs
- 1.1.6.2 May provide pass-through tax benefits

**1.2 Securities Products That Cannot be Sold by a Direct Participation Programs Representative**

**1.2.1 Real estate investment trusts (REITs)**

- 1.2.2 Master limited partnerships**
  - Roll-ups
  - Exchange listed real estate limited partnerships

**1.2.3 Public limited partnership units in the secondary market**

**1.2.4 Municipal securities**

- 1.2.5 Corporate securities (domestic and foreign)**
  - Stocks
  - Bonds
  - Rights and warrants
- 1.2.6 Options**
- 1.2.7 Mortgage-backed instruments**
  - Collateralized mortgage obligations (CMOs)
  - Real estate mortgage investment conduits (REMICs)
- 1.2.8 Mutual funds (closed-end and open-end investment company shares)**
- 1.2.9 Variable annuities**
- 1.2.10 U.S. government and agency securities**

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## 2.0

### TYPES OF DIRECT PARTICIPATION PROGRAMS

#### 2.1 Real Estate Programs

##### 2.1.1 Affordable housing

###### 2.1.1.1

###### Advantages

Tax credits

Passive losses

Predictable tax benefits

Long term, highly leveraged mortgage financing

###### 2.1.1.2

###### Risks

Changes in government policy and practice

Subsidized rent greater than market rent

Historic lack of appreciation potential

Cash distributions limited by Government regulations

Loss of rental and other subsidies

Highly leveraged financing

##### 2.1.2 Development properties (new construction)

###### 2.1.2.1

###### Advantages

Higher appreciation potential

Maintenance and replacement costs lower in early years

Leverage

Tax deferred cash flow

Passive losses

Long term take-out mortgage financing

###### 2.1.2.2

###### Risks

Market acceptability of new development

Pace of renting to tenants (rate of absorption)

Development costs in excess of forecast

Cost and availability of long-term mortgage financing

Competition - overbuilding-effect on rents

Governmental restrictions: zoning and building codes

Changing Governmental regulations: rent control and environmental

##### 2.1.3 Existing properties

###### 2.1.3.1

###### Advantages

Greater predictability of net operating income

- Higher reliability of operating cost forecasts
- Physical condition subject to inspection
- Known tenant composition
- Tax deferred cash flow
- Passive losses
- Financing often available from seller

2.1.3.2

Risks

- Higher maintenance and replacement costs
- Unpredictable major maintenance and rehabilitation costs
- Restrictions in existing leases
- Additional competitive properties
- Changing governmental regulations: rent control and environmental issues

**2.1.4**

**Land Development**

2.1.4.1

Advantages

- Potential for higher appreciation
- Seller financing-purchase money mortgage note
- Usually low leverage

2.1.4.2

Risks

- No cash flow
- Carrying costs (taxes, and debt service) with no revenue
- Government restrictions: zoning and environmental
- Lack of appreciation in excess of acquisition and carrying costs of land
- Institutional financing often difficult to obtain
- Higher potential for loss

**2.1.5**

**Sale-Leaseback**

2.1.5.1

Advantages

- Predictable taxable income, loss and cash flow
- Risk decreases as net worth of lessee increases
- Mortgage financing more readily available

2.1.5.2

Risks

- Term of lease
- Cash flow and appreciation restricted by lease
- Appreciation often more dependent on financial market conditions than performance of property
- Re-rental after termination of initial lease
- Cost of acquisition greater than market value of property

## **2.1.6 Mortgage partnerships**

2.1.6.1 Advantages  
First lien  
Predictable income  
Interest spread

2.1.6.2 Risks  
Junior liens  
Leverage  
Collection

## **2.1.7 Condominium securities**

2.1.7.1 Rental Pools

## **2.2 Oil and Gas Programs**

### **2.2.1 Types of programs**

2.2.1.1 Exploratory  
High deductibility of investment  
Return potential determined after drilling stage  
Higher risk of "dry holes"

2.2.1.2 Development  
High deductibility of investment  
Return potential less than returns on successful exploratory program  
Lease costs tend to be higher  
Lower dry-hole risk versus exploratory

2.2.1.3 Income  
Few front-end tax benefits  
Capitalized acquisition costs  
Cash flow program with reinvestment feature  
Factors to consider in evaluating an income program  
Amount of oil and gas reserves still in the ground  
Estimated future net revenues from reserves and calculated present value  
Present value less various risk factors to obtain "fair market value" of property  
Liquidity on present value  
Inflation hedge  
Possible future enhanced recovery techniques

- 2.2.1.4                   Combination investment (drilling and income)
  - Diversification may reduce amount of risk
  - Potential to achieve tax deferral and cash flow
- 2.2.1.5                   Completion
  - Intangible expenses and deductions
  - Depreciable tangible expenses
  - Receive a smaller percentage of revenue from wells
- 2.2.1                   Analyzing sharing arrangements of oil and gas programs (methods of allocating costs and revenues)**
- 2.2.2.1                   Overriding royalty interest
  - Does not share program costs
  - Shares in revenues through cost free interest in production revenues
    - Payable under an oil and gas lease out of total production of well or deposit
- 2.2.2.2                   Working interest
  - Interest in production revenues
  - Lessor does share program costs
- 2.2.2.3                   Reversionary working interest
  - Does share program costs
  - Shares in revenues after investors recover their costs
    - If the lessee's share of the oil extracted; the balance belongs to the land owner as his royalty interest plus owner's of overriding interest
- 2.2.2.4                   Net operating profits interest
  - Limited to private deals
- 2.2.2.5                   Disproportional sharing arrangement
  - Sponsor pays a lower percentage of all costs in return for a higher percentage of program revenues
  - Sponsor may share in costs of dry holes
  - Normally investors pay deductible costs and sponsor pays non-deductible costs

## **2.3                   Equipment Leasing Programs**

### **2.3.1                   Structure of programs**

- 2.3.1.1                   Financial (or full payout) lease--no residual value

2.3.1.2 Operating lease-- residual value

**2.3.2 Advantages**

2.3.2.1 Depreciation

2.3.2.2 Interest deductions on borrowed funds

2.3.2.3 Predictable income

**2.3.3 Risks**

2.3.3.1 Investor tax basis limited by at-risk rules

2.3.3.2 Investment interest limitations on use of tax losses

2.3.3.3 Alternative minimum tax may limit deductibility of losses

2.3.3.4 Uncertain residual value

2.3.3.5 Potential phantom income upon sale of equipment

2.3.3.6 Cost allocations

2.3.3.7 Competition impacts re-leasing and sale

**2.4 Miscellaneous Programs**

**2.4.1 Agricultural**

2.4.1.1 Available deductions

Write-offs on start-up programs

Row crops

Depreciable property, i.e. perennial plants, property improvements, etc.

2.4.1.2 Profits achieved by

Sales of agricultural products

Appreciation of land value

2.4.1.3 Risks include

Natural elements

Disease

Market conditions

**2.4.2 Livestock**

2.4.2.1 Holding period requirement

2.4.2.2 Capitalized costs

2.4.2.3 Capital gains

2.4.2.4 Deductible maintenance costs

**2.4.3 Entertainment**

2.4.3.1 Structure of entertainment programs  
Advertising service partnership  
Production service company

2.4.3.2 Movie syndications  
Income forecast method of depreciation  
Accounting standards

**2.4.4 Research and development/venture capital**

2.4.4.1 Deductibility of royalty income

**2.4.5 Debt-based (non-equity) direct participation programs**

2.4.5.1 Portfolio income

2.4.5.2 Characteristics of debt vs. equity

2.4.5.3 Tax treatment

2.4.5.4 Eligibility of retirement accounts

**2.4.6 Commodity pools**

2.4.6.1 Typically structured as limited partnerships, limited liability companies or business trusts

2.4.6.2 Commodity Pools are regulated both under the securities laws and the Commodity Futures Trading Commission Act

2.4.6.3 Commodity Pools typically invest in commodity futures contracts traded on regulated futures exchanges

**2.4.7 Like-kind exchanges**

2.4.7.1 Section 1031 of the Internal Revenue Code

2.4.7.2 Tenants-in-common structure

2.4.7.3 Applicability of private placement exemption rules and anti-fraud rules

## 3.0

### OFFERING PRACTICES APPLICABLE TO DIRECT PARTICIPATION PROGRAMS

#### 3.1 Types of Underwriting Commitments

##### 3.1.1 Best efforts

- Contingent
- All or none
- Mini-Max

##### 3.1.2 Firm commitment

#### 3.2 Syndication Practices

##### 3.2.1 Managed offerings

3.2.1.1 Selling group manager

3.2.1.2 Soliciting dealer

3.2.1.3 Dealer manager functions

- Performs due diligence
- Solicits and allocates retail participation by other broker-dealers
- Maintains books and records
- May assist issuer in planning and preparation of offering
- May coordinate investor relations after the offering
- Enters into dealer/manager agreement with the program sponsor
- May be an affiliate of the sponsor

3.2.1.4 Sponsor-managed offerings

- Each dealer enters into agreement directly with program sponsor
- Dealers are paid directly by the program sponsor

##### 3.2.2 Role of wholesalers

- Individuals or firms paid to retain selected dealers for the offering
- Interface between issuer and broker-dealers and their sales force
- Usually compensated on the basis of sales of program interests

##### 3.2.3 Due diligence

3.2.3.1 The exercise of reasonable care to determine that the offering disclosures are accurate and complete

3.2.3.2 Public offerings--statutory defense available

- 3.2.3.3 Private offerings--helps avoid fraud charges
- 3.2.3.4 Should be performed by broker-dealers making the offering
- 3.2.3.5 Typical activities
  - Verify all material statements in the offering documents
  - Confirm compliance with registration/exemption rules
  - Review financial data
  - Investigate management background
  - Check issuers track record
  - Review any assumptions in offering forecasts or projections
  - Evaluate all fees and other distributions of proceeds

**3.2.4 Finders**

- 3.2.4.1 Defined as an un-registered introducer
- 3.2.4.2 Prohibited practices
  - Sales compensation to non-members of a national securities exchange association registered with the Securities and Exchange Commission
  - Referrals by non-members of individual clients to broker-dealers in exchange for compensation from broker-dealer

**3.3 Subscription Practices**

**3.3.1 Signature pages of partnership documents**

- 3.3.1.1 Purchaser representations
  - Liquidity
  - Marketability
  - Suitability

**3.3.2 Responsibility of the DPP registered representatives**

- Familiarity with the DPP offering
- Timely delivery of the prospectus
- “Know your customer” rules
  - Understanding of the risks involved
  - Net worth, income and suitability
- Accuracy of investor’s representations

**3.3.3 Sales are conditioned upon acceptance of subscribers**

**3.3.4 Supervision of order by broker-dealer--review of documents**

### **3.4 Underwriting Compensation**

#### **3.4.1 Types of compensation**

3.4.1.1 Cash

3.4.1.2 Non-cash

3.4.1.3 Indeterminate

Carried interest /continuing compensation

Other securities

#### **3.4.2 FINRA guidelines on sales compensation in public offerings**

3.4.2.1 Limited to amount stated in offering document

3.4.2.2 Limit applies to total sales

3.4.2.3 10% of gross dollar amount of securities sold in public offerings; plus up to .5% for reimbursement of bona fide due diligence expenses

3.4.2.4 15% of proceeds for organization and offering expenses

3.4.2.5 Sharing commissions

## 4.0

### TAX ISSUES APPLICABLE TO DIRECT PARTICIPATION PROGRAMS

#### 4.1 Federal Tax Treatment of Direct Participation Programs

##### 4.1.1 General characteristics

- 4.1.1.1 Conduit nature of entity
- 4.1.1.2 Required to file informational tax returns (IRS Forms 1065 and 1120S)
- 4.1.1.3 Required to allocate profits, losses, deductions and credits to partners
- 4.1.1.4 Tax elections
- 4.1.1.5 Some choice of accounting method
- 4.1.1.6 Some selection of taxable year (generally calendar year)
- 4.1.1.7 State tax treatment - generally like federal

##### 4.1.2 Depreciation and amortization for tax purposes

- 4.1.2.1 Allows non-cash deduction based on entity's cost of depreciated or amortized asset
- 4.1.2.2 Depreciation requires asset held for production of income or used in trade or business
  - 4.1.2.2.1 Amortization allows straight line write-off of cost of intangible asset
- 4.1.2.3 Cannot depreciate unimproved land or inventory (e.g. lots for sale)
- 4.1.2.4 Types of depreciable properties
  - Personal property, equipment and land improvements
  - Residential rental property
  - Nonresidential real property
- 4.1.2.5 Tax benefits of depreciation
  - Deferral of tax liabilities on partnership income
  - Deductions in excess of income from partnership (passive income)
- 4.1.2.6 Basis of depreciable property-cost
  - Purchased property

- Constructed property
    - Improvements to property
- 4.1.2.7 Determination of recovery period
  - Depends on property type
  - Possession relinquished
  - Demolition
  - Exhaustion of allowable depreciation
- 4.1.2.8 Methods of depreciation
  - Straight line
  - Accelerated
- 4.1.3 Depletion--definition of depletable assets**
- 4.1.3.1 Cost method
- 4.1.3.2 Percentage method
- 4.1.3.3 Small producers and royalty owners (less than 1,000 barrels per day)
  - Limited to 50% of taxable income prior to depletion allowance
  - Limited to 65% of partners' taxable income from all sources
- 4.1.4 Deductibility of expense items**
- 4.1.4.1 Expenses deductible in year of occurrence
  - Interest (except construction interest)
  - Intangible drilling and development costs
  - Taxes--state and local
  - Direct payroll taxes incurred by the partnership
  - General operating costs
  - Service fees
  - Annual management fees
- 4.1.4.2 Expenses amortized over specified periods of time
  - Prepaid interest
  - Construction interest
    - Phase-in rules
    - Prepaid fees
    - Project financing fees
    - Loan standby or commitment fees
    - Rent-up fees (for leases over one year)
    - Organization fees
- 4.1.4.3 Non-deductible, capitalized expenses

Syndication related costs  
Securities brokerage compensation

**4.1.5 Tax credits**

4.1.5.1 Can offset tax on income taxes within limits, but does not offset alternative minimum tax (AMT)

4.1.5.2 Rehabilitation credits  
For certain buildings originally placed in service before 1936  
For certified historic structures and buildings located in historic districts

4.1.5.3 Low income housing credits  
Determined in the year project is placed in service  
Allowed over a specified number of years

**4.1.6 Potential recapture on sale or other disposition of property**

Tax credit  
Depreciation

**4.2 Tax Information Provided by Investment Entity to Investors (Schedule K-1)**

**4.2.1 Required to be sent to investors annually within a time usually specified in agreement of investment entity**

**4.2.2 Required to be filed with Internal Revenue Service with investment entity's tax return**

**4.2.3 Lists name, address and federal identifying number of investment entity and investor**

**4.2.4 Information required for S Corporations is substantially less than for other investment entities**

**4.2.5 Provides analysis of investor's capital account (not provided on S Corporation's K-1)**

4.2.5.1 Investor's capital account is not the same as the investor's tax basis

4.2.5.2 Investor's capital account balance can be negative in all investment entities other than S Corporations

4.2.5.3 Components of the capital account and their impact of its balance

Cash contributions increase balance  
Cash distributions decrease balance  
Non-cash property contributions increase balance  
Non-cash property distributions decrease balance  
Income and gain increase balance  
Losses decrease balance  
Other items such as tax exempt interest and non-deductible expenses such as entertainment increase or decrease balance

**4.2.6**            **Furnishes investor’s share of income, loss, deductions, investment interest, credits, adjustments and tax preference items, foreign taxes, other items and supplemental information required. For investment entities other than S corporations self employment information is furnished, if applicable**

**4.3**            **Opinions of Tax Counsel for Direct Participation Programs**

**4.3.1**            **Typically refer to tax consequences of each material tax issue in offering**

4.3.1.1            Opinion may be required as exhibit in certain programs.

**4.4**            **Federal Tax Qualifications for Limited Partnerships (LP) and Limited Liability Companies (LLC)**

**4.4.1**            **Tax consequences**

4.4.1.1            Newly formed entities can elect partnership LP/LLC tax status under certain circumstances

**4.4.2**            **Maintaining LP and LLC status of the entity**

4.4.2.1            Loss of conduit tax status means tax consequences at entity level and at partner/member level

**4.4.3**            **LPs and LLCs organized according to state statutes may automatically qualify for conduit tax status**

**4.5**            **Federal Tax Treatment of Limited Partnerships (LP) and Limited Liability Companies (LLC)**

**4.5.1**            **Sources of partner/member income, gain, loss and tax adjustments**

Taxable income and loss  
Capital gain and loss  
Investment interest income and interest expense  
Gains and losses from sales or exchanges of property used in trade or

business and involuntary conversions  
Tax credits  
Tax preference items

## **4.5.2           Disposition of property and interests**

- 4.5.2.1           Sale of LP/LLC interest
  - Capital gain or loss
  - Ordinary income
- 4.5.2.2           Tax free exchanges of LP/LLC property (Section 1031)
  - Requirement for like-kind exchange
  - No gain or loss
  - Tax basis is transferred
- 4.5.2.3           Gifts
  - Possibility of gift tax liability
  - Possibility of gain or ordinary income
- 4.5.2.4           Factors in disposition
  - Section 754 election--Step up basis upon the death of partner
  - Phantom income particularly in foreclosure or bankruptcy

## **4.5.3           Limitation on deduction of LP/LLC losses**

- 4.5.3.1           Tax basis
  - 4.5.3.1.1           Provides upper limit on deductibility of LP /LLC losses
  - 4.5.3.1.2           Unused losses may be held until there is basis
  - 4.5.3.1.3           Used to determine gain or loss on liquidation of LP /LLC or on sale or transfer of an interest
  - 4.5.3.1.4           LP/LLC's basis in its assets (inside basis)
  - 4.5.3.1.5           Partner's or member's basis is partner's interest in the LP or member's interest in the LLC (outside basis)
  - 4.5.3.1.6           Components of basis
    - Cash contribution
    - Non-cash property contribution
    - LP /LLC debt for which the investor is personally liable
    - Non-recourse LP /LLC debt (no limitation for qualified debt in real estate, at-risk limitation for other investments)

- 4.5.3.1.7 Factors resulting in an increase in basis
  - Taxable income and capital gains
  - Cash contributions
  - Non-cash contributions
  - Unused amortized deductions (i.e. organization costs)
  - Increase in LP /LLC debt for which partner/member is liable
  - Increase in non-recourse LP /LLC debt (no limitation for qualified debt in real estate, at-risk limitation for other investments)
  
- 4.5.3.1.8 Factors resulting in a decrease in basis
  - Taxable loss
  - Cash distribution
  - Non-cash distribution
  - Non-deductible, non-capitalized expenses (i.e. 50% of entertainment expenses)
  - Depletion deduction for oil and gas wells
  - Decrease in LP /LLC debt for which partner/member is liable
  - Decrease in non-recourse LP /LLC debt (no limitation for qualified debt in real estate, at-risk limitation for other investments)
  
- 4.5.3.2 Investment Interest
  - Limitation on annual deduction
  - Net investment income
  
- 4.5.3.3 Passive loss limitations
  - Losses from a passive activity
  - For limited partners and non-managing members generally only deductible against income from other passive activities
  - Passive losses carried forward but not backward
  
- 4.5.3.4 "At Risk" limitations on deduction of losses
  - Limited to partner's/member's capital contribution plus a portion of LP/LLC liabilities for which the partner/member is liable
  - Qualified non-recourse financing in real estate is exempt from "At Risk" limitations
  
- 4.5.3.5 Alternative minimum tax (AMT)
  - Major limit on potential tax benefits to individuals
  - Direct participation program preference items
  - Certain income tax brackets

## **4.6 Retirement Plans**

### **4.6.1 ERISA (Employee Retirement Income Security Act) requirements**

- 4.6.2           Types of retirement plans**
- 4.6.2.1           Individual retirement account (IRA)
  - Traditional IRA
  - Roth IRA
- 4.6.2.2           Keogh Plans/HR-10 Plans
- 4.6.2.3           Corporate pension plans
- 4.6.2.4           Corporate deferred payment profit sharing plans
- 4.6.2.5           401(k) plans--cash or deferred arrangements (CODAs)
- 4.6.2.6           403(b) plans--for employees of non-profit organizations
- 4.6.2.7           457 plans--for government employees
- 4.6.3           Suitability**
  - Prudent man rules
  - Self-directed or fiduciary directed
- 4.6.4           Rollover issues - maintaining non-taxed status**
- 4.6.5           Unrelated business taxable income --debt vs. equity**
- 4.6.6           Distributions from qualified plans -- tax effects vary**
- 4.6.7           Rules against self-dealing**

## 5.0

### REGULATION OF DIRECT PARTICIPATION PROGRAMS

#### 5.1 Federal Regulation of Direct Participation Programs

##### 5.1.1 Securities Act of 1933 and SEC Rules Thereunder - Registration of Securities

- 5.1.1.1 Definitions under the Act
  - Section 2(1) - Security
  - Section 2(2) - Person
  - Section 2(3) - Sale or sell; offer
  - Section 2(4) - Issuer
  - Section 2(11) – Underwriter

##### 5.1.2 Form of Offering

###### 5.1.2.1 Public programs

###### 5.1.2.1.1 Securities Act of 1933

5.1.2.1.1.1 Form S-1 registration (general securities)

5.1.2.1.1.2 Form S-11 registration (real estate programs)

5.1.2.1.1.3 Form SB-1 registration (small issue registration)

5.1.2.1.1.4 Regulation A – conditional small issues exemption

###### 5.1.2.2 Transactions exempt from registration

###### 5.1.2.2.1 Private offerings

5.1.2.2.1.1 Section 4(2) -- Transactions by an issuer not involving any public offering

5.1.2.2.1.2 Section 4(6) -- Transactions involving offers or sales by an issuer solely to one or more accredited investors up to the Section 3(b) maximum

5.1.2.2.1.3 Regulation D -- Rules governing the limited offer and sale of securities without registration under the Securities Act of 1933

5.1.2.2.1.3.1 Rule 501 -- Definitions and terms used in Regulation D

	Accredited investor
	Affiliate
	Aggregate offering price
	Number of purchasers
	Executive officer
	Issuer
	Purchaser representative
5.1.2.2.1.3.2	<p>Rule 502 -- General conditions to be met</p> <p>Integration—6-month safe harbor rule</p> <p>Information requirements</p> <p>    When information must be furnished</p> <p>    Type of information to be furnished</p> <p>Limitation on manner of offering</p> <p>Limitations on resale</p>
5.1.2.2.1.3.3	<p>Rule 503 -- Filing of notice of sale</p> <p>Filing Form D</p>
5.1.2.2.1.3.4	<p>Rule 504 -- Exemption for limited offers and sales of securities not exceeding \$1,000,000</p> <p>Exemption</p> <p>Conditions to be met</p> <p>Limitation on aggregate offering price</p>
5.1.2.2.1.3.5	<p>Rule 505 -- Exemption for limited offers and sales of securities not exceeding \$5,000,000</p> <p>Exemption</p> <p>Conditions to be met</p> <p>Limitation on aggregate offering price</p> <p>Limitation on number of purchasers</p> <p>Disqualification</p>
5.1.2.2.1.3.6	<p>Rule 506 -- Exemption for limited offers and sales without regard to dollar amount of offering</p> <p>Exemption</p> <p>Conditions to be met</p> <p>Limitation of number of purchasers</p> <p>Qualifications of purchasers</p>
5.1.2.2.1.3.7	<p>Rule 507 -- Disqualifying provision relating to exemptions under Rules 504, 505, and 506</p>
5.1.2.2.1.3.8	<p>Rule 508 -- Insignificant deviations from a term, condition or requirement of Regulation D</p>

- 5.1.2.2.2                   Intrastate offerings
- 5.1.2.2.2.1               Securities exempt from registration requirements for intrastate offerings
- 5.1.2.2.2.1.1             Section 3(a)(11) -- Any security which is part of an issue offered and sold only to persons resident within a single state or territory
- 5.1.2.2.2.1.2             Rule 147 -- "Part of an issue", "person resident" and" doing business with"
  - Part of an issue
  - Integration of offerings
  - Nature of the issuer
  - Offerees and purchasers; persons resident
  - Limitation of resales
  - Precautions against interstate offers and sales

## **5.2                   Communications with the Public**

### **5.2.1               Securities Act of 1933 and SEC Rules Thereunder**

- 5.2.1.1                   Section 2 -- Definitions under the Act
  - Section 2(8) -- Registration statement
  - Section 2(10) -- Prospectus
  - Rule 134 -- Communications not deemed a prospectus
- 5.2.1.2                   Section 5 -- Prohibitions relating to interstate commerce and the mails
  - Rule 135 -- Notice of certain proposed offerings
  - Rule 135A -- Generic advertising
- 5.2.1.3                   Section 6 -- Registration of securities and signing of registration statement
  - Regulation C -- Registration
    - Rule 425 -- Statement required in all prospectuses
    - Rule 425A -- Statement required on all prospectus regarding delivery of prospectuses by dealers
- 5.2.1.4                   Section 10 -- Information required in prospectus
  - SEC Guide 4 - Oil and gas
  - SEC Guide 5 - Real estate
- 5.2.1.5                   Section 11 -- Civil liabilities on account of false registration statement
- 5.2.1.6                   Section 12 -- Civil liabilities arising in connection with prospectus and communications

## **5.3 Federal Regulation of Broker-Dealers**

### **5.3.1 Securities Exchange Act of 1934 and SEC Rules Thereunder**

- 5.3.1.1 Section 3 -- Definitions and Application of Titles
  - Section 3(a)(3) -- Member
  - Section 3(a)(4) -- Broker
    - Rule 3a4-1 -- Associated persons of an issuer deemed not to be brokers
  - Section 3(a)(5) -- Dealer
  - Section 3(a)(8) -- Issuer
  - Section 3(a)(9) -- Person
  - Section 3(a)(10) -- Security
  - Section 3(a)(11) -- Equity security
  - Section 3(a)(12) -- Exempted security
  - Section 3(a)(13) -- Buy and purchase
  - Section 3(a)(14) -- Sale and sell
  - Section 3(a)(18) -- Persons associated with a broker or dealer
  - Section 3(a)(24) -- Participant
  - Section 3(a)(26) -- Self regulatory organization
  - Section 3(a)(35) -- Investment discretion
  - Section 3(a)(37) -- Records
  - Section 3(a)(39) -- Statutory disqualification
- 5.3.1.2 Section 10 -- Regulation of the use of manipulative and deceptive devices
  - 5.3.1.2.1 Rule 10b-1 -- Prohibitions with respect to securities exempted from registration
  - 5.3.1.2.2 Rule 10b-3 -- Employment of manipulative and deceptive devices by brokers or dealers
  - 5.3.1.2.3 Rule 10b-5 -- Employment of manipulative and deceptive devices  
False, misleading, or omitted material information
  - 5.3.1.2.4 Rule 10b-9 -- Prohibited representations in connection with certain offerings
    - Conditions of the underwriting
  - 5.3.1.2.5 Rule 10b-10 -- Confirmation of transactions  
Information disclosure requirements
- 5.3.1.3 Section 15(c) -- Registration and regulation of brokers and dealers-  
prohibitions and sanctions for fraud

- 5.3.1.3.1 Rule 15c1-2 -- Fraud and misrepresentation
- 5.3.1.3.2 Rule 15c1-3 -- Misrepresentation by brokers and dealers as to registration
- 5.3.1.3.3 Rule 15c1-5 -- Disclosure of control
- 5.3.1.3.4 Rule 15c2-4 -- Transmission or maintenance of payments received with underwritings
  - Handling investor funds
  - Bank escrow requirements
- 5.3.1.3.5 Rule 15c2-8 -- Delivery of prospectus (to customers); see also Rule 174 under the 33 Act
  - Preliminary prospectus (red herring)
  - Effective prospectus
  - Delivery to associated persons
  - Delivery to other broker-dealers by managing underwriter
- 5.3.1.4 Section 17 -- Accounts and records, reports, examinations of exchanges, members and others
  - 5.3.1.4.1 Rule 17a-8 -- Financial recordkeeping and reporting of currency and foreign transactions
  - 5.3.1.4.2 Rule 17f-2 -- Fingerprinting of securities industry personnel (general requirement)
- 5.3.1.5 Regulation FD – Disclosure requirements
- 5.3.1.6 Regulation S-P – Privacy of consumer financial information
- 5.4 Insider Trading**
  - 5.4.1 Insider Trading and Securities Fraud Enforcement Act of 1988**
    - 5.4.1.1 Section 3 -- Civil penalties of controlling persons for illegal insider trading by controlled persons
    - 5.4.1.2 Section 4 -- Increases in criminal penalties
    - 5.4.1.3 Section 5 -- Liability to contemporaneous traders of insider trading
- 5.5 Restrictions on Installment Sales for SEC Registered Public Offerings**

- 5.5.1 Regulation T -- Federal Reserve Board Requirements**
- 5.5.1.1 Treated as an extension of credit on a non-marginable security  
Not applicable to private offerings
- 5.5.2 Rule 3a12-9 -- Exemption of certain direct participation program securities from the restrictions regarding the extending or arranging of credit**
- 5.5.2.1 Business development plan
- 5.5.2.2 Specified property program
- 5.6 Investment Advisers Act of 1940**
- 5.6.1 Practices which would require registration**
- 5.7 FINRA/NASD Rules**
- 5.7.1 By-Laws**
- 5.7.1.1 Article I -- Definitions
  - Branch office
  - Broker
  - Dealer
  - Investment banking or securities business
  - Person associated with a member
- 5.7.1.2 Article III -- Qualifications of members and associated persons
- 5.7.1.3 Article IV -- Membership
- 5.7.1.4 Article V -- Registered representatives and associated persons
- 5.7.1.5 Article VI -- Dues, assessments and other charges
- 5.7.1.6 Article VII -- Board of governors
- 5.7.1.7 Article IX -- Committees
- 5.7.1.8 Article XII -- Disciplinary proceedings
- 5.7.1.9 Article XIII -- Powers of the Board to impose sanctions

- 5.7.1.10 Article XV -- Limitations of powers  
Section 2 -- Use of Name of the corporation by members

**5.7.2 General Provisions**

- 5.7.2.1 FINRA Rule 0110 -- Adoption of rules  
FINRA Rule 0140 – Applicability
- 5.7.2.2 FINRA Rule 0160 – Definitions in FINRA By-Laws

**5.7.3 Membership, Registration and Qualification Requirements**

- 5.7.3.1 NASD Rule 1020 – Registration of principals
  - Registration requirements
  - Definition of principal
  - Categories of principal registration
    - General securities principal
    - Limited principals
- 5.7.3.2 NASD Rule 1030 -- Registration of representatives
  - Registration requirements
  - Definition of representative
  - Categories of representative registration
    - General securities representative
    - Limited representative
- 5.7.3.3 NASD Rule 1060 -- Persons exempt from registration
- 5.7.3.4 NASD Rule 1070 -- Qualification examinations and waiver of requirements
- 5.7.3.5 NASD Rule 1080 -- Confidentiality of examinations
- 5.7.3.6 NASD Rule 1120 -- Continuing education requirements
  - Firm element
  - Regulatory element

**5.7.4 Conduct Rules**

- 5.7.4.1 FINRA Rule 2010 - Standards of commercial honor and principles of trade
- 5.7.4.2 FINRA Rule 2020 - Use of manipulative, deceptive, or other fraudulent devices
- 5.7.4.3 NASD Rule 2210 - Communications with the public

Definitions

Advertisement

Sales literature

Public appearance

Independently prepared reprint

Approval and recordkeeping

Filing requirements and review procedures

Content standards

Standards applicable to communication with the public

Standards applicable to advertisements and sales literature

IM-2210-1 – Guidelines to ensure that communications with the public are not misleading

IM-2210-4 – Limitations on use of FINRA's name

5.7.4.4 NASD Rule 2211 - Institutional sales material and correspondence

Definitions

Correspondences

Institutional sales material

Institutional investor

Existing retail customer

Approval and recordkeeping

Spot-check procedures

Content standards applicable to institutional sales material and correspondence

5.7.4.5 NASD Rule 2212 - Telemarketing

5.7.4.6 FINRA Rule 2232 – Customer Confirmations

5.7.4.7 FINRA Rule 2262 - Disclosure of control relationship with issuer

5.7.4.8 FINRA Rule 2269 - Disclosure of participation or interest in primary or secondary distribution

5.7.4.9 NASD Rule 2310 - Recommendations to customers (suitability)

5.7.4.10 FINRA Rule 2150 – Improper use of customers' securities or funds; prohibition against guarantees and sharing in accounts

Improper use

Prohibition against guarantees

Sharing in accounts; extent permissible

5.7.4.11 FINRA Rule 3240 - Borrowing from or lending to customers

5.7.4.12 NASD Rule 2420 - Dealing with non-members

- Transactions with non-members
  - Transactions with foreign non-members
  - Non-member broker or dealer
    - IM-2420 - Transactions between members and non-members
      - Member
      - Expelled dealer
      - Suspended dealer
      - Broker or dealer whose registration is revoked by the SEC
      - Membership resigned or canceled
- 5.7.4.13 NASD Rule 2430 - Charges for services performed
- 5.7.4.14 NASD Rule 2440 - Fair prices and commissions
- 5.7.4.15 FINRA Rule 5110 – Corporate Financing Rule-Underwriting terms and arrangements
  - Definitions
  - Filing requirements-public programs
  - Underwriting compensation and arrangements
- 5.7.4.16 FINRA Rule 5130- Restrictions on the purchase and sale of initial equity
  - Public offerings
    - General prohibitions
    - Preconditions for sale
    - General exemptions
    - Issuer-directed securities
    - Anti-dilution provisions
    - Stand-by purchasers
    - Undersubscribed offerings
    - Definitions
- 5.7.4.17 FINRA Rule 2310 - Direct participation programs
  - Definitions
  - Requirements
    - Application
    - Suitability
    - Disclosure
    - Organization and offering expenses
    - Valuation for customer accounts
    - Participation in rollups
- 5.7.4.18 NASD Rule 3010 - Supervision
  - Supervisory systems
  - Written procedures
  - Supervisory manual

- Readily accessible and continuously updated
  - Internal inspections
  - Review of transactions and correspondence
  - Qualifications investigated
  - Applicant's responsibility
  - Definitions
    - Office of supervisory jurisdiction (OSJ)
    - Branch office
- 5.7.4.19 FINRA Rule 3310 - Anti-money laundering compliance program
  - Bank Secrecy Act
- 5.7.4.20 FINRA Rule 3270 - Outside business activities of registered persons
- 5.7.4.21 NASD Rule 3040 - Private securities transactions (selling away)
  - Applicability to all associated persons of the member
  - Prompt written notice to the employer member
  - Transactions for compensation
  - Transactions not for compensation
  - Definitions
    - Private securities transaction
    - Selling compensation
- 5.7.4.22 NASD Rule 3050 - Transactions for or by associated persons
  - Determine adverse interest
  - Obligations of executing member
  - Obligations of associated persons concerning an account with a member
  - Obligations of associated persons concerning an account with an investment adviser, bank, or other financial institution
  - Exemption for transactions in investment company shares and unit investment trusts
- 5.7.4.23 FINRA Rule - 3220 Influencing and rewarding employees of others
- 5.7.4.24 FINRA Rule 4530 - Reporting requirements
- 5.7.4.25 NASD Rule 3110 - Books and records
  - Requirements
  - Customer account information
  - Record of written complaints
  - "Complaint" defined
  - Requirements when using predispute arbitration agreements with customers
  - Telemarketing requirements

5.7.4.26 FINRA Rule 2060 - Use of information obtained in fiduciary capacity

**5.7.5 FINRA Procedural Rules**

5.7.5.1 Rule 8000 -- Investigations and sanctions

5.7.5.1.1 Rule 8100 -- General provisions  
Rule 8110 - Availability of manual to customers

5.7.5.1.2 Rule 8200 -- Investigations  
Rule 8210 - Provision of information and testimony and inspection and copying of books

5.7.5.1.3 Rule 8300 -- Sanctions  
Rule 8310 - Sanctions for violation of the rules  
Rule 8311 – Effect of a suspension, revocation, cancellation, or bar  
Rule 8313 – Release of disciplinary complaints, decisions and other information  
Rule 8320 - Payment of fines, other monetary sanctions, or costs; summary action for failure to pay  
Rule 8330 - Costs of proceedings

5.7.5.2 Rule 9000 -- Code of Procedure

5.7.5.2.1 Rule 9100 -- Application and purpose  
Rule 9110 - Application  
Rule 9120 - Definitions  
Rule 9130 - Service; filing of papers  
Rule 9140 - Proceedings  
Rule 9160 - Recusal or disqualification

5.7.5.2.2 Rule 9200 -- Disciplinary proceedings  
Rule 9210 - Complaint and answer  
Rule 9220 - Request for hearing; extensions of time, postponements, adjournments  
Rule 9230 - Appointment of hearing panel, extended hearing panel  
Rule 9240 - Pre-hearing conference and submission  
Rule 9250 - Discovery  
Rule 9260 - Hearing and decision  
Rule 9270 - Settlement procedure  
Rule 9280 - Contemptuous conduct

5.7.5.2.3 Rule 9300 -- Review of disciplinary proceeding by National Adjudicatory Council and FINRA Board; application for SEC review

Rule 9310 - Appeal to or review by National Adjudicatory Council  
Rule 9320 - Transmissions of record; extensions of time,  
postponements, adjournments  
Rule 9340 - Proceedings  
Rule 9350 - Discretionary review by FINRA Board  
Rule 9360 - Effectiveness of sanctions  
Rule 9370 - Application to SEC for review

5.7.5.2.4 Rule 9500 -- Other Proceedings  
Rule 9520 - Eligibility Proceedings

5.7.5.2.5 Rule 9600 -- Procedures for Exemptions  
Rule 9610 - Application  
Rule 9620 - Decision  
Rule 9630 - Appeal

5.7.5.3 Rule 10000 -- Code of Arbitration Procedure

5.7.5.3.1 Rule 10100 -- Administrative provisions  
IM-10100 - Failure to act under provisions of Code of Arbitration  
Procedure  
Rule 10101 - Matters eligible for submission

5.7.5.3.2 Rule 10300 -- Uniform Code of Arbitration  
Rule 10301 - Required submission  
Rule 10302 - Simplified arbitration  
Rule 10308 - Selection of arbitrators  
Rule 10308(b) - Composition of arbitration panel; preparation  
of lists for mailing to parties  
Rule 10314 - Initiation of proceedings  
Rule 10321 - General provisions governing pre-hearing  
proceedings  
Rule 10330 - Awards

5.7.5.3.3 Rule 14000 -- Code of Mediation Procedure  
Rule 14104 --Mediation under the Code  
Rule 14108 - Limitation on liability  
Rule 14109 - Mediation ground rules

## **5.8 State (Blue Sky) Registration and Filing Requirements**

### **5.8.1 State Regulation of DPP Programs North American Securities Administrators Association (NASAA) Statement of Policy**

- 5.8.2 Exemptions from state registration**
- 5.8.3 Broker-dealer state registration**
- 5.8.4 Registered representative/principal state registration**

## 6.0

### FACTORS TO CONSIDER IN EVALUATING DIRECT PARTICIPATION PROGRAMS

- 6.1 Evaluation of the Direct Participation Program**
  - 6.1.1 Economic soundness of program**
  - 6.1.2 Basic objectives of program**
  - 6.1.3 Value of assets**
    - Cost to general partner
    - Cost to program
    - Third party appraisal of property, if applicable
  - 6.1.4 Nature of Assets**
    - Location
    - Economics of area
    - Demographics
    - Climatic conditions
    - Physical conditions
  - 6.1.5 Principal Risk factors**
    - Investment risk
    - Business/credit risk
    - Interest rate risk
    - Risk of liquidating investment at inappropriate times
    - Marketability or redeemability of the investment
    - Tax impact
    - Management ability
    - Market risk
    - Economic, social and political risk
    - Exchange rate risk
    - Lack of investment liquidity
    - Possible loss of principal
    - Unpredictability of income and expenses
    - Capability of general partner
    - Leverage
    - Competition
  - 6.1.6 Potential conflicts of interest**
    - Competing property interests held by the sponsor and his affiliates
    - Commingling program funds

Sponsor receives compensation for services rendered at favorable rates  
Purchase or sale of property to partnership by general partner

### **6.1.7 Sponsor and affiliate interest and compensation**

- 6.1.7.1 Organization and offering period
  - Acquisition and development fees
  - Other offering and organization fees paid
  - Selling compensation
  - Asset mark-ups
  - Cost reimbursement
- 6.1.7.2 Operational period
  - Asset management fees
  - Property management fees
  - Interest in profits, losses and cash distributions (subordinated or non-subordinated)
- 6.1.7.3 Termination period
  - Disposition fee
  - Cost reimbursement
  - Carried interest in gain, loss and cash distribution (subordinated or non-subordinated)

### **6.1.8 Sponsor's track record**

Review data from sponsor's previous programs to determine  
experience in the type of program being offered  
Success ratio versus type of program

### **6.1.9 Sources of offering proceeds**

Capital contributions  
Installment or staged payments  
Letters of credit  
Loans  
Assessments (additional capital contributions)

### **6.1.10 Use of offering proceeds**

- 6.1.10.1 Offering proceeds less offering and organization (front-end load) expenses equals amount available for investment
- 6.1.10.2 Types of offering and organization expenses
  - Underwriting compensation (sales and wholesaling fees)
  - Due diligence fees
  - Advisory fees (legal, accounting, consulting, investor relations, etc.)

Direct costs (printing, mailing, administrative, etc.)

- 6.1.10.3 Amounts of offering and organization expenses paid to sponsor and affiliates
- 6.1.10.4 Limits on offering and organization expenses in public programs
- 6.1.10.5 Indeterminate compensation adjustments on underwriting compensation
- 6.1.10.6 Use of amount available for investment
  - Acquisition of assets
    - Reimbursement of prepayments for loans, options, advisory fees, administrative costs--amounts paid to sponsor and affiliates
    - Acquisition fees (real estate commissions) -- amounts paid to sponsor and affiliates
    - Net cash to acquire assets
  - Working capital reserve

**6.1.11 Anticipated cash flow**

- Payments to investors
- Automatic re-investment plan
- Preferred returns
- Guaranteed returns
- Subordinated returns
- Cumulative returns
- Sharing ratio(s)

**6.1.12 Anticipated returns on investments**

- Analyze elements of return before and after taxes
- Examine tax factors by year over life of the investment
- Methods of calculating return and present value (time value of money)
  - Internal rate of return
  - Discounted cash flows

**6.2 Investor Suitability**

**6.2.1 Recommendation to customers (suitability/know your customer)**

- Financial status
- Tax status
- Tax identification number or social security number
- Investment objectives
- Ability to commit money for long periods (illiquidity)
- Financial ability to lose the amounts invested
- Purchaser representative requirements
- Risk tolerance

**6.2.2**

**Investor's understanding of the direct participation program**

Ability to understand risks of the underlying investment  
Lack of liquidity and marketability

**6.2.3**

**Alternative investment products -- appropriateness for investors, given the investor's investment objectives and risk-taking profile**

Treasury bills  
Money market funds  
Short-term government bond funds  
Intermediate government bond funds  
Long-term government bond funds  
Municipal securities  
Corporate securities  
Real-estate investment trusts  
Aggressive growth funds  
Speculative stocks  
Option trading

## SAMPLE QUESTIONS

The questions that appear below are similar in format and content to questions on the examination. This sample of questions, however, is not intended to exactly parallel either the level of difficulty or the subject coverage of the examination. Their purpose here is to assist candidates and training personnel in preparing for the types of multiple-choice questions which will appear on the examination.

1. In a joint venture, a venturer has liability that is equivalent to the liability of
  - (A) a limited partner
  - (B) a general partner
  - (C) a shareholder in a C corporation
  - (D) a shareholder in an S corporation
  
2. Which of the following is TRUE of a partner in a general partnership?
  - (A) He cannot participate in management without jeopardizing his status.
  - (B) He has limited liability.
  - (C) He has personal liability for obligations of the partnership.
  - (D) He is not responsible to creditors of the partnership beyond the subscription amount.
  
3. When calculating the cash flow from a residential property, which two of the following items must be considered?
  - I. The amount of the rent received.
  - II. The amount of cash expenses paid to operate the property.
  - III. The amount of cash expenses less depreciation.
  - IV. The amount of all amortized items.
  - (A) I and II
  - (B) I and IV
  - (C) II and III
  - (D) III and IV
  
4. Each of the following is true of a public limited partnership offering EXCEPT
  - (A) The offering must be filed with the SEC and FINRA.
  - (B) The offering may be advertised in securities industry magazines.
  - (C) The number of accredited investors is limited to 35.
  - (D) The offering may be made in more than one state.

## **ANSWERS TO SAMPLE QUESTIONS**

1. (B)
2. (C)
3. (A)
4. (C)