Real Estate Investment
Securities Association (REISA)

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March 14, 2011

Submitted via E-mail

Ms. Marcia E. Asquith
Senior Vice President and Corporate Secretary
Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington DC 20006-1500

Re: FINRA Regulatory Notice 11-04: Private Placements of Securities (the "Notice")

Dear Ms. Asquith:

On behalf of the Real Estate Investment Securities Association ("REISA"), this letter is submitted in response to the Financial Industry Regulatory Authority, Inc.'s ("FINRA") request for comments on the Notice. REISA is a trade association serving the real estate securities industry including all professionals active in offering, managing and distributing non-traded REITs, real estate partnerships, tenant-in-common interests (TICs), Delaware statutory trust interests (DSTs), real estate income and development funds, oil and gas interests, natural resources and alternative energy investments.

REISA works to maintain the integrity and reputation of the industry by promoting the highest ethical standards to its members and provide education, networking opportunities and resources. REISA connects members directly to key industry experts through intimate forums providing timely trends and education and helping create a diversified portfolio for their clients. The association was founded in 2003 and has over 600 members who are key decision makers that represent over 20,000 professionals throughout the nation including:

- Sponsors and managers of real estate and related offerings
- Broker-dealers
- Securities licensed registered representatives
- Registered investment advisers (RIAs)
- Accountants
- Attorneys
- Mortgage brokers
- Institutional lenders
- Qualified intermediaries
- Real estate agents
- Real estate brokers

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REISA believes in the importance of protecting the investing public while balancing the need for businesses and sponsors of quality real estate investment products, along with the FINRA members who sell these products, to be able to efficiently raise capital without an overly burdensome regulatory scheme. REISA believes that the amendments to FINRA Rule 5122 proposed in the Notice are far reaching and overly burdensome. REISA believes there are better, less restrictive ways to achieve what it believes are FINRA's laudable goals of investor protection.

The Notice proposes to amend FINRA Rule 5122, which currently only applies in circumstances in which a participating broker-dealer or its control entity is the issuer, and requires

(a) disclosure in the offering document of the intended use of offering proceeds, expenses and the amount of selling compensation to be paid to the broker-dealer and its associated persons,
(b) at least 85 percent of the offering proceeds to be used for the business purposes identified in the offering document and
(c) each offering document to be filed with FINRA for an *ex post* review to assess compliance with the rule.

The proposed amendments, however, would make similar requirements applicable to all private placements in which a FINRA member participates. The proposed rule requires the offering document to contain disclosure regarding the intended use of proceeds, the offering expenses and the amount of compensation that will be paid to broker-dealers and their associated persons. In addition, the proposed rule requires that at least 85 percent of offering proceeds must be used for the business purposes set forth in the disclosure document and not for offering costs and expenses, discounts, commissions or other cash or non-cash sales incentives. The disclosure document must also be submitted to FINRA at or prior to the time it is provided to any prospective investor.

Discussion

REISA believes that the proposed amendments would impose unnecessary burdens on, and create significant delays in, capital formation by small business issuers who utilize private placements. If the amendments are enacted as proposed, FINRA members may be reluctant to commence an offering until FINRA has "cleared" the offering because of the potential risk of having to make a rescission offer if FINRA has comments after the offering has commenced, which would significantly delay the offering. In addition, the proposed amendments create significant uncertainty for FINRA members including, but not limited to:

- confirming whether a filing was made with FINRA;
- whether the issuer applied the proceeds in accordance with the disclosure; and
- the duties of a FINRA member, unaffiliated with an issuer, to monitor the issuer's application of the proceeds of the offering.

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The Notice states that current Rule 5122, which only applies when a member or its control entity is the issuer, does not include several thousand offerings that would now be captured by the proposed amendments. (Notice at page 3) FINRA states that the proposed amendments are made "to provide investors with additional protection from fraud and abuse." Id. REISA believes strongly in investor protection and keeping fraud and abuse out of private placements of securities. However, REISA believes there are better and more effective ways to achieve similar results.

Exacerbation of Current Difficulties Facing Broker-Dealers in Private Placements

FINRA member broker-dealers are already facing significant burdens in connection with their participation in private placements, and the proposed amendments would significantly increase those difficulties. According to an article in Investment News, a total of almost 2,400 registered representatives have been displaced over the past year with the shuttering of at least 13 broker-dealers since March 2010.[1] There are a variety of reasons for these broker-dealers going out of business, including:

- an increase in arbitrations from investors due to decreases in the value of their investments and corresponding suitability issues,
- significant increases in costs, when available, for E&O insurance,
- reduction in the number of accredited investors available for Regulation D private placement offerings,
- net capital violations due to increasing E&O deductibles, and
- other increasing regulatory burdens and compliance costs.

While not yet out of business, other broker-dealers are struggling for many of the reasons set forth above. Many broker-dealers face significant challenges from arbitrations because of the significant costs incurred in connection with them. Unlike in civil litigation, where a motion to dismiss or motion for summary judgment can be filed and heard at the beginning of a case (before significant costs are incurred), an arbitration requires much of the work (and the costs associated with it) up front, before a motion to dismiss or for summary judgment can be heard. The costs of preparing for an arbitration (preparing an answer, scheduling conferences, discovery and writing briefs) become prohibitive, even where a motion to dismiss or for summary judgment would be granted on the facts.

Attempts by a number of bankruptcy trustees to "claw back" commissions paid to broker-dealers in failed private placement securities transactions have also created significant issues. The reasons for the failure of these private placements are varied and are not due to bad behavior on the part of broker-dealers. Notwithstanding the cause of the failures of these private placements, if bankruptcy trustees are allowed to reach these commissions, most of which have already been paid out to registered representatives or used to cover expenses of running the broker-dealer, a significant number of the broker-dealers who are currently just keeping their heads above water will find themselves added to the list of broker-dealers shuttering their doors.

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Disclosure-Based Regulation Should Replace Arbitrary Thresholds

REISA believes that instead of setting an arbitrary threshold of 85% of offering proceeds (or any other numerical limitation) to be used for the specified business purposes, which threshold may not work in all types of private placement investments, a better approach would be to require an estimated use of proceeds table, similar to that contained in SEC Industry Guide 5, which includes both dollar amounts as well as the percentage of offering proceeds, as set forth below.

Estimated Use of Proceeds[2]

	Amount	**Percentage of Gross Proceeds**
Gross Offering Proceeds	$_______	100.0%
Marketing and Due Diligence Expenses	________	____%
Selling Commissions	________	____%
Organization and Offering Expenses	________	____%
Available for Investment	________	____%
Acquisition Fee	________	____%
Loan Fee	________	____%
Real Estate Transaction Costs	________	____%
Reserve	________	____%
Debt Service Reserve	________	____%
Proceeds Utilized	________	____%
Offering and Organization Expenses and Fees	________	____%
Total Application	$_______	100.0%

A table similar to the one above would provide an investor a "road map" of the estimated use of the proceeds raised in the offering without placing arbitrary numerical limitations on the way in which a sponsor can utilize the offering proceeds. Some types of programs will find it appropriate to put 90% of the gross offering proceeds "in the ground"; some programs 85% and still other programs could only have 80% of the gross offering proceeds going into the ground. Each time a determination of the correct number is made, an exception will be found. Instead of setting up a system where the exceptions will overcome the rule, so long as the sponsor/issuer has outlined in detail where the proceeds will be used, setting an arbitrary number, such as 85%, may serve to stifle innovation and eliminate many potentially good investments from being sold. Many small businesses that rely on the private placement market will either have to find other ways of raising capital or do without. A sophisticated, accredited investor, who the SEC has determined is not in need of all of the protections of the securities laws, should be able to determine, based upon a detailed use of proceeds disclosure in an offering document, whether he wants to invest in that particular offering.

Another inherent problem of utilizing a numerical limitation is the difficulty in determining what compensation would and would not be included in the 15% limit. The application of FINRA's Rule 2310, which currently governs compensation in public direct

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participation programs, such as REITs, equipment financing and oil and gas programs, remains very subjective in its determination of what constitutes compensation and whether or not it should be included in the allowable compensation. Given the boundless number of private placement structures, investment objectives and strategies, trying to limit all compensation, and even how to determine what constitutes compensation, will be extremely difficult and subjective and will make small business capital formation through FINRA members significantly more difficult, time-consuming and costly. REISA believes that a disclosed-based system of regulation provides a more effective way of achieving FINRA's goal of investor protection while supporting innovation and capital formation for small businesses.

The Proposed Amendments Would Create Unnecessary Delays in Small Business Capital Formation

It is unlikely that many broker-dealers and/or issuers would close an offering given the possibility of FINRA raising an issue after reviewing the offering document disclosure that the issuer did not meet the 85% threshold requirements of amended Rule 5122, notwithstanding the Notice's statement that offerings can be completed prior to FINRA's review. If the disclosure in an offering document were found to (1) raise "an apparent investor protection issue," (2) be inadequate or (3) violate the limitations contained in the proposed rule after the offering were closed, investors could have rescission rights under state securities laws that would require issuers to return all of the investors' money, including sales commissions as well as statutory interest. Since FINRA will not be reviewing the offering documents in real time, many private placements will be unable to proceed or will be significantly slowed down so that broker-dealers can be comfortable that they are not proceeding with an offering that FINRA finds deficient.

The Potential Delays Could Drive Issuers to Unregistered Persons to Raise Capital

If the review of offering documents by FINRA either takes too long or is not "cleared" in some manner, issuers may decide that their capital needs will not wait. This could cause issuers to raise capital through unregistered, unlicensed persons. These unregistered persons would not be subject to the SEC's or FINRA's rules and regulations and investors could be at even greater risk than they are currently. It does not appear that the best interests of investors will be served if the capital formation for small business and the private placement of securities ends up being handled by unregistered and unlicensed persons.

The Requirement to File Offering Documents with FINRA Creates Significant Uncertainties

Finally, expanding current Rule 5122 to require FINRA members to file an offering document with FINRA at or prior to the time it is first used so that it applies not only to members' and affiliated members' private placements but to all FINRA members that "participate" in a private placement could create a number of issues. REISA does not anticipate that the actual process of filing an offering document will be difficult. However, if FINRA is going to review the substance of the filing (i.e., whether or not the filing meets the

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85% use of proceeds requirement), issuers whose structure does not fit within the rule's 85% requirement will have to be able to request exemptions or exceptions each time they are faced with a structure and/or a program that does not fit within the strict confines of a numerical requirement.

Another issue surrounding the filing requirement is that the rule does not address who has the obligation to file. In many private placements, there are large numbers of selling dealers who participate in the offering. Does the rule require each selling dealer to file the offering document with FINRA? If not, how does a selling group member know whether or not the offering document has been filed? If there are amendments to the offering documents is there a requirement to file each amendment and if so, whose responsibility is it to file the amendments and when do they need to be filed? Can a selling group member rely on a representation from the managing broker-dealer that the offering document has been filed and/or has been cleared by FINRA? Unlike a Form D filing with the SEC on its public website, the filing of an offering document with FINRA is not anticipated to be publicly available. How then would a member of the selling group be able to confirm that any particular member of the selling group had filed and/or filed timely?

In addition, how does a FINRA member ensure that an issuer applied the offering proceeds as disclosed in the offering document? Even if a FINRA member were to receive a representation from the issuer that the offering proceeds were applied in accordance with the offering document and/or were to be indemnified by the issuer for the issuer's incomplete or misleading disclosures, would the FINRA member be subject to an enforcement action by FINRA for its participation in the distribution for an issuer's violation of Rule 5122? By expanding the reach of the current Rule 5122 to FINRA members who are not controlled by or under common control with an issuer, the burdens and difficulties of ascertaining whether the disclosures are complete become much more burdensome and increase the risks to selling group members as a result of potential actions by FINRA.

REISA believes that FINRA should address these issues and their risks to its members in adopting final rules or in a Regulatory Notice to its members regarding compliance with any new requirements.

<u>REISA Best Practices</u>

While REISA understands that there are some broker-dealers who have defrauded their investors, it believes that most broker-dealers act honorably and in their investors' best interests. In 2006, REISA adopted best practices for tenant in common offerings and updated them in 2008. REISA is currently in the final phase of adopting best practices for Regulation D private placements (the "Best Practices"). The Best Practices address such issues as:

- suitability analysis under FINRA Rule 2111,
- disclosures to be included in private placement memoranda, such as
  - estimated use of proceeds,
  - risk factors,
  - compensation to sponsors, issuers and broker-dealers,

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  - conflicts of interest,
  - sponsor's prior performance and
  - management's experience,
- legal opinions,
- marketing materials,
- prohibition on general solicitation,
- due diligence,
- subscription paperwork,
- investor communication, and
- broker-dealer compensation issues.

REISA believes that the Best Practices serve many purposes, including establishing industry-wide standards which are disclosure-based rather than rules-based. REISA believes that disclosure-based rules provide flexibility to issuers and the FINRA members who assist them in raising capital as well as providing strong investor protections. REISA looks forward to sharing its Best Practices with FINRA as it has with its previous best practices.

Conclusion

For all of the reasons set forth above, REISA believes that the proposed requirements set forth in the Notice are overly burdensome and broad. REISA believes that a disclosure-based system, as discussed herein, would provide the protection for investors FINRA is seeking, while at the same time removing timing and procedural hurdles, as well as uncertainty, from the private placement market that drives many small businesses and capital formation throughout the country.

REISA appreciates the opportunity to comment on the Notice and looks forward to a continued dialogue with FINRA on these and other important issues for the protection of investors and the capital markets.

Sincerely,

Richard B. Chess
President, Real Estate Investment Securities Association

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[1] *B-Ds down: Total reps displaced now approaching 2,400,* Investment News, February 25, 2011.
[2] The estimated use of proceeds table presented is a sample of the types of tables found in private placement offering documents used by REISA members. The specific line items would be tailored to the specific transactions covered by the offering document.