REISA™
REAL ESTATE INVESTMENT SECURITIES ASSOCIATION

Real Estate Investment Securities Association (REISA)
Two Meridian Plaza
10401 North Meridian Street
Suite 202
Indianapolis, IN 46290
main: 317.663.4180
fax: 317.815.0871
toll-free: 866.353.8422
www.reisa.org

November 12, 2011

Submitted via *pubcom@finra.org*

Marcia E. Asquith
Office of the Corporate Secretary
Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington, DC 20006-1506

Re: *FINRA Regulatory Notice 11-44: Customer Account Statements*

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 Regulatory Notice 11-44: Customer Account Statements ("Regulatory Notice 11-44"). 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 800 members who are key decision makers that represent over 30,000 professionals throughout the nation including:

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

REISA™
REAL ESTATE INVESTMENT SECURITIES ASSOCIATION

Real Estate Investment Securities Association (REISA)
Two Meridian Plaza
10401 North Meridian Street
Suite 202
Indianapolis, IN 46290
main: 317.663.4180
fax: 317.815.0871
toll-free: 866.353.8422
www.reisa.org



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.

In Regulatory Notice 11-44, FINRA has proposed amendments to NASD Rule 2340[1] (*Customer Account Statements*) (the "Proposed Amendments") to address how FINRA member firms report per share estimated values of publicly registered, non-traded direct participation programs (DPPs) and publicly registered, non-traded real estate investment trusts (REITs) on customer account statements. The Proposed Amendments would:

a) Limit the time period during which the initial offering price (usually $10 per share) may be used as the basis for the per share estimated value to the period provided under Rule 415(a)(5) of the Securities Act of 1933, as amended (the "Initial Offering Period")[2];
b) Require FINRA member firms to deduct all organization and offering expenses[3] from the per share estimated value during the Initial Offering Period;
c) Prohibit a firm from using a per share estimated value, from any source, if it "knows or has reason to know the value is unreliable," based upon publicly available information or nonpublic information that has come to the firm's attention; and
d) Allow a firm to omit a per share estimated value on a customer account statement if the most recent annual report of the DPP or REIT does not contain a value that complies with the disclosure requirements of Rule 2340.[4]

---

[1] As part of the rulebook consolidation process, FINRA has proposed new FINRA Rule 2231 to replace NASD Rule 2340. See SR-FINRA-2009-028. The amendments discussed in Regulatory Notice 11-44 would be made to NASD Rule 2340 or new FINRA Rule 2231, depending upon the timing of final approval of this Regulatory Notice.
[2] The initial offering period is defined in Regulatory Notice 11-44 and by Rule 415 under the Securities Act of 1933, as amended, as lasting up to three years plus an additional 180-day extension period if a follow-on public offering has been registered.
[3] Defined in Regulatory Notice 11-44 as expenses incurred in connection with registration and distribution, including all forms of compensation paid to broker-dealers and affiliates in connection with the offering and are generally limited to 15% of the gross offering proceeds. These organization and offering expenses have three components: (a) underwriting compensation, (b) issuer expenses that are reimbursed or paid for with offering proceeds and (c) due diligence expenses.
[4] REISA has no comment on this particular aspect of the Proposed Amendments.

REISA™
REAL ESTATE INVESTMENT SECURITIES ASSOCIATION

Real Estate Investment Securities Association (REISA)
Two Meridian Plaza
10401 North Meridian Street
Suite 202
Indianapolis, IN 46290
main: 317.663.4180
fax: 317.815.0871
toll-free: 866.353.8422
www.reisa.org



REISA joins FINRA in its focus on investor protection and transparency relating to non-listed REITs and other types of DPPs. REISA also understands FINRA's Corporate Financing Department's push for action to ensure enhanced transparency and accountability. However, it is important to also recognize that these investment programs have a unique place in the market for real estate securities and the offering documents for these programs make it clear that the underlying portfolio contains illiquid, hard real estate assets that will intrinsically neither increase nor decrease in value until actually monetized by virtue of a "liquidity event." There are multiple disclosures in the offering documents for these programs that reference the long-term, illiquid nature of the DPPs and REITs and their portfolios, the types of investors who should and should not be investing their money in these types of programs, and the arbitrary nature of the offering price.

REISA has the following comments and observations relating to the Proposed Amendments to NASD Rule 2340 regarding Customer Account Statements.

1. <u>Deducting Issuer Organization and Offering Expenses.</u> Requiring that during the Initial Offering Period, all organization and offering expenses, including issuer costs, be deducted from the gross offering price resulting in a "net estimated value" for the purposes of customer account statement reporting, has a number of shortcomings and unintended consequences, as set forth below.

    a. A valuation during the Initial Offering Period that deducts underwriting compensation (selling commissions and dealer manager fees), as well as all organization and offering expenses, including issuer expenses, fails to acknowledge that such "estimated value" is just as arbitrary as the stated $10.00 per share price.
    b. Especially during the early part of the Initial Offering Period, when a REIT or DPP is ramping up its operations and its capital raising activities, the organization and offering expenses will comprise a significant percentage of offering proceeds raised and will not provide an accurate depiction of the per share estimated value of the DPP or REIT. Issuer expenses estimated to be 1% to 3% of gross offering proceeds at the maximum offering amount could, in fact, comprise 15% to 30% of gross offering proceeds in the initial stages of the capital raise.[5]

[5] For example, in a $1,000,000,000 maximum offering, just the initial SEC and FINRA filing fees would equal almost $200,000. Assuming the issuer breaks escrow at $2,000,000, issues 2,000 shares at $10 per share and pays underwriting compensation equal to 10% of the gross offering proceeds, the per share estimated value for customer account statement purposes at that time would equal $8.00 per share (without taking into account any other issuer organization and offering expenses). When gross offering proceeds

REISA™
REAL ESTATE INVESTMENT SECURITIES ASSOCIATION

Real Estate Investment Securities Association (REISA)
Two Meridian Plaza
10401 North Meridian Street
Suite 202
Indianapolis, IN 46290
main: 317.663.4180
fax: 317.815.0871
toll-free: 866.353.8422
www.reisa.org



c. In 2008, FINRA changed what is now FINRA Rule 2310 to eliminate the 0.50% of gross offering proceeds cap on due diligence expense reimbursements in order to encourage adequate due diligence to be performed on DPPs and REITs.[6] In Regulatory Notice 10-22, Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings, FINRA reminded its members of its significant obligations to perform due diligence and provided detailed guidance on how to do so, which guidance is used as a roadmap for all types of products, including DPPs and REITs. If the cost of performing adequate due diligence is required to be deducted from the per share estimated value to be disclosed on customer account statements, many issuers may become reluctant to reimburse FINRA members for due diligence expenses and FINRA members may (1) be required to either pay their own due diligence expenses, (2) cut back on the due diligence they perform on these DPPs and REITs or (3) stop selling DPPs and REITs because they cannot meet their due diligence obligations. In any of these scenarios, by requiring issuer organization and offering expenses to be deducted in calculating the per share value of a DPP or REIT, FINRA is discouraging the very behavior it has been trying to encourage when it lifted the cap on due diligence expense reimbursements.

2. <u>Calculation of Net Estimated Per Share Values after the Initial Offering Period and Appraised Value.</u>

a. After the Initial Offering Period, the per share estimated value to be "included on the customer account statement must be based on an appraisal of a DPP or REIT's assets, liabilities and operations." REISA believes that the proper method for determining the value of a DPP or REIT at any given time would be to appraise its assets deduct its liabilities and divide that by the number of shares outstanding. REISA believes that FINRA must clarify what it means to appraise "assets, liabilities <u>and operations</u>." (Emphasis added). If by including "operations" FINRA intends that the calculation include an "enterprise value" for the DPP or REIT, REISA believes that there are other considerations to be addressed,

equal $10,000,000, however, the same $200,000 in filing fees, 10% in underwriting compensation and 10,000 shares sold, the per share estimated value would equal $8.80. Nothing in the inherent value of the shares changed in the two scenarios except that the upfront, sunk issuer costs have been spread out over more shares. In either case, neither per share estimated value is a real reflection of the underlying value of the DPP, REIT or the shares, especially since the selling price remains $10.00 per share.

[6] See Notice to Members 08-35, effective August 6, 2008.

REISA™
REAL ESTATE INVESTMENT SECURITIES ASSOCIATION

Real Estate Investment
Securities Association (REISA)
Two Meridian Plaza
10401 North Meridian Street
Suite 202
Indianapolis, IN 46290
main: 317.663.4180
fax: 317.815.0871
toll-free: 866.353.8422
www.reisa.org



such as whether the per share estimated value is equal to, greater than or less than its actual "net asset value" (i.e., the sum of the value of its individual assets, less its liabilities) for reasons relating to market perception, interests rates, liquidity needs, investor sentiment regarding the industry sector or the economy generally.

b. FINRA's requirement for current data, i.e., an appraisal must be no less current than the most recent annual report, could be viewed as actually requiring a DPP or REIT to appraise its assets on a monthly or quarterly basis. For example, a DPP or REIT appraises all of its assets for purposes of calculating the per share estimated value but then has to take an impairment charge on one or more of the assets in its portfolio in the first or second quarter of the year. Would the DPP or REIT be required to come up with a new per share estimated value for the remainder of the year or is it sufficient to have the per share estimated value that was reported in the annual report be used for the entire year? Similarly, if the DPP or REIT acquired a number of assets (or sold a number of assets) during the year, would a change in the per share estimated value be required to take into account the addition of the new assets or the absence of the sold assets? If the DPP or REIT would be required to update its per share estimated value every quarter, every month or every time it bought, sold or took an impairment charge on one of its assets, the publicly registered, non-traded DPP or REIT will start to look very similar to its publicly traded DPP or REIT brethren with a regular "market price" being determined. This would fundamentally change the nature of the DPP and REIT product.

3. <u>Prohibiting the use of a per share estimated value if a FINRA member "knows or has reason to know the value is unreliable."</u> Such a prohibition will bring uncertainty and potential liability to FINRA members and could cause significant chaos in the market for DPPs and REITs. Some of the issues raised by the prohibition include the following:

   a. How does a FINRA member make the determination that the per share estimated value is unreliable?
   b. Is each FINRA member required to perform its own analysis as to the per share estimated value of each DPP or REIT held by its customers?

REISA™
REAL ESTATE INVESTMENT SECURITIES ASSOCIATION

Real Estate Investment
Securities Association (REISA)
Two Meridian Plaza
10401 North Meridian Street
Suite 202
Indianapolis, IN 46290
main: 317.663.4180
fax: 317.815.0871
toll-free: 866.353.8422
www.reisa.org



c. If a FINRA member makes a determination that the per share estimated value is unreliable and therefore does not include the value on its customer account statement, what type of disclosure is required in place of such value?
d. Does the FINRA member note on its customer account statement that it knew or had reason to know that the value provided or reported by the issuer was unreliable?
e. If there is a large selling group for a DPP or REIT and some members of the selling group believe that the value is reliable and others do not, what is the potential liability to each of those who include and exclude the value on the customer account statement?
f. If an introducing FINRA member believes the value is unreliable but the clearing FINRA member produces the customer account statements, how does the introducing FINRA member alert the clearing FINRA member about the issues relating to the reliability of the value?
g. What role does the clearing FINRA member play in the determination to include or exclude the value on customer account statements?

4. Transition Period. REISA believes that FINRA should include a transition period for implementing the Proposed Amendments in Regulatory Notice 11-44 given the significant changes that would occur, especially for those DPPs and REITs that are currently in their Initial Offering Periods, as well as those that are currently in registration, if the Proposed Amendments are adopted.

**Conclusion**

REISA remains committed to collectively working to improve the industry from the standpoint of transparency and valuation. REISA believes that while Regulatory Notice 11-44 has the right goals in mind, there are some issues with the Proposed Amendments that require some adjustments. REISA appreciates the opportunity to comment on Regulatory Notice 11-44 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

Richard B. Chess
President, Real Estate Investment Securities Association