NASD NOTICE TO MEMBERS 97-81

NASD Regulation Requests Comment On Proposed Amendments Relating To Compensation For Sale Of Public Offerings Of Direct Participation Programs; **Comment Period Expires January 9, 1998**

Suggested Routing

- ■ Senior Management
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Executive Summary

In the following document, NASD Regulation, Inc. (NASD Regulation℠) requests comment on proposed amendments to National Association of Securities Dealers, Inc. (NASD®) Rule 2810 that would modify the compensation that members are permitted to receive in connection with the sale of public offerings of direct participation program (DPP) securities. The proposed amendments would: (1) lower the front-end maximum permissible compensation from 10 percent to 8 percent; (2) permit a member to receive an annual investor service fee of .20 percent, with maximum front-end compensation of 7.5 percent; (3) permit a member to receive a "trail commission," in addition to the service fee, for each one percentage point give-up from front-end compensation of 7.5 percent; and (4) lower the maximum organization and offering expense guideline for large offerings.

Questions concerning this *Request For Comment* should be directed to Charles L. Bennett, Director, Corporate Financing, NASD Regulation; Suzanne E. Rothwell, Chief Counsel, Corporate Financing, NASD Regulation; or Carl R. Sperapani, Assistant Director, Corporate Financing, NASD Regulation, at (202) 974-2700.

Request For Comment

NASD Regulation encourages all members and interested parties to respond to the issues raised in this *Notice*. Comments should be mailed to:

Joan Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, N.W.
Washington, D.C. 20006-1500;

or e-mailed to:
pubcom@nasd.com

Comments must be received **by January 9, 1998**. Before becoming effective, any rule change developed as a result of the comments received must be adopted by the NASD Regulation, Inc., Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

NASD Regulation Request for Comment 97-81

Executive Summary

NASD Regulation, Inc. (NASD Regulation℠) requests comment on proposed amendments to National Association of Securities Dealers, Inc. (NASD®) Rule 2810 (DPP Rule or Rule) that would modify the compensation that members are permitted to receive in connection with the sale of public offerings of direct participation program (DPP) securities. The proposed amendments would: (1) lower the front-end maximum permissible compensation from 10 percent to 8 percent; (2) permit a member to receive an annual investor service fee of .20 percent, with maximum front-end compensation of 7.5 percent; (3) permit a member to receive a "trail commission," in addition to the service fee, for each one percentage point give-up from front-end compensation of 7.5 percent; and (4) lower the maximum organization and offering expense guideline for large offerings.

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Background

Current NASD Rules

Rule 2810 sets out the NASD's regulation of the underwriting terms and arrangements of public offerings of DPP securities. The Rule currently permits members to receive underwriting compensation for participating in the distribution of a public DPP offering of up to 10 percent of the offering proceeds received, with an additional 0.5 percent permitted for reimbursement of bona fide due diligence expenses. The Rule also restricts total organization and offering (O&O) expenses for any program sponsored by a member or its affiliate to no more than 15 percent of offering proceeds (or 4.5 percent additional O&O). "Compensation" is broadly defined to include all items of compensation paid directly or indirectly from whatever source to underwriters, broker/dealers and their affiliates. Moreover, the current rule also includes a provision prohibiting the receipt of compensation by members of an indeterminate nature, unless the structure of the indeterminate compensation satisfies certain conditions.[1]

The Tully Report

In May 1994, an industry committee chaired by Merrill Lynch Chairman Daniel P. Tully (the Committee) was formed at the request of Securities and Exchange Commission (SEC) Chairman Arthur Levitt to address concerns regarding conflicts of interest in the brokerage industry. The Committee's mandates were to review industry compensation practices for registered representatives (RRs) and branch managers, identify actual and perceived conflicts of interest for RRs and branch managers, and identify the "best practices" used in the industry to eliminate, reduce or mitigate such conflicts. The Committee issued its report on April 10, 1995 (Tully Report). Among some of the "best practices" identified, the Tully Report recommended that:

• Compensation policies should be designed to align the interest of all three parties to the relationship—the client, the RR, and the brokerage firm—and to encourage long-term relationships among them.

• Member policies should encourage representatives to understand their client's objectives, and to educate the clients about markets and risks.[2]

Generally, the Tully Report's findings and conclusions reflected a growing concern that the securities industry should more closely align the interests of brokerage firms and RRs to those of their customers and should encourage long-term relationships between firms and RRs and their customers.

Discussion

Response To The Tully Report

NASD Regulation believes that the current compensation structure for the sale of DPPs in Rule 2810 should be amended to better align the interests of the investor, the salesperson, and the member as recommended by the Tully Report. DPPs are a long-term, illiquid security product in which investors need continuing information on the performance of their investment. The current compensation structure in the DPP Rule does not encourage members or their RRs to provide continuing information to their customers regarding the program over its life, nor does it promote members' continued review of the program's activities on behalf of its customers. Importantly, NASD Regulation also believes that amending the current compensation structure will also align the interests of the general partner or sponsor with those of the investor—although the Tully Report does not focus on this relationship.

Finally, NASD Regulation is concerned that the current compensation structure that assumes the member will obtain its compensation at the time of sale does not properly focus the member and the member's RRs on whether the quality of the investment will provide continuing returns to investors, thus creating an impression on the part of investors that the broker/dealer is significantly rewarded for the sale of DPP products regardless of the subsequent performance of the program. It was, therefore, determined that the compensation structure should be revised to align the interests of the member and the RR with those of the customer on the performance of the program recommended by the member.[3]

Description Of Proposed Amendments

Base Fee

Under the current guideline in the DPP Rule, members and their RRs are permitted to receive compensation from any source for the sale of DPPs that does not exceed 10 percent of gross offering proceeds (base fee), plus .5 percent of gross offering proceeds, to reimburse the member for its costs related to mandatory due diligence.[4] In light of current practices where most programs do not pay members more than 8 percent in front-end commissions, NASD Regulation is proposing to reduce the base compensation from 10 percent to a maximum of 8 percent, while retaining the .5 percent guideline for due diligence. The decrease in the base fee will increase the amount of investors' capital contribution invested in assets acquired by the program.

Service Fee

In order to encourage members and their RRs to provide continuing information to customers regarding DPP securities and promote members' review of program activities, NASD Regulation is proposing to amend Rule 2810 to give members the alternative to trade off one-half of 1 percent from the 8 percent base fee to receive *annually* a service fee of 20 basis points for providing "investor relations" services to their customers (service fee). This alternative fee structure would be comprised of a 7.5 percent maximum base fee, plus a maximum of 0.5 percent for due diligence, plus an additional maximum 0.20 percent of gross offering proceeds sold by the member.

Although the *amount* of the fee is determined as a percentage of gross offering proceeds, the *source* of the payment of the fee is either the program's annual cash available for distribution (*i.e.*, total program cash flow except for amounts held for restoration or reserves) or fees that are paid by the program to the general partner. If the service fee is paid out of annual cash available for distribution, the service fee would be pro-rated against the investor's adjusted capital contribution (investor's original investment, minus cash distributions from sale and refinancing of assets). This has the effect of decreasing the member's payout as the assets of the program are liquidated and sales proceeds are distributed to investors. Finally, to ensure that both the general partner and investors contribute proportionately to the member's service fee, the definition of "cash available for distribution" has been drafted to require that the service fee be deducted from the "program's total funds provided from operations." However, the proposal does not apply the pro-ration requirement in the event that the service fee is paid entirely out of general partner fees.[5]

In order to receive the service fee, the member must enter into a written agreement with the program which obligates the member to: (1) provide services to its customers so long as the member receives the annual service fee; and (2) respond to customers' requests for copies of reports and statements of account and to customers' questions regarding the periodic reports and performance of the program. The written agreement must also require that the general partner or sponsor of the program: (1) respond to inquiries by the member regarding the operation of the program; and (2) distribute annually to limited partners, no later than four months after the end of the program's fiscal year, a report on the operation of the program containing audited financial reports for at least a one-year period. NASD Regulation believes that this provision is key to the ability of the member to perform its services and will more closely align the interests of the general partner with those of the member and its customer.

Trail Fee

In order to encourage members to share in their customers' investment risk, the proposed amendments would permit a member to negotiate with the general partner to receive a "trail fee" in return for an additional give-up of front-end compensation from the 7.5 percent limitation, but only if the member is also receiving a service fee for providing services to its customers. The trail fee proposal is structured differently for "appreciating asset" and "depleting asset" programs.[6]

In each case, the trail commission is proposed to allow members to receive annually a specified percentage of program cash flows in exchange for a one percentage point give-up from the 7.5 percent limitation. This structure results in a payment that will vary annually, depending on the amount of program cash flows, in order to demonstrate that the member is risking current compensation against the receipt of future compensation—thereby more clearly aligning the interests of the member with those of its customers. Thus, if there is insufficient cash flow for payment of the member's trail fee in any year, the program does not accrue an obligation to pay the fee in the next year.[7]

In addition, the payment of the trail fee is subject to different subordinations, depending on whether the fee is calculated on the program cash flow from operations or from the sale and refinancing of assets. These subordinations are intended to more clearly align the interests of broker/dealers with those of their customers in recommending programs that the member believes will perform well. However, the subordination requirements only apply if the fee is paid from annual cash available for distribution from the program. Payment of the trail fee from general partner fees is not subject to any subordination.

Appreciating Asset Programs

With respect to appreciating asset programs, members would be permitted to receive, for each one percentage point deducted from front-end compensation of 7.5 percent, 1.75 percent of "annual cash distributions from operations" and from "net proceeds remaining from the sale or refinancing of assets," as well as .5 percent for due diligence and a .20 percent service fee. The term "annual cash distributions from operations" essentially refers to the program's operational cash flows, as distinguished from cash provided from sale and refinancing of assets. If the trail fee calculated on annual cash distributions from operations is paid from annual cash available for distribution, then the member's fee is subordinated to a cumulative annual non-compounded return of at least 6 percent on limited partner adjusted capital contribution. The payment of the trail fee calculated on sale and refinancing of assets, if paid from annual cash available for distribution, would be subject to the limited partners receiving at least 100 percent of capital contribution plus a cumulative annual non-compounded return of at least 6 percent on limited partner adjusted capital contribution. No subordination applies, as set forth above, if the fee is entirely paid from general partner fees.

Depleting Asset Programs

With respect to depleting asset programs, the structure is similar to that for appreciating asset programs, but uses different percentages because of the different amounts that generally flow to investors from the management of the asset versus the sale of the asset, and uses a different investor capital contribution concept. The proposal would permit members to receive, for each one percentage point deducted from front-end compensation of 7.5 percent, 1.5 percent of annual cash distributions from operations and of net proceeds remaining from the sale and refinancing of assets, as well as .5 percent for due diligence and a .20 percent service fee. If the trail fee calculated on annual cash distributions from operations is paid from annual cash available for distribution, then the member's fee is subordinated to a cumulative annual non-compounded return of at least 8 percent on limited partner "remaining capital contribution and preference." This term applies only in the case of depleting asset programs and means the investor's original capital contribution, less annual cash distributions from cash available for distribution but increased by the annual limited partner preferential return. If the fee calculated on net proceeds remaining from the sale and refinancing of assets is paid from annual cash available for distribution, this fee would be paid only after the limited partners receive at least 100 percent of capital contribution, plus a cumulative annual non-compounded return of at least 8 percent on limited partner remaining capital contribution and preference. No subordination applies, as set forth above, if the fee is entirely paid from general partner fees.

Organization And Offering Expenses

Currently, the guideline for O&O expenses for members affiliated with the issuer are limited to 15 percent, which is composed of a maximum 10 percent commission and .5 percent for due diligence, which leaves 4.5 percent for the additional expenses of the affiliated sponsor in structuring the program. Such expenses are required to be paid on an accountable basis. NASD Regulation is proposing that O&O expenses should be permitted at the current rate of 4.5 percent for smaller offerings to cover fixed, up-front expenses of an issuer, but decrease for larger offerings in order to ensure that additional investor capital was applied to the program. Based on anecdotal information as to the amount of fixed expenses for program offerings, it appears that the break-even level occurs in offerings between $30 to $50 million, representing O&O expenses of $1.35 to $2.25 million under the current guideline.

Therefore, NASD Regulation is proposing that the current 4.5 percent guideline continue to apply to offerings with proceeds up to $50 million; that the next $50 million dollars in offering proceeds be subject to a 4 percent guideline; and offering proceeds above $100 million be subject to a 3.5 percent guideline. In addition, the introductory language of the provision is proposed to be amended to reflect that the affiliated issuer's O&O expenses may only be reimbursed by the program on an accountable basis.

Solicitation Of Comments With Respect To Other Securities Products

Comments are requested as to whether the compensation structure proposed for the sale of public offerings of DPPs, or any parts of the proposed compensation structure, should be considered as a permissible structure in the case of any other securities product. In particular, sales of public offerings of real estate investment trust securities (REITs), although not within the definition of DPP in Rule 2810, are currently subject to the 10 percent compensation guideline in Rule 2810. Comment is requested as to whether members' compensation for the sale of REITs should be subject to the proposed new DPP compensation structure since REITs are required by Internal Revenue Service regulations to distribute their income to investors. Alternatively, commenters should address whether REITs should be subject to the compensation guidelines for corporate securities applied pursuant to NASD Rule 2710, or if the current 10 percent guideline continues to be justified for REIT offerings. It is anticipated that the compensation guidelines for corporate securities will generally result in lower compensation for the sale of REIT offerings than is currently permitted under the 10 percent guideline contained in Rule 2810.

Request For Comment

NASD Regulation encourages all members and interested parties to respond to the issues raised in this *Notice*. Comments should be mailed to:

Joan Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, N.W.
Washington, D.C. 20006-1500;

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Comments must be received **by January 9, 1998**. Before becoming effective, any rule change developed as a result of the comments received must be adopted by the NASD Regulation, Inc., Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

Text Of Proposed Amendments to Rule 2810

(Note: New text is underlined; deletions are bracketed.)

Rule 2810. Direct Participation Programs

(a) Definitions

For the purposes of this Rule, the following terms shall have the stated meanings:

<u>( ) Adjusted capital contribution—original capital contribution reduced by cash distributions from net proceeds of the sale and refinancing of assets.</u>

<u>( ) Capital contribution—the gross amount of investment in a program.</u>

<u>( ) Cash distributions from operations—the portion of cash distributions paid from funds provided by operations, excluding funds provided from net proceeds of the sale and refinancing of assets.</u>

(2) Cash available for distribution—[cash flow less amount set aside for restoration or creation of reserves.] <u>the program's total funds provided from operations (including net proceeds from the sale and refinancing of assets) reduced by amounts set aside for restoration or creation of reserves.</u>

(3) [Cash flow—cash funds provided from operations, including lease payments on net leases from builders and sellers, without deduction for depreciation, but after deducting cash funds used to pay all other expenses, debt payments, capital improvements and replacements.]

( ) Remaining capital contribution and preference—original capital contribution reduced by annual cash distributions from cash available for distribution and increased by the annual limited partner preferential return.

(b) Requirements

(4) Organization and Offering Expenses

(A) No member or person associated with a member shall underwrite or participate in a public offering of a direct participation program if the organization and offering expenses are not fair and reasonable, taking into consideration all relevant factors.

(B) In determining the fairness and reasonableness of organization and offering expenses for purposes of subparagraph (A) hereof, the arrangements shall be presumed to be unfair and unreasonable if:

(i) the total amount of all items of compensation from whatever source payable to underwriters, broker/dealers, or affiliates thereof, which are deemed to be in connection with or related to the distribution of the public offering, exceeds [currently effective compensation guidelines for direct participation programs published by the Association;*]:

a. 8 percent of the offering proceeds received ("front-end compensation"), plus 0.5 percent for reimbursement of bona fide due diligence expenses; or

b. 7.5 percent of front-end compensation, plus 0.5 percent for reimbursement of bona fide due diligence expenses, plus an annual service fee of 0.20 percent of offering proceeds sold by the member (which 0.20 percent is either paid out of annual cash available for distribution and prorated against the limited partner's adjusted capital contribution or paid out of general partner fees), if the member enters into a written agreement with the program which requires that:

1. the member provide services to its customers that are investors in the program so long as the member may receive the annual service fee compensation, including responding to customers' requests for reports and statements of account, and responding to customers' questions regarding the periodic reports and performance of the program; and

2. the general partner or sponsor of the program respond to inquiries by the member regarding the operation of the program and distribute annually to limited partners, no later than four months after the end of the program's fiscal year, a report on the operation of the program containing audited financial reports for at least a one-year period; and

c. for each 1.00 percentage point deducted from front-end compensation of 7.5 percent, a member that provides continuing services under subparagraph (4)(B)(i)b. may receive an amount (which amount must be paid currently either out of annual cash available for distribution and subject to the following subordinations or out of general partner fees and not subject to the following subordinations) that is equal to:

1. Real Estate, Cable TV, and Other Appreciating Asset Programs

A. 1.75 percent of annual cash distributions from operations, subordinated to a cumulative annual non-compounded return of at least 6 percent on limited partner adjusted capital contribution; and

B. 1.75 percent of cash distributions from net proceeds remaining from the sale and refinancing of assets after limited partners have received at least 100 percent of capital contribution plus a cumulative annual non-compounded return of at least 6 percent on limited partner adjusted capital contribution; or

2. Oil and Gas, Equipment Leasing, and Other Depleting Asset Programs

A. 1.50 percent of annual cash distributions from operations subordinated to a cumulative annual non-compounded return of at least 8 percent of limited partner remaining capital contribution and preference;

B. 1.50 percent of cash distributions from net proceeds remaining from the sale and refinancing of assets after limited partners have received at least 100 percent of capital contribution plus a cumulative annual non-compounded return of at least 8 percent on limited partner remaining capital contribution and preference;

(ii) organization and offering expenses paid by a program on an accountable basis in which a member or an affiliate of a member is a sponsor exceeds the following percent of offering proceeds received in addition to front-end compensation received under paragraph (b)(4)(B)(i) [currently effective guidelines for such expenses published by the Association;**]:

a. 4.5 percent on the first $50 million of offerings proceeds;

b. 4.0 percent on the second $50 million of offering proceeds; or

c. 3.5 percent on offering proceeds that exceed $100 million.

(iii) any compensation in connection with an offering is to be paid to underwriters, broker/dealers, or affiliates thereof out of the proceeds of the offering prior to the release of such proceeds from escrow, provided, however, that any such payment from sources other than proceeds of the offering shall be made only on the basis of bona fide transactions;

(iv) commissions or other compensation are to be paid or awarded either directly or indirectly, to any person engaged by a potential investor for investment advice as an inducement to such advisor to advise the purchaser of interests in a particular program, unless such person is a registered broker/dealer or a person associated with such a broker/dealer; or

(v) except as permitted under paragraph (b)(4)(B)(i), the program provides for compensation of an indeterminate nature to be paid to members or persons associated with members for sales of program units, or for services of any kind rendered in connection with or related to the distribution thereof, including, but not necessarily limited to, the following: a percentage of the management fee, a profit sharing arrangement, brokerage commissions, and overriding royalty interest, a net profits interest, a percentage of revenues, a reversionary interest, a working interest, a security or right to acquire a security having an indeterminate value, or other similar incentive items; provided, however, that an arrangement which provides for continuing compensation to a member or person associated with a member in connection with a public offering shall not be presumed to be unfair and unreasonable if all of the following conditions are satisfied:

a. the continuing compensation is to be received only after each investor in the program has received cash distributions from the program aggregating an amount equal to his cash investment plus a six percent cumulative annual return on his adjusted investment;

b. the continuing compensation is to be calculated as a percentage of program cash distributions;

c. the amount of continuing compensation does not exceed three percent for each one percentage point that the total of all compensation pursuant to subparagraph (B)(i) received at the time of the offering and at the time any installment payment is made fall below nine percent; provided, however, that in no event shall the amount of continuing compensation exceed 12 percent of program cash distributions; and

d. if any portion of the continuing compensation is to be derived from the limited partners' interest in the program cash distributions, the percentage of the continuing compensation shall be no greater than the percentage of program cash distributions to which limited partners are entitled at the time of the payment.

Footnotes To Rule Language

* [A guideline for underwriting compensation of ten percent of proceeds received, plus a maximum of 0.5% for reimbursement of bona fide due diligence expenses, was published in Notice to Members 82-51 (October 19, 1982).]

** [A guideline for organization and offering expenses of 15 percent of proceeds received was published in Notice to Members 82-51 (October 19, 1982).]

Endnotes

[1] Rule 2810 also includes a provision prohibiting the receipt of compensation by members of an indeterminate nature, unless the arrangement is structured to permit members to receive compensation of an indeterminate nature that is no more than 3 percent of program cash distributions for each 1 percent of front-end cash commissions below 9 percent that the member gives up; provided that in no event shall the amount of continuing compensation exceed 12 percent of program cash distributions. This provision is not proposed to be deleted.

[2] *See Report of the Committee on Compensation Practices*, April 10, 1995, pp. 12-13. Other recommended "best practices" included prohibiting sales contests or permitting such contests only if based on broad measures. The NASD previously adopted amendments to the DPP Rule that prohibit non-cash sales contests for the sale of DPPs.

[3] *See also Notice to Members 97-50* (August 1997) requesting comment on the regulation of payment and receipt of cash compensation incentives for the sale and distribution of investment company and variable contract securities.

[4] Members generally receive the entire 10 percent fee in front-end compensation, paid at the time of the offering of securities. However, members are also permitted to receive an interest in back-end cash flow of the program, so long as the aggregate of all compensation paid does exceed the 10 percent guideline. There are several public programs structured in this fashion.

[5] Permissible arrangements under this provision include payment of the member's service fee: (1) solely from annual cash available for distribution, subject to the pro-ration requirement; (2) solely from general partner fees; or (3) a combination of these two sources.

[6] Appreciating asset programs are those, like real estate and cable TV, where it is anticipated that the program asset will increase in value. While there are returns to investors that occur from the program's operations, it is the eventual sale of the asset that provides the major returns to the investor. Depleting asset programs are those, like oil and gas and equipment leasing, where the program's operations deplete the value of the asset. The major returns to investors occur on a continuing basis as the asset is used, and the sale of the asset recovers only its residual or salvage value. It is anticipated that the staff will issue interpretations from time to time as to whether a particular type of program is considered an appreciating or depleting asset pro-

gram in order to provide guidance to the membership as to which trail fee structure should be followed under Rule 2810.

[7] The rule language requires that the trail fee be paid "currently" in order to prevent accrual of the fee obligation. In comparison, the service fee is a mandatory annual payment of a smaller amount that does not vary annually, as the fee is received for ongoing services provided by the member to its customers.