

# NASD NOTICE TO MEMBERS 97-14

## NASD Files With The SEC Proposed Amendment To Regulate The Disclosure Of Values For Illiquid Direct Participation Program And Real Estate Investment Trust Securities On Customer Account Statements

### Suggested Routing

- Senior Management
- Advertising
- Corporate Finance
- Government Securities
- Institutional
- Internal Audit
- Legal & Compliance
- Municipal
- Mutual Fund
- Operations
- Options
- Registration
- Research
- Syndicate
- Systems
- Trading
- Training

### Executive Summary

On February 21, 1997, NASD Regulation, Inc. (NASD Regulation<sup>SM</sup>) filed with the Securities and Exchange Commission (SEC) an amendment to NASD<sup>®</sup> Conduct Rule 2340 to regulate the disclosure of values for unlisted and illiquid direct participation program (DPP) and real estate investment trust (REIT) securities on customer account statements. The proposed amendment would, among other things, require that an estimated value for DPP/REIT securities be disclosed under certain circumstances and mandate cautionary disclosures. The SEC will publish the proposed amendment in the *Federal Register*, indicating a time period when members and others may comment. The new rules will not become final until approved by the SEC.

### Introduction

NASD Regulation is publishing this Notice to alert members to the fact that a proposed amendment to regulate the inclusion of unlisted and illiquid DPP and REIT securities on customer account statements was submitted to the SEC for approval on February 21, 1997. The proposed amendment will be published by the SEC for public comment in the *Federal Register*. This proposal was originally published for comment in *Notice to Members 94-96* and has been significantly revised in response to the comments received. This Notice describes the proposed amendment as submitted to the SEC.

Although the text of the Rule as filed with the SEC is attached to this Notice, members should not rely on the text herein as the final version of the amendment, or as the version that will be published by the SEC for public comment in the *Federal Register*. It is possible that the amendment will be revised before publication in the *Federal Register* or before final approval by the SEC. Moreover, the

proposal that will be published in the *Federal Register* will include a more complete discussion of the background of the amendment and a discussion of the changes made in response to comments received on *Notice to Members 94-96*. NASD Regulation recommends that members only submit comments to the SEC in response to the SEC's publication of the amendment in the *Federal Register*.

### Background

Rule 2340 requires members who conduct a general securities business to provide account statements to customers on at least a quarterly basis containing a description of any securities position, money balances, or account activity in the accounts since the prior account statements were sent. "Account activity" includes, but is not limited to, purchases, sales, interest credits or debits, charges or credits, dividend payments, transfer activity, securities receipts or deliveries, and/or journal entries relating to securities or funds in the possession or control of the member. "General securities member" refers to any member that conducts a general securities business and is required to calculate its net capital pursuant to the provisions of SEC Rule 15c3-1(a), except for paragraphs (a)(2) and (a)(3). However, a member that does not carry customer accounts and does not hold customer funds and securities is exempt from the provisions of Rule 2340.

NASD Regulation has filed a proposed rule change with the SEC to amend Rule 2340 to provide regulatory guidance to members regarding the disclosure of values for DPP<sup>1</sup> securities on customer account statements to regulate the manner in which information is provided to investors as to the performance of their DPP investment assets. In particular, NASD Regulation has been

concerned that a significant number of NASD members continue to carry DPP securities on customer account statements at original purchase price and has determined that this practice needs to be eliminated. In addition, the proposed amendment to Rule 2340 would also apply to certain REIT securities, which are not included in the NASD's definition of DPP security in paragraph (a)(4) of Rule 2810, to ensure similarity of treatment under NASD rules of the two products.

## Description Of Proposed Amendments

### Scope And Definitions

The new requirements in Rule 2340 are proposed to apply to DPP securities and REIT securities. The definitions of DPP and REIT securities proposed in subparagraphs (c)(3) and (4) of Rule 2340 encompass only unlisted DPPs and REITs, since an investment in listed securities provides investors with some measure of liquidity and market values. Thus, the definitions exclude securities listed on a national securities exchange or The Nasdaq Stock Market, Inc., as well as securities that are in a depository and settle regular way. The definition of DPP securities proposed in subparagraph (c)(3) also excludes any program registered as a commodity pool, since those programs generally offer investors a security that is redeemable by the issuer, at the customer's option at regular intervals and at ascertainable values.

### Requirements To Place Estimated Values On Customer Account Statements And Guidance On Appropriate Sources Of Valuations—Subparagraphs (b)(1)-(2)

The amendment contains two specific circumstances under which general securities members are obligated to provide to customers estimated val-

ues for DPP and/or REIT securities in the customers' accounts.

In the first circumstance, under subparagraph (b)(1) of the amendment, if a general securities member participated in the public offering of DPP or REIT securities, then the member must list the DPP/REIT securities on its customer account statements with estimated values if such values are available pursuant to subparagraphs (b)(3)(A)(ii) or (iii) of the amendment. When a general securities member participates in the public offering of DPP or REIT securities, NASD Regulation believes that the member should inform its customers of the estimated value of the DPP or REIT securities. Subparagraph (b)(3)(A)(iii) permits a member to include an estimated value that is contained in an annual report distributed to investors pursuant to Sections 14(a) or 14(c) of the Securities Exchange Act of 1934 (Act) or in a periodic report filed with the SEC under Section 13 or 15(d) of the Act.<sup>2</sup> This provision is intended to address the concern of members regarding their liability for disclosing an estimated value, by permitting the member to rely on the liabilities under the federal securities laws that attach to the general partner's or trustee's disclosure. Subparagraph (b)(3)(A)(ii) also permits a member to include an estimated value provided by an independent source engaged by the member. Where a member is obligated to include an estimated value for DPP/REIT securities on customer account statements under subparagraph (b)(1), the member is permitted to include valuations from both an independent source and an annual/periodic report, if the member determines to do so.

In considering this mandatory obligation, NASD Regulation determined that there are circumstances where the member should be required to refrain from using an estimated value that the member believes is inappro-

priate. Therefore, proposed subparagraph (b)(1) also provides that a member shall not include an estimated value of the securities on the account statement if the member believes that the estimated value was inaccurate as of the date of the valuation or is no longer accurate due to a material change in the operations or assets of the program. With respect to the latter phrase, the assets of a real estate limited partnership would be considered to be impaired, for example, where the lessee fails to perform under the lease. Similarly, the sale of property would be considered a material change because the sale reduces the value of the program.

In the second circumstance, under subparagraph (b)(2) of the amendment, if a general securities member or its affiliate acts as a fiduciary in connection with partnership or trust securities that are held in retirement accounts and discloses individual DPP/REIT estimated values to retirement account holders,<sup>3</sup> then the member must disclose the same valuations on the statements of all other customers owning such securities. NASD Regulation believes that when a member or its affiliate acts as a fiduciary for retirement accounts and provides **individual** DPP/REIT security values to its retirement account customers, other customers of the broker/dealer should receive the same values being provided to retirement account customers. The requirement to disclose the ERISA or IRA valuation to other customers would not conflict with the fiduciary and custodial obligations imposed by the Department of Labor and the IRS. However, neither the Department of Labor (which administers ERISA Regulations) or the IRS (which administers IRA and other retirement products) specifically require fiduciaries to provide **individual** values for any assets held in the retirement account. Therefore, if the general securities member acting

as a fiduciary does not provide individual values for the DPP and/or REIT securities in the retirement account, proposed new subparagraph (b)(5), discussed more fully below, is intended to provide an exception from the requirement to disclose individual values.<sup>4</sup>

#### **Appropriate Source For Estimated Values—Subparagraph (b)(3)(A)**

The amendment would add new subparagraph (b)(3)(A) to require that, where DPP and/or REIT securities are listed on the statement with an estimated value, such values shall be, under proposed subsection (b)(3)(A)(ii), provided by an independent source engaged by the member, or, under proposed subsection (b)(3)(A)(iii), from a valuation provided in an annual report distributed to investors or in a periodic report required to be filed with the SEC (discussed more fully above). A member may use an estimated value from either or both of these sources.

In addition, under proposed subparagraph (b)(3)(A)(iv), an estimated value for the DPP/REIT securities may be developed by the member only where a valuation by an independent source or from an SEC annual and periodic report is not available.

In addition, subparagraph (b)(3)(A)(i) requires that any value provided must be developed from data which is as of a date no more than 18 months before the date the customer account statement is issued. NASD Regulation believes that this requirement is appropriate because an estimated value, accurate upon its first use on a customer account statement, may become stale due to length of time or occurrence of subsequent events (such as the sale of a major asset of the partnership). The 18-month standard is believed to provide sufficient time for the member

and for an independent valuation source to develop an estimated value for DPP/REIT securities based on the audited financial statements contained in Form 10-K of the DPP or REIT that is filed by March 30th and is based on financial statements dated December 31st of the prior year. This standard would permit the member to continue to use a valuation based on, for example, the December 31, 1995, financials during April, May, and June 1997, while a new estimated value based on the December 31, 1996, financials is being developed. In developing an objective standard, NASD Regulation considered whether investors would be disadvantaged if an event occurred that would render an estimated value disclosed on customer account statements obsolete during the 18-month period. As set forth above, members are prohibited from including an estimated value on the account statement that the member believes was inaccurate at the time it was developed or is no longer accurate as a result of a material change in the operations or assets of the program or trust.

#### **Segregation Of DPP/REIT Securities—Subparagraphs (b)(3)(B) And (b)(6)**

If an estimated value is disclosed for the DPP/REIT securities on a customer's account statement, subparagraph (b)(3)(B) of the proposed change would require that DPP and REIT securities must be segregated from other securities into a separate location on the customer account statement. NASD Regulation believes that investments in non-publicly traded DPP and REIT securities and the estimated values that may be disclosed regarding their performance differ sufficiently from the prices of other securities and that customers will benefit from having the DPP and/or REIT securities grouped together. The segregation of these securities into a separate location on the customer account

statement should also lessen the possibility of misleading customers regarding the estimated values for DPP/REIT securities since the valuations will be distinguished from listed securities and accompanied by cautionary disclosures.

Subparagraph (b)(6) of the proposed change requires that DPP/REIT securities listed on customer account statements without an estimated value shall also be segregated. Thus, the requirement to segregate DPP/REIT securities will apply regardless of whether the security is listed with or without an estimated value.

#### **Disclosure Of The Source Of The Estimated Value—Subparagraph (b)(3)(B)(i)**

The amendment would require in subparagraph (b)(3)(B)(i) that members provide disclosure of a brief and easily understood statement relating to the source of the estimated value, provided that the customer is informed as to how to obtain a more complete and detailed explanation of the methodology from the member. The provision includes two examples of such a brief statement: the statement may say that "the value represents an estimate of the investor's interest in the assets owned by the DPP or REIT" or that "the value . . . represents an estimate of the value of the investor's DPP and/or REIT securities."

#### **Disclosure Of Nature Of DPP/REIT Securities—Subparagraph (b)(3)(B)(ii)**

Subparagraph (b)(3)(B)(ii) is proposed to require disclosure in close proximity to the location of the DPP/REIT securities on the account statement that DPP securities are generally illiquid securities and the estimated value disclosed may not be realizable if the customer seeks to

liquidate the security. The requisite disclosure is considered to be sufficiently proximate if it is located on the same page that the DPP and/or REIT securities are listed.

#### **Aggregation Of Estimated Values For DPP/REIT Securities With The Value Of Other Securities In Subtotals And In The Total Account Value—Subparagraphs (b)(4)(A) And (B)**

A general securities member that discloses an estimated value for a DPP and/or REIT security on a customer account statement is prohibited, under proposed subparagraph (b)(4)(A), from aggregating the estimated value of the DPP/REIT securities with the value of any other securities in any subtotal on the statement. In addition, under proposed subparagraph (b)(4)(B), if a member wishes to include the estimated value of the DPP/REIT securities in the total account value on the statement, the member is required to provide disclosure in close proximity to the total account value of the subtotal for DPP/REIT securities and of the illiquid nature of the securities as required by subparagraph (b)(3)(B)(ii), as discussed above. NASD Regulation considers “close proximity” to require that the subtotal for DPP/REIT securities and the cautionary disclosure appear on the same page as the total account value.

#### **Use Of Purchase Price—Subparagraph (b)(4)(C)**

Subparagraph (b)(4)(C) is proposed to prohibit members from using the original purchase price of a DPP or REIT security on a customer account statement as the estimated value. However, additional language is included to clarify that the same dollar value of the purchase price may be used where a valuation methodology results in the estimated value and purchase price being equivalent.

Thus, regardless of the mandatory obligations in subparagraphs (b)(1) and (b)(2) to disclose an estimated value for DPP/REIT securities under certain circumstances, the member may not use the original purchase price as the required estimated value.

#### **Retirement Account Statements With No Individual Values—Subparagraph (b)(5)**

Proposed subparagraph (b)(5) states that, if a retirement account statement prepared in accordance with ERISA and IRS regulations includes an aggregate value of the assets held in the account, but does not provide individual values for any of the assets, then the member is only required to include disclosure on the account statement that DPP and/or REIT securities included in the account are generally illiquid securities. As a result of the exception provided in subparagraph (b)(5) from subparagraphs (b)(1)-(4), the member may include the value of DPP/REIT securities in the total account value. NASD Regulation believes that since individual values are not required to be provided for any of the assets in the retirement account, the other provisions that would, in particular, require disclosures along with the display of the total account value, are unnecessary.

#### **Required Disclosure For Unpriced Securities—Subparagraph (b)(6)**

Subparagraph (b)(6) is proposed to require that where no valuation for DPP/REIT securities is disclosed on the statement, the member shall segregate the DPP/REIT securities on the account statement and the account statement must include disclosure that DPP/REIT securities are generally illiquid securities, the value of the security may be different than its purchase price, and, if applicable, that accurate valuation information is not available.

#### **Implementation Of Amendment**

To provide members (or their service organizations) sufficient time to modify their computer systems to comply with the amendment, the NASD is requesting that the amendment become effective six months after SEC approval. During that time, the NASD will issue a *Notice to Members* announcing SEC approval of the amendment and the anticipated effective date. In addition, the staff of the NASD Regulation Corporate Financing Department will respond to inquiries by members and their service organizations regarding compliance with the amendment. To the extent that interpretive issues arise during this period that are applicable to those members that are subject to the amendment, the NASD will issue a *Notice to Members* to clarify for all members the application of this Rule change.

Questions concerning this Notice may be directed to Suzanne E. Rothwell, Associate General Counsel, NASD Regulation, at (202) 728-8247; or Charles L. Bennett, Director, and Carl R. Sperapani, Assistant Director, Corporate Financing Department, NASD Regulation, at (301) 208-2700.

#### **Text Of Proposed Amendment**

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

#### **Rule 2340. Customer Account Statements**

##### **(a) General**

Each general securities member shall, with a frequency of not less than once every calendar quarter, send a statement of account (“statement”) containing a description of any securities positions, money balances, or account activity to each customer whose account had a security position, money balance or

account activity during the period since the last such statement was sent to the customer.

**(b) DPP/REIT Securities**

(1) If a member participated in the public offering of any direct participation program (DPP) or real estate investment trust (REIT) securities (as these terms are defined below) and an estimated value of DPP or REIT securities is available pursuant to subparagraphs (3)(A)(ii) or (iii), the member shall list the DPP and/or REIT securities on the statement with an estimated value; except that the member shall not include on the account statement an estimated value that the member believes is inaccurate as of the date of the valuation or is no longer accurate as a result of a material change in the operations or assets of the program or trust; or

(2) If the member or an affiliate of the member, acting as a fiduciary, provides estimated values of DPP and/or REIT securities to accounts that are subject to Employee Retirement Income Securities Act (“ERISA”) and Internal Revenue Service (“IRS”) regulations, the member shall disclose the same valuations on the statements of all other customers owning such securities.

(3) If DPP and/or REIT securities are listed on the statement with an estimated value:

(A) such estimated value shall be:

(i) developed from data which is as of a date no more than 18 months prior to the date the statement is issued; and

(ii) provided by an independent source engaged by the member; and/or

(iii) provided in an annual report of the DPP or REIT distributed to

investors pursuant to Sections 14(a) or 14(c) of the Act, as applicable, or a periodic report filed by the DPP or REIT with the Commission under Sections 13 or 15(d) of the Act; or

(iv) developed by the member, if valuations pursuant to subparagraphs (ii) and (iii) are not available; and

(B) the member shall segregate DPP and/or REIT securities by listing them on the statement separately from non-DPP and non-REIT securities and shall include on the statement:

(i) a brief and easily understood description of the type of estimated value provided (e.g., that the value represents an estimate of the investor’s interest in the assets owned by the DPP or REIT or represents an estimate of the value of the investor’s DPP and/or REIT securities) and its source, and how a customer may obtain a complete and detailed explanation of the valuation methodology employed; and

(ii) disclosure in close proximity to the listing of DPP and/or REIT securities that DPP and/or REIT securities are generally illiquid securities and the estimated value disclosed may not be realizable if the customer seeks to liquidate the security.

(4) In disclosing on the statement an estimated value of DPP and/or REIT securities, the member shall not:

(A) aggregate the estimated value of DPP and/or REIT securities with the value of any other securities in any subtotal on the statement;

(B) aggregate the estimated value of DPP and/or REIT securities with the value of any other securities in the total account value unless the statement includes the total estimated value of DPP and/or REIT securities and the disclosure required by subparagraph (3)(B)(ii) in close proximity

to the total account value; and

(C) include the original issue price of a DPP or REIT security as the estimated value (unless valuation of the securities by another method indicates the same dollar amount as the original issue price).

(5) Notwithstanding subparagraphs (b)(1)-(4), if a retirement account statement prepared in compliance with ERISA and IRS regulations includes DPP and/or REIT securities and individual values are not provided for any of the assets in the account, the member shall disclose on the statement that DPP and/or REIT securities are generally illiquid securities.

(6) If the DPP and/or REIT securities are listed on the statement without a price and without an estimated value, the member shall segregate the DPP and/or REIT securities by listing them on the statement separately from non-DPP and non-REIT securities and shall include on the statement disclosures that: DPP and/or REIT securities are generally illiquid securities; the value of the security may be different than its purchase price; and, if applicable, accurate valuation information is not available.

[(b)] (c) **Definitions** For purposes of this Rule[,];

(1) the term “account activity” shall include, but not be limited to, purchases, sales, interest credits or debits, charges or credits, dividend payments, transfer activity, securities receipts or deliveries, and/or journal entries relating to securities or funds in the possession or control of the member.

(2) [(c) For purposes of this Rule,] the term “general securities member” shall refer to any member which conducts a general securities business and is required to calculate its net

capital pursuant to the provisions of SEC Rule 15c3-1(a), except for paragraph (a)(2) and (a)(3). Notwithstanding the foregoing definition, a member which does not carry customer accounts and does not hold customer funds and securities is exempt from the provisions of this section.

(3) the term “direct participation program securities” shall include equity securities issued by a “direct participation program” as defined in Rule 2810 that would be included on a customer’s statement of account even if not held by the member, but does not include securities on deposit in a registered securities depository and settled regular way, securities listed on a national securities exchange or The Nasdaq Stock Market, or any program registered as a commodity pool with the Commodities Futures Trading Commission.

(4) the term “real estate investment trust securities” shall include equity securities issued by a real estate investment trust as defined in Section 856 of the Internal Revenue Code that would be included on a customer’s statement of account even if not held by the member, but does not include securities on deposit in a registered securities depository and settled regular way or securities listed on a national securities exchange or The Nasdaq Stock Market.

(d) No change.

### Endnotes

<sup>1</sup> The term *direct participation program* is defined in NASD Rule 2810 subparagraph (a)(4) to be a “program which provides for flow-through tax consequences regardless of the structure of the legal entity or vehicle for distribution . . .” The definition would cover most limited partnerships and specifically excludes real estate investment trusts.

<sup>2</sup> The reporting requirements of the Act do not impose a mandatory obligation on general partners or trustees to provide an estimated value to investors in a periodic report or in the annual report.

<sup>3</sup> The Employee Retirement Income Securities Act (ERISA) and Internal Revenue Service (IRS) regulations require, at least annually, that a retirement account fiduciary provide to the account holder a statement of the total value of all the assets in the account.

<sup>4</sup> The adoption of such an exception does not represent a view that the proposed requirement to provide individual ERISA/IRA valuations to other customers of the broker/dealer will discourage members from providing such individual valuations. To the contrary, fiduciaries are increasingly providing individual values for each asset in a retirement account to permit the account holder to make withdrawals when the account holder has reached the age when ERISA/IRS regulations require annual mandatory withdrawals that do not exceed a percentage-of-assets limitation.

© National Association of Securities Dealers, Inc. (NASD), March 1997. All rights reserved.