Regulatory Notice 08-35

Public Offerings of DPPs and REITs

SEC Approves Amendments to NASD Rule 2810 (Direct Participation Programs)

Effective Date: August 6, 2008

Executive Summary

NASD Rule 2810 (Direct Participation Programs) addresses the regulation of compensation, fees and expenses in public offerings of direct participation programs and unlisted real estate investment trusts. Effective August 6, 2008, amendments to Rule 2810:[1]

1. provide greater clarity to the Rule's underwriting compensation limits and the use and allocation of offering proceeds;
2. require disclosure regarding the liquidity of prior programs offered by the same sponsor;
3. prohibit sales loads on reinvested dividends; and
4. enable *bona fide* training and education meetings at appropriate locations.

Questions concerning this *Notice* should be directed to

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Notice Type

- Rule Amendment

Suggested Routing

- Corporate Financing
- Compliance
- Legal
- Operations
- Senior Management

Key Topic(s)

- Compensation Limitations
- Direct Participation Programs
- Due Diligence
- Loads on Reinvested Dividends
- Real Estate Investment Trusts

Referenced Rules & Notices

- NASD Rule 1031
- NASD Rule 2810
- NTM 04-50
- NTM 82-51

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Background and Discussion

NASD Rule 2810 governs the underwriting terms and arrangements of direct participation programs (DPPs) and unlisted real estate investment trusts (REITs) (collectively, Investment Programs). The Rule requires that, prior to participating in a public offering of an Investment Program, the participating member firm, or a participating firm that files on behalf of other member firms, must file information regarding the offering with the FINRA Corporate Financing Department and receive a "no objections" opinion regarding the proposed terms and arrangements in the offering. Among the terms and arrangements that are reviewed by FINRA staff are the level of organization and offering expenses (O&O expenses).

O&O Expenses

Rule 2810 limits the amount of O&O expenses for an Investment Program to 15 percent of the gross proceeds of the offering. O&O expenses have three components: (1) issuer expenses that are reimbursed or paid for with offering proceeds; (2) underwriting compensation; and (3) due diligence expenses. Each of these items is discussed below.

A. Issuer Expenses

Issuer expenses that are reimbursed or paid for with offering proceeds in connection with the offering typically include such items as:

(i) assembling and mailing offering materials, processing subscription agreements and generating advertising and sales materials;

(ii) legal and accounting services provided to the sponsor or issuer;

(iii) salaries and non-transaction-based compensation paid to employees or agents of the sponsor or issuer for performing services for the issuer;

(iv) transfer agents, escrow holders, depositories, engineers and other experts; and

(v) registration and qualification of securities under federal and state law, including taxes and fees and FINRA fees.

Issuer expenses that are reimbursed or paid for out of offering proceeds must be specifically identified in the filing with FINRA. Because FINRA staff cannot determine whether unaccountable payments to a sponsor or issuer or payments designated as "miscellaneous" are *bona fide* issuer expenses, FINRA staff will include such payments as part of underwriting compensation.

B. Underwriting Compensation

Rule 2810 also limits the amount of underwriting compensation, from whatever source,[2] that can be paid to underwriters, broker-dealers or affiliates for an Investment Program to 10 percent of the gross proceeds of the offering. The 10 percent limit on underwriting compensation is included as part of the 15 percent limit on O&O expenses. For example, an Investment Program may have issuer and due diligence expenses equal to 5 percent of the gross proceeds of the offering, and underwriting compensation expenses equal to 10 percent of the gross proceeds from whatever source. It is important to understand that the 10 percent limit for underwriting compensation may not be exceeded, even if the total of all O&O expenses is below 15 percent. By way of further example, an Investment Program with issuer expenses equal to 3 percent of the gross proceeds is not permitted to use 12 percent of the gross proceeds for underwriting compensation; the maximum amount of underwriting compensation is capped at 10 percent of the gross proceeds of the offering.

The limit on underwriting compensation includes all items of compensation, paid from whatever source, such as any amounts deducted from the offering proceeds or amounts paid to member firms, underwriters or affiliates in the form of trail commissions.[3] Once member firms have been paid in the aggregate compensation that reaches this limit, either in the form of front-end commission payments, trail commissions, fee reimbursements or a combination of these payments, then no member firm may receive additional compensation.

Underwriting compensation includes payments to wholesaling or retailing firms engaged in the solicitation, marketing, distribution or sales of Investment Program securities. It also includes payments for training and education meetings, and contributions to conferences and meetings held by non-affiliated broker-dealers for their registered representatives. Payments related to legal services provided to a broker-dealer participating in the offering and advertising and sales material generated by a broker-dealer participating in the offering will also be counted as underwriting compensation.[4]

C. Due Diligence

The final component of O&O expenses is due diligence expenses. The amendments to Rule 2810 eliminate the 0.5 percent cap on due diligence expenses.[5] Thus, all *bona fide* due diligence expenses that are included on a detailed and itemized invoice and presented by the member firm to the Investment Program or other entity that pays or reimburses such expenses will be included as part of the O&O expenses. Alternatively, the amount of due diligence expenses may be treated in the calculation of underwriting compensation as a non-accountable expense provided that, when aggregated with all other non-accountable expenses, the amount does not exceed 3 percent of the offering proceeds.[6]

Allocation of Compensation

A. Dual Employees

Rule 2810(b)(4)(D) addresses the allocation of compensation for dual employees of the issuer or Investment Program sponsor and an affiliated broker-dealer. The amendments are designed to achieve clarity and ease of administration by taking an "all-in" or "all-out" approach to allocating compensation, with two important exceptions discussed below.

In general, payments to registered persons will be "all-in" and included as underwriting compensation, whereas payments to unregistered persons will be "all-out" and not included as underwriting compensation.[7] The Rule contemplates two types of payments to registered persons: (1) transaction-based compensation to registered persons in connection with the offering of the Investment Program; and (2) non-transaction-based compensation to registered persons who are nevertheless engaged in the solicitation, marketing, distribution or sales of an Investment Program's securities. As noted above, both types of payments are "all-in" and included as part of the 10 percent limit on underwriting compensation.

The Rule contains an exception for non-transaction-based compensation to registered persons whose (1) job functions in connection with the offering are solely and exclusively clerical or ministerial or (2) whose sales activities in connection with the Investment Program are *de minimis* and incidental to their clerical or ministerial job functions.[8] The exception does not employ a particular metric with respect to how much time engaged in sales activities would constitute more than a *de minimis* level. The exception is intended to be a very narrow one for registered persons whose sales activities are truly incidental to their primary job functions.

B. Allocations in Connection With More Than One Offering

If a dual employee receives compensation, expenses or other payments for services provided in connection with more than one Investment Program, or for private placements in addition to an Investment Program(s), payments to such employees may be reasonably allocated among the offerings. When filing information with FINRA under Rule 2810, firms should provide a reasonable allocation of all payments, expenses and overhead, taking into account relevant factors, including, but not limited to, the time periods spent on particular offerings, the relative sizes of the offerings, resource allocation and the number of investors in each program. The filings should include an explanation of the factors the firm relied on in its proposed allocation of payments and expenses between programs. In the course of FINRA staff's review of particular offerings, information and representations by member firms with respect to such factors will vary. Rule 2810 does not codify these factors and their respective weights; rather, staff will continue its current review practices to permit reasonable basis allocations.

C. Individual Employee Analysis

In general, issuers prefer to characterize non-transaction-based compensation as issuer-expenses rather than underwriting compensation. Yet, if a registered representative receives non-transaction-based compensation, all compensation paid to such person will be treated as underwriting compensation under the "all-in" approach outlined above, unless such person falls within the narrow clerical and ministerial or *de minimis* exception. Notwithstanding the efficiencies and clarity provided by the "all-in" approach, FINRA staff will conduct a detailed per-employee analysis for up to ten registered representatives regarding whether a portion of such registered representative's non-transaction-based compensation should be included as part of issuer expenses rather than underwriting compensation. Specifically, FINRA staff will, where sufficient information is provided by the Investment Program, make a determination as to whether some portion of a registered representative's non-transaction based-compensation should be treated as issuer expenses with respect to the following:

- dual employees of a member firm and the sponsor, issuer or other affiliate with respect to an Investment Program with 10 or fewer registered representatives that engage in solicitation, marketing, distribution or sales of the Investment Program's securities;[9] or
- dual employees who are among the top ten highest-paid executives in an Investment Program based on non-transaction-based compensation.[10]

As discussed above, for all other registered representatives who are dual employees, the amendments provide that their total compensation is either "all in" the underwriting compensation calculation or "all out." In order for FINRA to conduct the per-employee analysis for up to ten dual employees, as noted above, firms must provide information from which FINRA staff can readily determine the time spent in particular job functions. While FINRA staff will always include transaction-based compensation in the compensation calculation, staff may determine based on its review that certain salary or non-transaction-based payments made to a dual employee should be allocated to issuer expenses if the person is engaged in activities other than solicitation, marketing, distribution or sales of the Investment Program's securities.[11]

Reinvested Dividends

Rule 2810(b)(4)(B)(vi) provides that it shall be presumed an unfair and unreasonable business practice to charge a sales load or commission on securities purchased through the reinvestment of dividends. To avoid disruption of prior offerings, this prohibition does not apply to any offering the registration statement for which became effective, pursuant to the Securities Act of 1933, prior to August 6, 2008, the effective date of the rule change. In addition, to avoid the indirect payment of loads on reinvested dividends, the Rule provides that the calculation of 10 percent of the gross proceeds of the offering excludes securities purchased through the reinvestment of dividends.

Liquidity Disclosure

As amended, the disclosure provisions set forth in Rule 2810(b)(3)(D) require member firms and their associated persons to inform prospective investors whether the sponsor has offered prior Investment Programs for which the prospectus disclosed a date or time period when the program might be liquidated, and whether the prior programs in fact liquidated on or around that date or time period. This provision requires that member firms selling Investment Programs must disclose whether prior programs offered by the program sponsor liquidated on or during the date or time period disclosed in the prospectuses for those programs. For example, if a sponsor has offered 10 prior programs and only two of them liquidated by the date or time period set forth in the prospectus, the firm would be required to disclose these facts on a quantified, numerical basis.

FINRA recognizes that delays in liquidity may be due to market conditions and other factors beyond the sponsor's control and that, in some cases, investors may benefit from delays in liquidity. It is permissible to convey these facts, when relevant, in addition to the facts regarding the sponsor's liquidity track record, so long as investors are provided with a complete picture of liquidity issues upon which to base an investment decision.

It is FINRA staff's view that a member firm is permitted to rely upon the liquidity information as provided to the member firm by the sponsor or general partner of the Investment Program, provided that the firm does not know or have reason to know that the information is inaccurate.

Location of Training and Education Meetings

FINRA believes that an important part of *bona fide* training and education meetings for Investment Programs may be inspecting real estate, oil and gas production facilities, and other types of assets that will be held and managed by the program. Accordingly, Rule 2810(c)(2)(ii) has been amended to provide that a training or education meeting may include a location at which a "significant or representative" asset is located.

Endnotes

1 *See* Exchange Act Release No. 57803 (May 8, 2008), 73 FR 27869 (May 14, 2008) (Order Approving Proposed Rule Change; File No. SR-NASD-2005-114).

2 Payments contributed to or paid by the sponsor, issuer or an affiliate to or on behalf of a participating member will be included in the compensation calculation.

3 Trail commissions for Investment Programs are included as part of the 10 percent underwriting compensation. *See NASD Notice to Members 04-50* (July 2004) (Treatment of Commodity Pool Trail Commissions under Rule 2810).

4 Legal services provided to a broker-dealer typically include, but are not limited to: filing the offering with FINRA; responding to FINRA comments; and drafting and reviewing dealer, marketing and other agreements in connection with the offering.

5 The 0.5 percent cap on due diligence expenses, like the 15 percent cap for O&O expenses and the 10 percent cap for underwriting compensation, had been FINRA policy since 1982. *See NASD Notice to Members 82-51* (October 1982) (Direct Participation Program Compensation Guidelines).

6 An issuer or sponsor may reimburse a law firm conducting due diligence on behalf of a member firm or member firms directly, so that the firm need not go through the extra step of first itself paying the law firm and then seeking reimbursement from the issuer or sponsor. FINRA is of the view that a law firm could not provide *bona fide* due diligence to the member firm in an offering if its client is the issuer or sponsor. Further, FINRA has no view as to the method of reimbursement for due diligence services that should be used so long as it does not undermine the law firm's duties to its client, the broker-dealer.

7 Firms that do not appropriately register individuals who are engaged in the member's investment banking or securities business will be in violation of NASD Rule 1031 and subject to enforcement action.

8 Though legal, compliance and internal audit personnel are permitted to be registered, their functions would be considered "clerical or ministerial" for purposes of the exception if their functions are confined exclusively to the exercise of their "compliance" responsibilities and do not involve any solicitation, marketing, distribution or sales of the Investment Program (including supervision of anyone involved in such activities).

9 The Investment Program may have no more than 10 registered representatives engaged in such activities.

10 The term "executive" is not intended as a formal job designation or title, but rather as a characterization of the registered representative dual employee's role in the Investment Program. Member firms must identify in filings which executives are the Investment Program's top ten based on non-transaction-based compensation.

11 Payments related to the *supervision of* employees engaged in solicitation, marketing, distribution or sales of an Investment Program's securities (*e.g.*, salaries, bonuses, expense reimbursements and like payments) will be included in the compensation calculation.

Attachment A

Text of Proposed Amendments to Rule 2810. Proposed additions are underlined; proposed deletions are in brackets.

2810. Direct Participation Programs

(a) No Change.

(b) Requirements

(1) Application

No member or person associated with a member shall participate in a public offering of a direct participation program, [or] a limited partnership rollup transaction or, where expressly provided below, a real estate investment trust as defined in Rule 2340(d)(4) ("REIT"), except in accordance with this paragraph (b), provided however, this paragraph (b) shall not apply to an initial or secondary public offering of or a secondary market transaction in a unit, depositary receipt or other interest in a direct participation program that complies with subparagraph (2)(D).

(2) No Change.

(3) Disclosure

(A) Prior to participating in a public offering of a direct participation program or REIT, a member or person associated with a member shall have reasonable grounds to believe, based on information made available to him by the sponsor through a prospectus or other materials, that all material facts are adequately and accurately disclosed and provide a basis for evaluating the program.

(B) through (C) No Change.

(D) Prior to executing a purchase transaction in a direct participation program or a REIT, a member or person associated with a member shall inform the prospective participant of all pertinent facts relating to the liquidity and marketability of the program or REIT during the term of the investment[;]. Included in the pertinent facts shall be information regarding whether the sponsor has offered prior programs or REITs in which disclosed in the offering materials was a date or time period at which the program or REIT might be liquidated, and whether the prior program(s) or REIT(s) in fact liquidated on or around that date or during the time period. [provided, however, that paragraph (b) shall not apply to an initial or secondary public offering of a secondary market transaction in a unit, depositary receipt or other interest in a direct participation program which complies with subparagraph (2)(D).]

(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 or REIT 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 that are deemed to be in connection with or related to the distribution of the public offering for purposes of subparagraph (A) hereof, the arrangements shall be presumed to be unfair and unreasonable if:

(i) organization and offering expenses, as defined in subparagraph (b)(4)(C), in which a member or an affiliate of a member is a sponsor, exceed an amount that equals fifteen percent of the gross proceeds of the offering;

[i] (ii) the total amount of all items of compensation from whatever source, including compensation paid from offering proceeds and in the form of "trail commissions," 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 an amount that equals ten percent of the gross proceeds of the offering (excluding securities purchased through the reinvestment of dividends) [currently effective compensation guidelines for direct participation programs published by the Association];[*]

[(ii) organization and offering expenses paid by a program in which a member or an affiliate of a member is a sponsor exceed currently effective guidelines for such expenses published by the Association;**]

(iii) No change.

(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 or REIT, unless such person is a registered broker/dealer or a person associated with such a broker/dealer; [or]

(v) the program or REIT provides for compensation of an indeterminate nature to be paid to members or persons associated with members for sales of the program [units] or REIT, 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, an[d] over-riding 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.]

(vi) the program or REIT charges a sales load or commission on securities that are purchased through the reinvestment of dividends, unless the registration statement registering the securities under the Securities Act of 1933 became effective prior to [the effective date of this proposed rule change]; or

(vii) the member has received reimbursement for due diligence expenses that are not included in a detailed and itemized invoice, unless the amount of the reimbursement is included in the calculation of underwriting compensation as a non-accountable expense allowance, which when aggregated with all other such non-accountable expenses, does not exceed three percent of offering proceeds.

(C) The organization and offering expenses subject to the limitations in subparagraph (b)(4)(B)(i) above include the following:

(i) issuer expenses that are reimbursed or paid for with offering proceeds, including overhead expenses, which issuer expenses include, but are not limited to, expenses for:

a. assembling, printing and mailing offering materials, processing subscription agreements, generating advertising and sales materials;

b. legal and accounting services provided to the sponsor or issuer;

c. salaries and non-transaction-based compensation paid to employees or agents of the sponsor or issuer for performing services for the issuer;

d. transfer agents, escrow holders depositories, engineers and other experts; and

e. registration and qualification of securities under federal and state law, including taxes and fees and NASD fees;

(ii) underwriting compensation, which includes but is not limited to items of compensation listed in Rule 2710(c)(3) including payments:

a. to any wholesaling or retailing firm that is engaged in the solicitation, marketing, distribution or sales of the program or REIT securities;

b. to any registered representative of a member who receives transaction-based compensation in connection with the offering, except to the extent that such compensation has been included in a. above;

c. to any registered representative who is engaged in the solicitation, marketing, distribution or sales of the program or REIT securities, except:

1. to the extent that such compensation has been included in a. above;

2. for a registered representative whose functions in connection with the offering are solely and exclusively clerical or ministerial; and

3. for a registered representative whose sales activities are de minimis and incidental to his or her clerical or ministerial job functions; or

d. for training and education meetings, legal services provided to a member in connection with the offering, advertising and sales material generated by the member and contributions to conferences and meetings held by non-affiliated members for their registered representatives.

(iii) due diligence expenses incurred when a member affirmatively discharges its responsibilities to ensure that all material facts pertaining to a program or REIT are adequately and accurately disclosed in the offering document.

(D) Notwithstanding subparagraphs (b)(4)(C)(ii)b. and c. above, for every program or REIT filed with the Corporate Financing Department (the "Department") for review, the Department shall, based upon the information provided, make a determination as to whether some portion of a registered representative's non-transaction-based compensation should not be deemed to be underwriting compensation if the registered representative is either:

(i) a dual employee of a member and the sponsor, issuer or other affiliate with respect to a program or REIT with ten or fewer registered representatives engaged in wholesaling, in which instance the Department may make such determination with respect to the ten or fewer registered representatives engaged in wholesaling; or

(ii) a dual employee of a member and the sponsor, issuer or other affiliate who is one of the top ten highest paid executives based on non-transaction-based compensation in any program or REIT.

[(C)](E) All items of compensation paid by the program or REIT directly or indirectly from whatever source to underwriters, brokers/dealers, or affiliates thereof, including, but not limited to, sales commissions, wholesaling fees, due diligence expenses, other underwriter's expenses, underwriter's counsel's fees, securities or rights to acquire securities, rights of first refusal, consulting fees, finder's fees, investor relations fees, and any other items of compensation for services of any kind or description, which are deemed to be in connection with or related to the public offering, shall be taken into consideration in computing the amount of compensation for purposes of determining compliance with the provisions of subparagraphs (A) and (B).

[(D)](F) The determination of whether compensation paid to underwriters, broker/dealers, or affiliates thereof is in connection with or related to a public offering, for purposes of this subparagraph (4), shall be made on the basis of such factors as the timing of the transaction, the consideration rendered, the investment risk, and the role of the member or affiliate in the organization, management and direction of the enterprise in which the sponsor is involved.

(i) An affiliate of a member which acts or proposes to act as a general partner, associate general partner, or other sponsor of a program or REIT shall be presumed to be bearing investment risk or purposes of this paragraph (b) if the affiliate:

a. through b. No Change.

c. has a net worth equal to at least five percent of the net proceeds of the public offering or $1.0 million, whichever is less; provided, however, that the computation of the net worth shall not include an interest in the program offered but may include net worth applied to satisfy the requirements of this paragraph (b) with respect to other programs or REITs; and

d. agrees to maintain net worth as required by subparagraph c. above under its control until the earlier of the removal or withdrawal of the affiliate as a general partner, associate general partner, or other sponsor, or the dissolution of the program or REIT.

(ii) No Change.

[(E)](G) Subject to the limitations on direct and indirect non-cash compensation provided under subparagraph [(E)](C), no member shall accept any cash compensation unless all of the following conditions are satisfied:

(i) through (v) No Change.

(5) Valuation for Customer Account Statements

No member may participate in a public offering of direct participation program or REIT securities unless[:] [(A)] the general partner or sponsor of the program or REIT will disclose in each annual report distributed to investors pursuant to Section 13(a) of the Act a per share estimated value of the direct participation program securities, the method by which it was developed, and the date of the data used to develop the estimated value.

(6) No Change.

(c) Non-Cash Compensation

(1) No Change.

(2) Restriction on Non-Cash Compensation

In connection with the sale and distribution of direct participation program or REIT securities, no member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation, except as provided in this provision. Non-cash compensation arrangements are limited to the following:

(A) through (B) No Change.

(C) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(i) No Change.

(ii) the location is appropriate to the purpose of the meeting, which shall mean a United States[an] office of the offeror or the member holding the meeting, or a facility located in the vicinity of such office, or a United States regional location with respect to meetings of associated persons who work within that region or, with respect to [regional] meetings with direct participation programs or REITs, a United States location at which a significant or representative asset of the program or REIT is located;

(iii) through (iv) No Change.

(D) through (E) No Change.

(d) No Change.

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

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