

Customer Account Statements

FINRA Requests Comment on Proposed Amendments to NASD Rule 2340 to Address Values of Unlisted Direct Participation Programs and Real Estate Investment Trusts

Comment Period Expires: April 11, 2012

Executive Summary

FINRA seeks comment on a revised proposal to amend NASD Rule 2340 (Customer Account Statements) to address the per share estimated values at which unlisted Direct Participation Programs (DPPs) and unlisted Real Estate Investment Trusts (REITs) are reported on customer account statements. The revised proposal reflects changes based on comments to the amendments FINRA proposed in [Regulatory Notice 11-44](#).

Under the revised proposal, general securities members would no longer be required to provide a per share estimated value, unless and until the issuer provides an estimate based upon an appraisal of assets and liabilities in a periodic or current report filed under the Securities Exchange Act of 1934. During the initial offering period, member firms would have the option of using a modified net offering price or designating the securities as “not priced.” Additionally, the revised proposal modifies the account statement disclosures that accompany the per share estimated value. The revised proposal also includes alternative requirements for DPPs or REITs that calculate a daily net asset value (NAV).

The text of the proposed amendments to NASD Rule 2340 (Customer Account Statements) is set forth in Attachment A.

Questions regarding this *Notice* may be directed to:

- ▶ Thomas M. Selman, Executive Vice President, Regulatory Policy, at (202) 728- 6977;
- ▶ Joseph E. Price, Senior Vice President, Corporate Financing/Advertising Regulation, at (240) 386-4623; or
- ▶ Gary L. Goldsholle, Vice President and Associate General Counsel, Office of the General Counsel, at (202) 728-8104.

March 2012

Notice Type

- ▶ Request for Comment

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Senior Management

Key Topics

- ▶ Customer Account Statements
- ▶ Unlisted Real Estate Investment Trusts (REITs)
- ▶ Unlisted Direct Participation Programs (DPPs)

Referenced Rules & Notices

- ▶ FINRA Rule 2310
- ▶ NASD Rule 2340
- ▶ Notice to Members 01-08
- ▶ Regulatory Notice 11-44
- ▶ Rule 415 under the Securities Act of 1933

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by April 11, 2012.

Member firms and other interested parties can submit their comments using the following methods:

- ▶ Emailing comments to pubcom@finra.org; or
- ▶ Mailing comments in hard copy to:

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

To help FINRA process and review comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: The only comments that FINRA will consider are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the FINRA website. Generally, FINRA will post comments as they are received.¹

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the FINRA Board of Governors, and then must be filed with the SEC pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).²

Background

As discussed in [Regulatory Notice 11-44](#), NASD Rule 2340 generally requires each general securities member firm to send account statements to customers at least quarterly. The account statements must include a description of any securities positions, money balances and account activity since the firm issued the prior account statement. A firm that does not carry customer accounts and does not hold customer funds or securities is not a general securities member firm and is not subject to the provisions of NASD Rule 2340.

Paragraph (c) of the rule contains specific provisions addressing the estimated values of DPPs and REITs on customer account statements. The rule generally requires that a general securities member firm include a per share estimated value for a DPP or REIT security held in a customer's account whenever a value appears in the issuer's annual report. The rule states that the per share estimated value included on a customer account statement may

be obtained from the annual report, an independent valuation service or any other source. The rule requires that firms develop a per share estimated value on a customer account statement from data that is not more than 18 months old. The rule also requires a firm to remove or amend a per share estimated value if the firm can demonstrate that the value was inaccurate as of the date of valuation or is no longer accurate as a result of a material change in operations. DPPs and REITs are the only securities identified in NASD Rule 2340 for which per share estimated account values are required on an account statement.

In *Regulatory Notice 11-44*, FINRA proposed several modifications to NASD Rule 2340 that were designed to improve the quality of the information provided to customers. The proposed amendments in *Regulatory Notice 11-44* (original proposal) would have limited the time period for which the per share estimated value may be based upon the gross offering price, to the initial three-year offering period provided under Rule 415(a)(5) of the Securities Act of 1933 (initial offering period). It also would have required firms to deduct organization and offering expenses from the gross offering price to reach a per share estimated value (net offering price). In addition, the original proposal would have prohibited 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. Finally, the original proposal would have allowed 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 NASD Rule 2340.

Comments Received on Regulatory Notice 11-44

FINRA received 25 comments on the original proposal. While some commenters supported the proposal, many expressed concern about two elements: (1) the proposed requirement that the net offering price, rather than a gross offering price, be provided during the initial offering period, and (2) the proposed requirement that a general securities member firm refrain from providing a per share estimated value if it knows or *has reason to know* the value is unreliable.

The commenters provided numerous bases for objecting to the proposal’s net offering price requirement. Some commenters addressed the practical limitations of calculating a net offering price, stating that a net offering price might vary over time as certain fixed expenses are allocated across a larger number of units sold, or might vary based upon the amount of selling concessions allocated to a particular broker-dealer. In addition, commenters noted that displaying a net offering price might create incentives to reduce expenditures on due diligence and might complicate implementation of issuer dividend reinvestment and redemption plans.

Of greater import from a policy perspective were the comments that implied that the gross offering price was not representative of value. One commenter stated that the gross offering price is an arbitrary figure and “does not reflect actual value.”³ Commenters also stated that since the gross offering price does not reflect an estimate of the true value of the shares, the gross price net of organization and offering expenses cannot reflect such an estimate. As one broker-dealer stated, “[b]ecause the \$10 public offering price is not a reflection of the net asset value of the security – subtracting organizational and offering expenses from this arbitrary number to create a second arbitrary number fails to properly address the issue – *i.e., that the net asset value of the security is not calculable until the assets have been invested.*”⁴

Another commenter added that the net offering price “is not reflective of the investment’s actual value,” and “deducting organization and offering expenses from an arbitrary starting price that does not reflect intrinsic value will leave investors confused, as the net amount is a misrepresentation of what investors may believe is an intrinsic value.”⁵ Commenters also suggested that a net price would “confuse investors” and be “artificially low.”⁶

Most commenters stated that they would support a requirement that member firms present a per share estimated value based upon an appraisal of the issuer’s assets and liabilities after the initial offering period. As noted by one commenter, the “appraisals will be more relevant if they are done at a time when it is reasonably likely that a significant portion of the offering proceeds will have been invested.”⁷

Revised Proposal⁸

FINRA proposes to eliminate the requirement from the existing rule that a member firm include a per share estimated value for a DPP or REIT security held in a customer’s account whenever any value appears in the issuer’s annual report. Instead, FINRA proposes to require that a firm provide a per share estimated value based upon an appraisal from the issuer’s most recent periodic or current report. We agree with commenters that the appraised value that appears in the issuer’s periodic or current reports should provide the most reliable per share estimated value. Requiring the gross offering price or net offering price to be included in customer account statements simply because it appears in the issuer’s annual report does not address issues of value.

While the proposal would not require the presentation of net offering price, it would permit firms to present net offering price (modified as described below) until an appraised value appears in the issuer’s periodic or current reports, but in no event after the second quarterly public filing following the initial offering period. An appraised value during most of the initial offering period would not be as useful to investors because most of the assets in the program will typically consist of cash and short-term, liquid securities. By the time of this second quarterly filing, if the issuer has not included an appraised value in its periodic or current reports, then a member firm would be permitted only to indicate that the security

is “not priced” in its customer account statements. This quarterly filing “grace period” is designed to ensure that issuers have had sufficient time to conduct an appraisal and include an appraised value after the initial offering period. Moreover, a quarterly public filing deadline might occur immediately after the initial offering period, and for this reason the proposal would allow firms to present the net offering price until the issuer has filed one more quarterly filing, unless the issuer includes an appraised value in its periodic or current reports before that time.

During the period in which the issuer has not provided an appraised value (but extending no longer than the second quarterly filing after the initial offering period) a member may present a modified version of net offering price or list the securities as “not priced.” To address some of the practical limitations of calculating a net price, FINRA proposes to redefine “net offering price” for purposes of the rule as the gross offering price less any front-end underwriting compensation expenses (as defined in Rule 2310(b)(4)(c)(ii)) reimbursed or paid for with offering proceeds. As such, firms would not be required to subtract either issuer expenses, due diligence expenses, or trail fees, unlike the original proposal. Simplifying the methodology to arrive at a net offering price should ease the burdens on firms electing to use that figure. Moreover, since the net offering price would reflect only the amount of front-end underwriting compensation expenses (used typically to pay the wholesaler and dealers), that value will be easily identified by firms participating in the offering and the estimated value would not have any undesired implications on the operation and pricing of an issuer’s dividend reinvestment or share repurchase plans.

In light of the comments and concerns expressed herein about the appropriateness of using gross offering price as a per share estimated value, and the requirements under the existing rule that firms provide an estimated value on a customer account statement where one is contained in the annual report, pending adoption of the proposed amendments to Rule 2340, FINRA will accept exemptive requests from firms that do not wish to use a gross offering price on a customer account statement. Paragraph (e) of the existing rule grants FINRA authority to exempt firms from the provisions of the rule for good cause shown. A firm that requests to remove a gross offering price from a customer account statement because that price is not indicative of the estimated value will generally be deemed to have met this standard.

Reliability of Estimated Values

Commenters expressed concern about the proposed requirement that a general securities member firm refrain from providing a per share estimated value if it knows or *has reason to know* the value is unreliable. The purpose of this proposal was to clarify the meaning of a current provision in the rule, which requires a firm to refrain from including a per share estimated value if the firm “can demonstrate” the value is inaccurate. However, in light of the other changes to the original proposal, FINRA has withdrawn that particular proposed requirement concerning the reliability of appraised values.

Under the revised proposal, we anticipate that per share estimated values will be almost exclusively derived from values based on appraisals obtained by issuers and included either in the issuer's periodic or current reports or a daily NAV calculation. As such, firms typically will have no reason to question their reliability, and the proposed requirement should not be necessary. If, however, a firm is aware of red flags as to the reliability of a per share estimated value, at a minimum, the firm must follow up with the issuer or its independent valuation service and ask the issuer or independent valuation service to reconsider the valuation in light of the information. The member firm must evaluate the response received to determine whether continuing to include the per share estimated NAV is appropriate in light of the red flags identified. The revised proposal does not require a member firm to include a per share estimated value on its customer account statements that it reasonably believes is unreliable.

Account Disclosures

NASD Rule 2340 requires that when a per share estimated value is provided on an account statement, firms must make certain disclosures pertaining to the illiquid nature of these securities and the source of the estimated net asset value. FINRA proposes to augment and refine these disclosures to assist investors in understanding them. First, FINRA proposes that the requirement to describe the value and the methodology by which a per share estimated value has been determined should apply only to the net offering price that may appear before the issuer provides an appraised value. Second, FINRA proposes to replace the terms "illiquid" and "liquidity" with terms more likely to be familiar to ordinary investors. Third, FINRA proposes disclosures directing customers to the issuer for information on redemption and the per share estimated value. Specifically, FINRA proposes that a general securities firm disclose:

- ▶ that the per share estimated value is being reproduced from the issuer's public filings with the SEC and is being presented without inquiry or investigation;
- ▶ the methodology by which any net price is calculated;
- ▶ that no public market currently exists for the securities, and even if the customer is able to sell these securities, the value the customer receives may be less than the per share estimated value reflected on the statement; and
- ▶ that additional information about redemption options and the per share estimated value reflected on the statement is available from the issuer.

As noted above, in recent years some unlisted DPPs and REITs have developed a daily NAV.⁹ To accommodate this new development, FINRA proposes an alternative and parallel regime for unlisted DPPs and REITs calculating a daily NAV. For these securities, a general securities firm would have to publish the per share daily estimated NAV as of the end of the statement period. The proposed required account statement disclosures are virtually identical and would reflect only small changes based upon the daily NAV method. The proposal requires disclosure that:

- ▶ the per share estimated daily NAV is provided by the issuer and is being presented without inquiry or investigation;
- ▶ notwithstanding the availability of a per share estimated daily NAV, no public market currently exists for the securities, and even if the customer is able to sell these securities, the value the customer receives may be less than the per share estimated value reflected on the statement; and
- ▶ additional information about redemption options and the per share estimated daily NAV reflected on the statement is available from the issuer.

Endnotes

1. FINRA will not edit personal identifying information, such as names or email addresses, from submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (November 2003) (NASD Announces Online Availability of Comments) for more information.
2. *See* Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes, however, take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.
3. Letter from David T. Hirschmann, President and Chief Executive Officer, Center for Capital Markets Competitiveness of the United States Chamber of Commerce, dated November 11, 2011 (Chamber of Commerce).
4. Letter from Stephanie L. Brown, Managing Director and General Counsel, LPL Financial, dated November 12, 2011 (emphasis in original).
5. Chamber of Commerce.
6. Letters from Martel Day, Chairman, Investment Program Association, dated November 11, 2011, and Jeffrey W. Rubin, Chair, Federal Regulation of Securities Committee, Business Law Section, American Bar Association, dated November 16, 2011.

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7. Letter from W.P. Carey & Co. LLC, dated November 11, 2011.
8. 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 herein would be made to NASD Rule 2340 or new FINRA Rule 2231, depending upon the timing of SEC approval.
9. One commenter described a new type of unlisted DPP and REIT with a daily, fluctuating NAV. Letter from Michael Weil, CEO, Realty Capital Securities, LLC, and Nicholas S. Schorsch, Chairman and CEO, American Realty Capital, dated November 11, 2011. Daily NAV REITs calculate the NAV in part based on appraisals of properties by an independent valuation firm in accordance with guidelines established by the board of directors. Changes in daily NAV typically reflect factors such as portfolio income, interest expense and unrealized capital gains or losses on assets and accrued fees and expenses. For DPPs and REITs that calculate a daily NAV, firms should use the daily NAV from the issuer for the end of the period of the customer account statement.

Attachment A

Below is the text of the proposed amendments to NASD Rule 2340.

2340. Customer Account Statements

(a) General

No Change.

(b) Delivery Versus Payment/Receive Versus Payment (DVP/RVP) Accounts

No Change.

(c) Unlisted DPP/REIT Securities

(1) A general securities member that holds in a customer's account a direct participation program (DPP) or real estate investment trust (REIT), or any other member that elects to provide per share estimated net asset value (NAV) on an account statement must publish a per share estimated NAV and accompanying disclosures as provided herein:

(A) Non-Daily NAV Securities

(i) Appraised Value

A member must publish on regularly scheduled account statements the per share estimated NAV based upon an appraisal of assets and liabilities from the issuer's most recent periodic or current report filed with the SEC under the Act, unless the member reasonably believes that such per share estimated NAV is unreliable.

(ii) Net Offering Price

A member may publish on account statements a net offering price that, at a minimum, deducts any front-end underwriting compensation expenses as defined in Rule 2310(b)(4)(c)(ii) reimbursed or paid for with offering proceeds, until the sooner of the presentation of an appraisal of the assets and liabilities in the issuer's periodic or current report, or the issuer's filing of its second quarterly filing following the effective period of the first registration statement for the DPP or REIT securities.

(iii) Disclosures

A member must disclose in connection with any per share estimated NAV or net offering price that:

(a) the per share estimated NAV is being reproduced from the issuer's public filings with the SEC and is being presented without inquiry or investigation;

(b) the methodology by which any net offering price is calculated;

(c) no public market currently exists for the securities, and even if the customer is able to sell the securities, the value received may be less than the per share estimated NAV or net offering price; and

(d) additional information about redemption options and the per share estimated NAV is available from the issuer.

(B) Daily NAV Securities

A member must publish the per share estimated daily NAV as of the end of the statement period, unless the member reasonably believes that such per share estimated daily NAV is unreliable, and disclose in connection with any per share estimated daily NAV that:

(i) the per share estimated daily NAV is provided by the issuer and is being presented without inquiry or investigation;

(ii) notwithstanding the availability of a per share estimated daily NAV, no public market currently exists for the securities, and even if the customer is able to sell the securities, the value received may be less than the per share estimated daily NAV reflected on the statement; and

(iii) additional information about redemption options and the per share estimated daily NAV reflected on the statement is available from the issuer.

(d) Definitions

No Change.

(e) Exemptions

No Change.

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