Regulatory Notice 15-02

DPP and Unlisted REIT Securities

SEC Approves Amendments to FINRA Rule 2310 and NASD Rule 2340 to Address Values of Direct Participation Program and Unlisted Real Estate Investment Trust Securities

Effective Date: April 11, 2016

Executive Summary

The SEC approved amendments to NASD Rule 2340 (Customer Account Statements) to modify the requirements relating to the inclusion of per share estimated values for direct participation program (DPP) and unlisted real estate investment trust (REIT) securities on account statements, and to FINRA Rule 2310 (Direct Participation Programs) to make corresponding changes to the requirements applicable to members' participation in public offerings of DPP or REIT securities.[1] The amendments become effective on April 11, 2016.

The amended rule text is available at *www.finra.org/notices/15-02*.

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Background & Discussion

NASD Rule 2340 currently requires a general securities member to include on account statements an estimated value of a DPP or REIT security from the annual report, an independent valuation service or any other source, unless the member can demonstrate the estimated value is inaccurate. FINRA Rule 2310 provides that a member may not participate in a DPP or REIT offering unless the general partner or sponsor will disclose a per share estimated value in each annual report.

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Notice Type

- Rule Amendment

Suggested Routing

- Compliance
- Legal
- Senior Management

Key Topics

- Customer Account Statements
- Direct Participation Programs
- Unlisted Real Estate Investment Trusts

Referenced Rules & Notices

- FINRA Rule 2310
- NASD Rule 2340

The general industry practice is to use the offering price (or "par value") of DPP and REIT securities as the per share estimated value during the offering period, which can continue as long as seven and one-half years. The offering price, typically $10 per share, often remains constant on customer account statements during this period even though various costs and fees have reduced investors' principal and underlying assets may have decreased in value.

The SEC recently approved FINRA's proposed amendments to Rule 2340 and Rule 2310 that require general securities members to provide more accurate per share estimated values on customer account statements, shorten the time period before a valuation is determined based on an appraisal and provide various important disclosures. The effective date of the amendments is April 11, 2016.

I. NASD Rule 2340 (Customer Account Statements)

NASD Rule 2340 generally requires that general securities members provide periodic account statements to customers, on at least a quarterly basis, containing a description of any securities positions, money balances or account activity since the last statement. Paragraph (c) addresses the inclusion of per share estimated values for DPP and REIT securities held in customer accounts or included on customer account statements. The rule also provides for several disclosures regarding the illiquidity and resale value of DPP and REIT securities.

The SEC has approved amendments to Rule 2340(c) to require, among other things, general securities members to include in customer account statements a per share estimated value for a DPP or REIT security developed in a manner reasonably designed to ensure that the per share estimated value is reliable. In addition, the amended rule provides two methodologies for calculating the per share estimated value for a DPP or REIT security that is deemed to have been developed in a manner reasonably designed to ensure that it is reliable: (1) the net investment methodology and (2) the appraised value methodology. The amended rule also imposes various enhanced disclosure obligations, as discussed below.

A. Net Investment Methodology

The amendments to Rule 2340(c)(1)(A) require "net investment" to be based on the "amount available for investment" percentage in the "Estimated Use of Proceeds" section of the offering prospectus. Where "amount available for investment" is not provided, the amended rule requires "net investment" to be based on another equivalent disclosure that reflects the estimated percentage deduction from the aggregate dollar amount of securities registered for sale to the public of sales commissions, dealer manager fees and estimated issuer offering and organization expenses. In addition, the amended rule clarifies that when an issuer provides a range of amounts available for investment, a member may use the maximum offering percentage unless the member has reason to believe that such percentage is unreliable. If the member has reason to believe that it is unreliable, the member must use the minimum offering percentage. The rule permits the net investment value to be used until 150 days following the second anniversary of breaking escrow in the public offering.

B. Appraised Value Methodology

The appraised value methodology, which can be used at any time, consists of the appraised valuation disclosed in the issuer's most recent periodic or current report filed with the SEC. As amended, Rule 2340(c)(1)(B) requires that the per share estimated value disclosed in an issuer's most recent periodic or current report be based on valuations of the assets and liabilities of the DPP or REIT, and that those valuations be:

- performed at least annually;
- conducted by, or with the material assistance or confirmation of, a third-party valuation expert or service; and
- derived from a methodology that conforms to standard industry practice.

Where a DPP is subject to the Investment Company Act of 1940 (1940 Act) (e.g., business development companies), instead of a valuation that meets the appraisal requirements listed immediately above, the rule requires that the appraised value must be consistent with the valuation requirements of the 1940 Act and the rules thereunder.

C. Disclosures

New Rule 2340(c)(2)(A) requires members that use the "net investment" methodology to provide, if applicable, enhanced disclosure relating to the return of investors' capital (often referred to as "over distributions") in order to address potential misunderstanding by customers when their capital is returned to them through a distribution that otherwise could appear to represent earnings on their investment. Rule 2340(c)(2)(A) requires an account statement that provides a "net investment" per share estimated value for a DPP or REIT security to disclose, if applicable, prominently and in proximity to disclosure of distributions and the per share estimated value the following statements: "IMPORTANT – Part of your distribution includes a return of capital. Any distribution that represents a return of capital reduces the estimated per share value shown on your account statement."

The disclosure under new Rule 2340(c)(2)(A) applies only to an account statement that provides a "net investment" per share estimated value where part of the distribution includes a return of capital. Thus, for example, this requirement does not apply to an account statement that provides an "appraised value" for the per share estimated value, which already would reflect returns of capital.

However, the disclosures under new Rule 2340(c)(2)(B) are required for all account statements that provide a per share estimated value for a DPP or REIT security. Pursuant to this new provision, a member must disclose that the DPP or REIT securities are not listed on a securities exchange, are generally illiquid and that, even if a customer is able to sell the securities, the price received may be less than the per share estimated value provided in the account statement.

II. FINRA Rule 2310 (Direct Participation Programs)

FINRA Rule 2310(b)(5) generally provides that a member may not participate in a public offering of DPP or REIT securities unless specified disclosures about the value of such securities will be made by the general partner or sponsor of the DPP or REIT in each annual report distributed to investors pursuant to Section 13(a) of the Exchange Act. FINRA amended the requirements to correspond to the amendments to NASD Rule 2340(c). As amended, Rule 2310(b)(5) prohibits a member from participating in a public offering of the securities of a REIT or DPP unless the issuer of the DPP or REIT has agreed to disclose:

- a per share estimated value of the DPP or REIT security, developed in a manner reasonably designed to ensure it is reliable, in the DPP or REIT periodic reports filed pursuant to Section 13(a) or 15(d) of the Exchange Act;
- an explanation of the method by which the value was developed; and
- the date of the valuation.

In addition, amended Rule 2310(b)(5) prohibits a member from participating in a public offering of the securities of a REIT or DPP unless the issuer of the DPP or REIT has agreed to disclose, in a periodic or current report filed pursuant to Section 13(a) or 15(d) of the Exchange Act within 150 days following the second anniversary of breaking escrow and in each annual report thereafter, a per share estimated value:

- based on the valuations of the assets and liabilities of the DPP or REIT performed at least annually by, or with the material assistance or confirmation of, a third-party valuation expert or service;
- derived from a methodology that conforms to standard industry practice; and
- accompanied by a written opinion or report by the issuer, delivered at least annually, that explains the scope of the review, the valuation methodology used and the basis for the reported value.

The amendments to Rule 2310(b)(5) do not apply to DPPs that are subject to the 1940 Act as such DPPs are already required to determine and publish net asset value on a regular basis.

Endnotes

1. *See* Securities Exchange Act Release No. 73339 (October 10, 2014), 79 FR 62489 (October 17, 2014) (Order Approving SR-FINRA-2014-006, as Modified by Amendment No. 1).

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