

August 7, 2006

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: File No. SR-NASD-2005-114

Dear Ms. Morris:

The Investment Program Association (“IPA”) appreciates this opportunity to comment on proposed rule changes by the National Association of Securities Dealers, Inc. (“NASD”) that would amend the provisions of NASD Conduct Rule 2810 regulating compensation, fees, and expenses in public offerings of real estate investment trusts (“REITs”) and direct participation programs.¹ The proposed rule changes were described in Release No. 34-54118 (“Proposal”).²

The Proposal contemplates extensive changes to Rule 2810. The IPA will not address all of the proposed changes, but does have comments in the areas described more fully below. The IPA’s comments include the following:

- The wholesaling provisions should be drawn to focus with greater precision on those activities which the NASD has historically interpreted as wholesaling – solicitation, distribution and sales – and should not include clerical, administrative or ministerial services.
- In order to accurately calculate underwriting compensation, a sponsor or affiliate should be able to make a good faith allocation, based on records maintained in

¹ The IPA, organized in 1985, is the national trade association representing the interests of investors in non-traded investment programs including partnerships, non-traded REITs, and limited liability companies. Most major program sponsors belong to the IPA. More information about the IPA is available at our website, <http://ipa-dc.org>.

² Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change Relating to the Regulation of Compensation, Fees, and Expenses in Public Offerings of Real Estate Investments Trusts and Direct Participation Programs, Release No. 34-54118, File No. SR-NASD-2005-114 (July 10, 2006), 71 Fed. Reg. 40569 (July 17, 2006).

accordance with appropriate procedures consistently applied, between underwriting compensation and consideration for non-broker/dealer services.

- Under appropriate circumstances and with full disclosure, members should be able to receive due diligence expenses that are not supported by a detailed and itemized invoice, when such due diligence expenses are included in underwriting compensation and subject to the 10% limit and are subject to the 3% limit on non-accountable expenses.
- The rule should explicitly provide that its non-cash compensation provisions apply only to public offerings.

The Wholesaling Provisions Should Be Drawn To Clarify What Are Wholesaling Functions

The proposed rule change would require, in Rule 2810(b)(4)(C)(ii)(a), that underwriting compensation includes payments to any wholesaler that is engaged in the solicitation, marketing, distribution or sales of the direct participation program or REIT securities and any employee of the wholesaler involved in the solicitation, development, maintenance and monitoring of selling agreements and relationships with broker/dealers and accounts and account holders at broker/dealers.³ The Proposal notes that NASD staff views wholesaling as a quintessential sales activity in connection with the distribution of investment programs and thus should be part of underwriting compensation. While the IPA agrees that wholesaling is a sales activity, it believes that, in light of the history and purpose of restrictions on wholesaling compensation, the provision should be revised to limit its scope to activities in the investment banking or securities business, excluding activities performed by persons who are not (and are not required to be) required representatives or registered principals of a member.

The NASD addressed wholesaling in NASD Notice to Members 85-29 (Apr. 1985), where it noted that a problem arises when the sponsor of a direct participation program assigns the responsibility for contact between the issuer and the retail brokerage community to full-time specialists, who are often assigned geographic areas of responsibility and provided compensation in the form of salary or commissions based on the sales levels that occur within their areas of responsibility. Notice to Members 85-29 stated that, when the NASD Corporate Financing Department (“Department”) determines that such a wholesaling function exists within the sponsor or general partner, the Department will request that the Securities and Exchange Commission be contacted to determine whether the individuals are required to be registered as

³ The Proposal incorrectly states that this proposed change was described in NASD Notice to Members 04-07 (Feb. 2004). While Notice to Members 04-07 stated that employees of a member engaged in wholesaling functions will always be deemed to be engaged in underwriting activities, it did not spell out the NASD’s view of what constitutes a wholesaling function or include the referenced rule language. This proposed change has not, therefore, previously been the subject of comment by the IPA or other members of the public.

broker-dealers under the Securities Exchange Act of 1934; if the sponsor has an NASD member affiliate, the individuals will be requested to register with the member. In addition, the Department will include all salaries, expense reimbursements, bonuses and other forms of compensation associated with the wholesaling function in the limits on underwriting compensation.

The use of wholesaling personnel, then, presents two separate but closely related issues: whether those personnel are required to be registered representatives or registered principals, and whether their compensation is underwriting compensation. Logically, sales activities that require personnel to be registered are, in essence, a broker-dealer activity and part of the underwriting process. Conversely, as the NASD acknowledged in Notice to Members 85-29, where contacts with the broker-dealer community are made by bona fide employees of the issuer who do not perform wholesaling activities on a regular basis, without transaction-based compensation and incidental to their other duties and responsibilities, such persons generally are not required to register as broker-dealers. Indeed, it is only the need for registration that brings wholesaling activities within the NASD's purview.

Unfortunately, the proposed wholesaling provisions appear to go beyond activities that would require personnel to be registered representatives or registered principals. Employees involved in maintaining and monitoring selling agreements and relationships typically perform only clerical, administrative or ministerial services. For example, employees will respond to participating broker/dealers by mailing them the selling agreements, following up to collect the agreements, calculating the fees due to such participating broker/dealers under the agreements, and so forth. Such services do not require registration and should not be wholesaling activities. The effect of these broad provisions is to expand "wholesaling" beyond the traditional understanding of its role in the offering process and to put sponsors that are affiliated with NASD members at a competitive disadvantage. The proposed change is particularly onerous for smaller and newer firms, which find it necessary to devote greater resources to promotional activities.

With these principles in mind, the IPA believes that proposed Rule 2810(b)(4)(C)(ii)(a) should be drawn to focus with greater precision on what have traditionally been considered wholesaling activities. Specifically, the IPA believes that underwriting compensation should include payments to any wholesaler that is engaged in the solicitation, distribution or sales of the program or REIT securities and to any employee of the sponsor (or a non-member affiliate thereof) who is engaged in such activities and is, or is required to be, a registered representative or registered principal of a member. Underwriting compensation should not include compensation to employees for services that do not require registration, even if the employee is

in fact a registered representative.⁴ The IPA proposes that proposed Rule 2810(b)(4)(C)(ii)(a) be revised to provide as follows:

a. to any member acting as a wholesaler that is engaged in the solicitation, distribution or sales of the program or REIT securities and any employee of the sponsor, issuer or other affiliate who is engaged in such activities and is, or is required to be, a registered representative or registered principal of a member;

In addition, the IPA would contemplate that the Notice to Members announcing the rule change would specifically address the nonapplicability of Rule 2810(b)(4)(C)(ii)(a) to clerical and administrative services and other services that do not require registration..

A Sponsor or Affiliate Should Be Able To Allocate Dual Employees' Compensation Between Underwriting Compensation and Consideration for Non-Broker/Dealer Services

Proposed Rule 2810(b)(4)(C)(ii)(b) provides that, for dual employees who receive transaction-based compensation, when the program or REIT has fewer than ten people engaged in wholesaling, filers can provide detailed per-employee information to the Department for review, following which the Department can conclude that certain payments should not be allocated to underwriting compensation. In light of the proposed wholesaling provisions discussed above, however, the IPA believes that this provision should be substantially revised.

Employees engaged in wholesaling activities may spend only a portion of their time on those activities, with the remainder of their time devoted to non-broker/dealer services. In such cases, an accurate calculation of underwriting compensation requires that their time be accurately allocated. While some employees receive transaction-based compensation, others do not. There is no need to limit allocations to employees who receive transaction-based compensation, especially since the allocation process is likely to be simpler for employees engaged in wholesaling activities who do not receive transaction-based compensation.

While smaller programs and REITs do have a particular need to be able to make such allocations, the IPA believes that a correct calculation of underwriting compensation requires

⁴ NASD Conduct Rule 1031(a) allows members to register a person who performs legal, compliance, internal audit, back-office operations, or similar responsibilities for the member, or a person who performs administrative support functions for registered personnel. Such persons typically are registered on a voluntary basis and would not be required to be registered representatives. The IPA does not believe that services performed by such persons should be considered wholesaling services, unless these registered representatives would be required to be registered.

that programs and REITs of all sizes be able to allocate their expenses correctly. In addition, the IPA suggests that a review by the Department is unnecessary, particularly with respect to employees who do not receive transaction-based compensation.

Accordingly, the IPA proposes that, with respect to compensation payable to dual employees who are also (or who are required to be) registered representatives or registered principals of a member, a sponsor or affiliate should be able to make a good faith allocation, based on records maintained in accordance with appropriate procedures consistently applied, between underwriting compensation and consideration for non-broker/dealer services. With respect to services for which the employee receives any transaction-based compensation, all such services should be allocated to underwriting compensation. It is understood that such records will be available for inspection by the NASD in its routine examinations of members. Such records should not be required, of course, if the sponsor or affiliate does not make such an allocation.

In this regard, by analogy, the IPA proposes that such a dual employee allocation would also be available with respect to the 180-day look-back for pre-offering compensation required by NASD Conduct Rule 2710(d)(1). For example, a program or REIT, especially a smaller program or REIT, may have a period of six months or more during which it is not conducting an offering. During this period, its wholesaling personnel may be re-assigned to non-wholesaling duties.

For simplicity of computation, the IPA also proposes a de minimis exception for such dual employees who devote no more than 15% of their time to a distribution. The IPA believes that such a standard should simplify the task of tracking the time of employees who played only a minimal role in an offering.

To implement the foregoing, the IPA proposes that proposed Rule 2810(b)(4)(C)(ii)(b) not be adopted and that the following language be added to Rule 2810 instead:

In calculating underwriting compensation for purposes of Rule 2710(d)(1) and Rule 2810(b)(4)(C)(ii)(a), a sponsor, issuer or affiliate may make a good faith allocation, based on records maintained in accordance with appropriate procedures consistently applied, between compensation payable to employees who are also (or who are required to be) registered representatives or registered principals of a member for wholesaling or other underwriting services and compensation for non-broker/dealer services; provided, that, with respect to services for which the employee receives any transaction-based compensation, all compensation for such services shall be allocated to underwriting compensation. Notwithstanding the foregoing, if an employee devotes no more than 15% of his or her time to a public offering, then none of such employee's compensation shall be allocated to underwriting compensation for such public offering.

Under Appropriate Circumstances and with Full Disclosure, Members Should Be Able To Receive Due Diligence Expenses Without a Detailed and Itemized Invoice

The proposed rule changes would eliminate the existing 0.5% limit on due diligence expenses, but would require that due diligence expenses be supported by a detailed and itemized invoice. Such due diligence expenses would be part of organization and offering expenses, but would not be part of underwriting compensation. The IPA supports these changes. However, the IPA believes that members also should be able to receive due diligence expenses that are not supported by a detailed and itemized invoice, when (i) such due diligence expenses are included in underwriting compensation and subject to its 10% limit, (ii) such due diligence expenses, together with any other non-accountable expenses, do not exceed the 3% non-accountable expense allowance contemplated by NASD Conduct Rule 2710(f)(2)(B), and (iii) there is appropriate disclosure in the offering documents.

The Proposal and Notice to Members 04-07 warn that any due diligence reimbursement that is mischaracterized as actual bona fide due diligence expenses in a filing with the NASD or in an offering document would be deemed to be undisclosed underwriting compensation, and the mischaracterization would violate NASD rules and the federal securities laws. The IPA believes that this strong language ignores the many judgment calls that necessarily are made in the characterization of due diligence expenses. Accordingly, the IPA believes that the rule should provide that inadvertent mischaracterizations of expenses as due diligence expenses should not be deemed violations of NASD rules, so long as such expenses were characterized as due diligence expenses in good faith and the requirements described above are met. The “insignificant deviations” provisions of Rule 508 of Regulation D, 17 C.F.R. § 230.508, is an example of a similar concept that has been applied with success in the federal securities law rules.

To implement the foregoing, the IPA proposes the following language to replace proposed Rule 2810(b)(4)(B)(vii):

(vii) the member has received reimbursement for due diligence expenses that are not included in a detailed and itemized invoice, other than due diligence expenses (and any expenses mischaracterized as due diligence expenses, so long as such mischaracterization was inadvertent and in good faith)

a. that are deemed to be underwriting compensation for purposes of the ten percent limit provided by Rule 2810(b)(4)(B)(i);

b. that, together with any other non-accountable expenses, do not exceed the three percent maximum non-accountable expense allowance provided by Rule 2710(f)(2)(B); and

c. as to which there is full disclosure in the offering document.

Non-Cash Compensation Provisions Should Apply Only To Public Offerings

The IPA supports the proposed changes to the non-cash compensation provisions described in the Proposal. However, the IPA believes that the rule should explicitly provide that the non-cash compensation provisions apply to public offerings, rather than to private placements. Rule 2810(b) is explicit in its application to public offerings, but Rule 2810(c)(2), which contains the non-cash compensation provisions, is phrased more broadly as applying to sales and distributions. We understand from our conversations with the NASD staff that the non-cash compensation rules are not intended to apply to private placements, which we believe is the right result.⁵ To implement this change, the first sentence of Rule 2810(c)(2) could be revised as follows:

In connection with the public offering 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.

Thank you for your consideration of these comments. If you have any questions or wish to discuss them further, please do not hesitate to call me at the number above.

Very truly yours,



Rosemarie Thurston, Chair
Legal/Regulatory Affairs Committee

cc: Joseph Price, Vice President
Corporate Financing Department, NASD

⁵ The IPA is aware that the NASD is considering more extensive revisions to its non-cash compensation rules, as discussed in NASD Notice to Members 05-40 (June 2005).