



NASAA

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**NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.**

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August 11, 2006

VIA EMAIL: rule-comments@sec.gov

Nancy M. Morris, Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, D.C. 20549-1090

**Re: File No. SR-NASD-2005-114; Release No. 34-54118** - Proposed Amendments to NASD Rule 2810 Relating to Compensation, Fees, Expenses, and Offering Practices for Direct Participation Programs (“DPPs”) and Real Estate Investment Trusts (“REITs”)

Dear Ms. Morris:

By this letter the North American Securities Administrators Association (“NASAA”) submits its comments on the National Association of Securities Dealers’ (“NASD”) proposed amendments to NASD Conduct Rule 2810 regulating compensation and sales practices for DPPs and REITs. These proposed changes were originally included in NASD Notice to Members NTM 04-07.

### **Introduction**

DPP programs and non-exchange traded REITs (“Investment Programs”) involve some of the highest fees and greatest sponsor conflicts of interest of any product sold to retail investors. They typically provide limited or no liquidity. These programs also raise serious concerns relating to investor suitability, because they charge higher sales commissions and organizational and offering expenses than most other investments. Taken together, these characteristics make Investment Programs riskier than many other securities.

NASAA strongly supports the majority of the NASD’s rule proposals. These rule reforms will uphold and reinforce the duties of fair dealing and suitability that brokerages and their personnel have to customers. However, NASAA urges NASD to take the additional step of banning broker sales contests, rather than trying to reform them.

NASAA will not address all of the proposed changes to Rule 2810, but does have comments on the proposals described more fully below.

### **Organization and Offering Expenses.**

The proposals reform the selling and organizational and offering expense rules for Investment Programs by making those rules more explicit and objective. Under the proposals, selling

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compensation payable to underwriters, broker-dealers, or affiliates may not exceed 10% of gross proceeds, regardless of the source from which it is derived. Total organization and offering expenses may not exceed 15% of gross offering proceeds, including any compensation and due diligence expenses.

**i. Issuer Organizational and Offering Expenses**

Investment programs typically originate from large sponsors, where numerous persons have roles in the promotion, wholesaling, and selling of the programs. In view of this, the NASD is correct in taking an inclusive view as to which expenses constitute organization and offering expenses (“O&O”).

The O&O expenses listed by the NASD rules are costs that are integral to getting an Investment Program established and sold. These include: (i) expenses, including overhead expenses, for assembling and mailing offering materials; processing subscription agreements and generating advertising and sales materials; (ii) legal services provided to the sponsor or issuer; and (iii) salaries and non-transaction-based compensation paid to employees or agents of the sponsor or issuer for performing such services. Also included would be expenses for transfer agents, escrow holders depositories, engineers and other experts, and registration and qualification of securities under federal and state law, including taxes and fees and NASD fees.

The NASD’s accurately labels these expenses as types of O&O. To do otherwise would allow these expenses to be excluded from the definition of O&O, which could permit evasion of the expense cap.

**ii. Limits on Compensation**

NASAA agrees with the NASD’s approach of applying the 10% compensation limit to selling compensation paid from any source. This language will permit the NASD to accurately apply the cap on selling compensation.

**iii. Dual Employees**

For large programs and syndicators, the NASD is appropriately conservative regarding the compensation payable to “dual employees,” who are involved in the retailing of the offering, but may also provide non-distribution services to the sponsor. NASAA agrees that payments to any employee whose compensation is contingent upon or will vary depending on how much money is raised or the amount of securities sold should be treated as underwriting compensation.

For smaller programs, with fewer than 10 people engaged in wholesaling, the NASD proposes to carry out an allocation between selling compensation payable to the employee and compensation for other duties. This may be a logical approach to regulating smaller sponsors. If this approach is adopted, NASAA urges the NASD to ensure that these employees will not be paid selling compensation under another label.

**iv. Wholesaling**

NASAA agrees with the NASD staff that wholesaling is a quintessential sales activity in connection with the distribution of investment programs and thus should be part of underwriting compensation.

The wholesaling process is invisible to most investors, and it is not well disclosed in program prospectuses. NASAA urges the SEC, NASD, and other regulators to bring greater scrutiny to wholesaling activities. This scrutiny should include: careful review of internal use marketing material and policing the ways that sponsors and wholesalers gain access to brokerage personnel.

**v. Training and Education Meetings, Legal Services to Broker-Dealers Participating in the Offering, and Advertising and Sales Materials**

NASAA supports including the costs of training meetings, legal services to broker-dealers and of advertising and sales materials as underwriting compensation, because the meetings relate to the marketing of these programs.

**vi. Due Diligence**

NASAA strongly agrees with the NASD's position that mischaracterizing underwriting compensation as due diligence costs would violate NASD rules and the federal securities laws. Such mischaracterizations would also violate the anti-fraud provisions of the state securities laws.

The "due diligence" allowances should not be used to cover sales and marketing costs. The proposed amendments will help assure any expenditures labeled as due diligence costs will be used only for that purpose. NASAA agrees with the proposal to require that a member may not accept any payments or reimbursements for due diligence expenses unless those costs are included in a detailed and itemized invoice.

**b. Liquidity Disclosure**

NASAA strongly supports the proposal that a member selling an investment program must inform prospective investors whether the sponsor has offered prior programs for which the prospectus disclosed a date or time period when the program might be liquidated, and whether, in fact, the program actually liquidated on or around that time or time period. This requirement addresses an important gap in the disclosure that is provided to potential investors.

**c. Sales Loads on Reinvested Dividends**

NASAA strongly agrees with the NASD's proposal to prohibit sales commissions on reinvested distributions. Reinvestment of distributions typically does not involve a separate investment decision by the investor who purchased the program, so it is inappropriate to charge selling commissions on reinvestments. Also, since many investment programs pay distributions by returning investors' capital, charging commissions on the reinvestments would result in double selling compensation.

**d. Non-Cash Compensation Provisions**

**i. Location of Training Meetings**

NASAA agrees with the proposed requirement that any training meeting be held at a location appropriate to the purpose of the meeting (e.g., at the office of the member or the location of a significant or representative asset of the program). Some program sponsors have used training and

education meetings as a bonus for high producing brokers; we urge the NASD to examine these meetings carefully.

**ii. Sales Contests: Total Production and Equal Weighting Requirements**

The NASD proposes any sales contests be based on a salesperson's total production, and that all products should be equally weighted. These proposals may diminish some of the problems posed by product-specific sales contests; however, NASAA urges that sales contests should be abolished.

Investors typically are not aware of sales contests. Contests create incentives that are directly contrary to the obligations that broker-dealers and agents have to their customers, particularly the obligation of fair dealing and the obligation to ensure that sales are suitable for customers. In view of these fundamental problems with sales contests, NASAA urges the NASD and SEC to take immediate steps to abolish them.

If you have any questions regarding the comments contained in this letter, please do not hesitate to contact Denise Voigt Crawford, Commissioner of the Texas State Securities Board and Chair of NASAA's Corporation Finance Section or Peter Cassidy, Attorney for the Massachusetts Securities Division and Chair of NASAA's Direct Participation Programs Policy Project Group.

Sincerely,

A handwritten signature in black ink, appearing to read 'Patricia D. Struck', with a long horizontal stroke extending to the right.

Patricia D. Struck  
NASAA President and  
Wisconsin Securities Administrator