

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-73339; File No. SR-FINRA-2014-006)

October 10, 2014

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving Proposed Rule Change, as Modified by Amendment No. 1, Relating to Per Share Estimated Valuations for Unlisted DPP and REIT Securities

I. Introduction

On January 31, 2014, Financial Industry Regulatory Authority, Inc. (“FINRA”) (f/k/a National Association of Securities Dealers, Inc. (“NASD”)) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act” or “Exchange Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to amend provisions in the NASD and FINRA rulebooks addressing per share estimated valuations for unlisted direct participation program (“DPP”) and real estate investment trust (“REIT”) securities. In particular, FINRA proposes revising NASD Rule 2340 (Customer Account Statements) to modify the requirements relating to the inclusion of a per share estimated value for unlisted DPP and REIT securities on a customer account statement and FINRA Rule 2310 (Direct Participation Programs) to modify the requirements applicable to members’ participation in a public offering of DPP or REIT securities.

The proposed rule change was published for comment in the Federal Register on February 19, 2014.³ The Commission received eighteen (18) comment letters in response to the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Exchange Act Release No. 71545 (Feb. 12, 2014), 79 FR 9535 (Feb. 19, 2014) (Notice of Filing of Proposed Rule Change Relating to Per Share Estimated Valuations for Unlisted DPP and REIT Securities) (“Notice of Filing”). The comment period closed on March 12, 2014.

Notice of Filing.⁴ On March 14, 2014, FINRA extended the time period in which the Commission must approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to approve or disapprove the proposed rule change to May 20, 2014. On May 20, 2014, the Commission issued an order instituting proceedings pursuant to Section 19(b)(2)(B) of the Act⁵ to determine whether to approve or disapprove the proposed rule change. The order was published for comment in the Federal Register on May 27, 2014.⁶ The Commission received six (6) comment letters in response to the Proceedings Order.⁷

⁴ Letters to Elizabeth Murphy, Secretary, SEC, from Mark Goldberg, Chairman, Investment Program Association, dated February 5, 2014; David T. Bellaire, Esq., Executive Vice President and General Counsel, Financial Services Institute, dated February 5, 2014; Mark Kosanke, President, Real Estate Investment Securities Association, dated February 11, 2014; Steven A. Wechsler, President and Chief Executive Officer, National Association of Real Estate Investment Trusts, dated February 14, 2014; Jeff Johnson, Chief Executive Officer, Dividend Capital Diversified Property Fund Inc., dated February 28, 2014; Michael Crimmins, Chief Executive Officer and Managing Director, KBS Capital Markets Group, dated February 28, 2014; Scott Ilgerfritz, Immediate Past-President, Public Investors Arbitration Bar Association, dated March 11, 2014; Thomas Price, Managing Director, Securities Industry and Financial Markets Association, dated March 12, 2014; Steve Morrison, Senior Vice President and Associate Counsel, LPL Financial, dated March 12, 2014; Jacob Frydman, Chairman and Chief Executive Officer, United Realty Trust Incorporated, dated March 12, 2014; Dechert LLP, dated March 12, 2014; David Hirschmann, President and Chief Executive Officer, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce, dated March 12, 2014; Steven A. Wechsler, President and Chief Executive Officer, National Association of Real Estate Investment Trusts, dated March 12, 2014; Kirk Montgomery, Head of Regulatory Affairs, CNL Financial Group, LLC, dated March 12, 2014; Mark Goldberg, Chairman, Investment Program Association, dated March 12, 2014; David T. Bellaire, Esq., Executive Vice President and General Counsel, Financial Services Institute, dated March 12, 2014; Martel Day, Principal, NLR Advisory Services, LLC, dated March 12, 2014; and Mark Kosanke, President, Real Estate Investment Securities Association, dated March 12, 2014. Comment letters are available at www.sec.gov. The Commission discussed these comments in the Proceedings Order. See infra note 6.

⁵ 15 U.S.C. 78s(b)(2)(B).

⁶ Exchange Act Release No. 72193 (May 20, 2014), 79 FR 30217 (May 27, 2014) (Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule

On July 11, 2014, FINRA filed a letter responding to comments and Amendment No. 1 to the proposed rule change.⁸ A notice of the amendment was published for comment in the Federal Register on July 22, 2014.⁹ The Commission received six (6) comment letters in response to the Notice of Amendment.¹⁰ On September 16, 2014, FINRA filed a letter responding to these comments.¹¹

Change Relating to Per Share Estimated Valuations for Unlisted DPP and REIT Securities) (“Proceedings Order”). The comment period closed on June 26, 2014.

⁷ Letters to Elizabeth Murphy, Secretary, SEC, from Kenneth Mills, dated June 24, 2014; Jason Doss, President, Public Investors Arbitration Bar Association, dated June 25, 2014; Mark Kosanke, President, Real Estate Investment Securities Association, dated June 26, 2014; Thomas F. Price, Managing Director, Operations, Technology and BCP, Securities Industry and Financial Markets Association, dated June 26, 2014; David T. Bellaire, Executive Vice President and General Counsel, Financial Services Institute, dated June 26, 2014; and Peter Peters, dated July 15, 2014. Comment letters are available at www.sec.gov.

⁸ Letter to Kevin O’Neill, Deputy Secretary, SEC, from Matthew E. Vitek, Associate General Counsel, FINRA, dated July 11, 2014 (“FINRA’s First Response Letter”). FINRA’s First Response Letter is available at www.sec.gov.

⁹ Exchange Act Release No. 72626 (July 16, 2014); 79 FR 42590 (July 22, 2014) (Notice of Filing of Amendment No. 1 to Proposed Rule Change Relating to Per Share Estimated Valuations for Unlisted DPP and REIT Securities) (“Notice of Amendment”). The comment period closed on August 12, 2014.

¹⁰ Letters to Elizabeth Murphy, Secretary, SEC, from Mark Goldberg, Chairman, Investment Program Association, dated July 28, 2014 (“IPA Letter”); Steven A. Wechsler, President and Chief Executive Office, National Association of Real Estate Investment Trusts, dated August 12, 2014 (“NAREIT Letter”); Frederick P. Baerenz, President and Chief Executive Officer, AOG Wealth Management, dated August 12, 2014 (“AOG Letter”); Daniel R. Gilbert, Chief Investment and Operating Officer, NorthStar Asset Management Group, Inc., dated August 12, 2014 (“NorthStar Letter”); David T. Bellaire, Executive Vice President and General Counsel, Financial Services Institute, dated August 12, 2014 (“FSI Letter”); and Andrea Seidt, President, North American Securities Administrators Association, Inc., and Commissioner, Ohio Division of Securities, dated August 22, 2014 (“NASAA Letter”). Comment letters are available at www.sec.gov.

¹¹ Letter to Brent J. Fields, Secretary, SEC, from Matthew E. Vitek, Associate General Counsel, FINRA, dated September 16, 2014 (“FINRA’s Second Response Letter”). FINRA’s Second Response Letter is available at www.sec.gov.

This order approves the proposed rule change, as modified by Amendment No. 1.

II. Description of the Proposal, as Modified by Amendment No. 1

A. Proposed Revisions to NASD Rule 2340 (Customer Account Statements)

FINRA proposes to amend NASD Rule 2340 to require general securities members to include in customer account statements a per share estimated value for an unlisted DPP or REIT security, developed in a manner reasonably designed to ensure that the per share estimated value is reliable, as well as to make related disclosures.¹² FINRA also proposes two methodologies for calculating the per share estimated value for a DPP or REIT security that would be 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.¹³ Each methodology is described in greater detail below, along with other proposed revisions.

1. Net Investment Methodology

Under the proposal, the net investment methodology would reflect the “net investment” disclosed in the issuer’s most recent periodic or current report. More specifically, the proposal would require “net investment” to be based on the “amount available for investment” percentage in the “Estimated Use of Proceeds” section of the offering prospectus;¹⁴ alternatively, where “amount available for investment” is not provided, the proposal would require “net investment” to be based on another equivalent disclosure that reflects the estimated percentage deduction

¹² See Proposed NASD Rule 2340(c).

¹³ See Proposed NASD Rule 2340(c)(1).

¹⁴ “This disclosure is typically included in the prospectus for REIT offerings and is described in the SEC’s Securities Act Industry Guide 5 (Preparation of registration statements relating to interests in real estate limited partnerships).” Notice of Filing at note 12.

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.¹⁵

The proposal would not require the calculation of “net investment” to involve the deduction from the per share estimated value of “over-distributions.”¹⁶ The proposal would, however, require members that use the net investment methodology to provide a per share estimated value for a DPP or REIT security to disclose in the customer account statement the following statement: “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.”¹⁷ The proposal would require the member to disclose this statement prominently and in proximity to the disclosure of distributions and the per share estimated value.¹⁸

In addition, the proposal would clarify that when an issuer provides a range of amounts available for investment, the proposal would allow a general securities member to 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.¹⁹

¹⁵ See Proposed NASD Rule 2340(c)(1)(A).

¹⁶ See Notice of Filing at note 20 (generally describing “over-distributions” as a return of investor capital as a distribution rather than the use of that capital to generate return on investment); see also Notice of Amendment (clarifying that “over-distributions” should be excluded from the calculation of “net investment”).

¹⁷ See Proposed NASD Rule 2340(c)(2)(A).

¹⁸ Id.

¹⁹ See Proposed NASD Rule 2340(c)(1)(A).

Finally, the proposal would allow a member to use the net investment methodology at any time before 150 days following the second anniversary of the breaking of escrow.²⁰

2. **Appraised Value Methodology**

Under the proposal, the appraised value methodology would consist of the appraised valuation disclosed in the issuer's most recent periodic or current report. More specifically, the proposal would require: (1) that the valuation be based on valuations of the assets and liabilities of the DPP or REIT; and (2) that those valuations: (a) be performed at least annually; (b) be conducted by, or with the material assistance or confirmation of, a third-party valuation expert or service; and (c) be derived from a methodology that conforms to standard industry practice. The proposal would allow a member to use the appraised value methodology at any time.²¹

The proposed rule change would, however, provide a different requirement for DPPs subject to the Investment Company Act of 1940 ("1940 Act") (e.g., business development companies). Specifically, FINRA acknowledged that business development companies that fall under the definitions of DPP are subject to the 1940 Act, which already requires the issuer to determine and publish its net asset value on a regular basis.²² Thus, for these DPPs, the proposed rule would require the appraised value methodology to be consistent with the valuation requirements of the 1940 Act and the rules thereunder.²³

²⁰ See Id. See also Notice of Filing at note 11 (stating that "[g]enerally, offering proceeds are placed in escrow until the minimum conditions of the offering are met, at which time the issuer is permitted to access the offering proceeds").

²¹ See Proposed NASD Rule 2340(c)(1)(B).

²² See Notice of Amendment.

²³ See Proposed NASD Rule 2340(c)(1)(B).

3. **General Disclosures**

The proposal would also require members to include specific disclosures on customer account statements that provide a per share estimated value for a DPP or REIT security (calculated using either the net investment methodology or the appraised value methodology). In particular, the proposal would require a member to include disclosures stating that the DPP or REIT security is not listed on a national securities exchange, is generally illiquid, and that, even if a customer is able to sell the security, the price received may be less than the per share estimated value provided in the statement.²⁴

B. **Proposed Revisions to FINRA Rule 2310 (Direct Participation Programs)**

FINRA also proposes to amend FINRA Rule 2310(b)(5) to prohibit 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:

- (1) a per share estimated value of the DPP or REIT security that is: (a) developed in a manner reasonably designed to ensure it is reliable, and (b) disclosed in the DPP's or REIT's periodic reports filed pursuant to Sections 13(a) or 15(d) of the Act; an explanation of the method by which the value was developed; and the date of the valuation; and
- (2) a per share estimated value of the DPP or REIT security that is: (a) based on 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; (b) derived from a methodology that conforms to standard industry practice; and (c) disclosed in the DPP's or REIT's periodic reports filed pursuant to Sections 13(a) or

²⁴ See Proposed NASD Rule 2340(c)(2)(B).

15(d) of the Act within 150 days following the second anniversary of breaking escrow (and in each annual report thereafter); and a concomitant written opinion or report by the issuer, delivered at least annually to the member that explains the scope of the review, the valuation methodology used, and the basis for the reported value.

The proposed rule change would, however, except DPPs subject to the 1940 Act from the requirements of proposed Rule 2310(b)(5). As stated above, FINRA acknowledged that such DPPs are subject to an existing regulatory framework (the 1940 Act) that already requires the issuer of their securities to determine and publish their net asset value on a regular basis.²⁵

C. **Technical Change**

FINRA also proposes making a change to its Rules Manual to conform to the other revisions discussed above by deleting FINRA Rule 5110(f)(2)(L) (Corporate Financing Rule – Underwriting Terms and Arrangements). That paragraph currently provides that it is unfair and unreasonable for a member or person associated with a member to participate in a public offering of a REIT unless the trustee will disclose in each annual report distributed to investors a per share estimated value of the trust securities, the methodology by which it was developed, and the date of the data used to develop the value.

The text of the proposed rule change is available at the principal office of FINRA, on FINRA's website at <http://www.finra.org>, and at the Commission's Public Reference Room.

²⁵ See Notice of Amendment.

III. Description of Comments on the Proposal, as Amended, and FINRA’s Response

A. Comments

As stated above, the Commission received six (6) comment letters in response to the Proceedings Order.²⁶ Those commenters generally reiterated concerns expressed in response to the Notice of Filing.

In addition, the Commission received six (6) comment letters in response to the Notice of Amendment.²⁷ Four (4) of these commenters fully supported the proposal.²⁸ Two (2) other commenters, however, raised concerns (discussed below).²⁹

One of the concerned commenters supported aspects of the proposal.³⁰ This commenter, however, encouraged rejecting the proposal’s requirement for members to report initial share prices, stating that substituting “a flawed share pricing system with a different flawed pricing system is apt to lead to confusion rather than clarity.”³¹ This commenter also suggested that market forces are sufficiently driving improvements in the unlisted DPP and REIT industry, noting changes in fee structures.³²

²⁶ See supra note 7.

²⁷ See supra note 10.

²⁸ FSI Letter, IPA Letter, NAREIT Letter, and NorthStar Letter.

²⁹ AOG Letter and NASAA Letter.

³⁰ AOG Letter (stating that “providing sponsor companies with a formula and timeline . . . for appraising and reporting the values [other than the initial value] of non-traded REITS is very valuable” and “[providing] broker-dealers assurance that they can rely on those values is also very helpful”).

³¹ Id.

³² Id.

The second concerned commenter also supported aspects of the proposal.³³ This commenter, however, opposed the following other aspects of the proposal:

- (1) The commenter opposed excluding over-distribution from the valuation calculation under the net investment methodology, stating that excluding it would decrease the accuracy and transparency of the disclosed values of DPP and REIT securities.³⁴
- (2) The commenter also expressed concern that members could use the net investment methodology's requirements concerning offering and organization expenses to manipulate valuation of DPP and REIT securities.³⁵
- (3) In addition, the commenter recommended that FINRA require disclosure of the identity of the third-party valuation expert or service used to obtain a valuation under the appraised value methodology and clarify that such third-party must be independent.
- (4) Finally, the commenter opposed the extension of the effective date of the proposal, as amended, stating that "industry should not need an additional year-and-a-half to make the necessary changes" and "[investors] should not be forced to wait another year for more transparent price reporting."³⁶

B. FINRA's Response

In its response letter, FINRA stated that it has considered the concerns raised by the two concerned commenters.³⁷ FINRA also stated, however, that it believes that the proposal, as

³³ NASAA Letter (stating that "[r]equiring securities to be valued on the customer account statement enhances transparency to the customer").

³⁴ See supra note 16 and surrounding text.

³⁵ See supra note 19 and surrounding text.

³⁶ NASAA Letter.

³⁷ FINRA's Second Response Letter. See, e.g., FINRA's First Response Letter (summarizing and responding to commenters' concerns about calculating over-

amended, “significantly improves the transparency of the per share estimated value of DPP and REIT securities on customer account statements.”³⁸ Accordingly, FINRA declined making any additional changes in response to commenters’ concerns but stated that it would “continue to monitor practices in this area to determine whether additional changes are necessary.”³⁹

IV. Discussion and Commission Findings

The Commission has carefully considered the proposal, as amended; the comments received; and FINRA’s responses to the comments. Based on its review of the record, the Commission finds that the proposal is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.⁴⁰ In particular, the Commission finds that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that FINRA’s rules be designed to

distributions); FINRA’s First Response Letter (proposed NASD Rule 2340(c)(1)(A) (stating that if a member has reason to believe that the maximum offering percentage is unreliable, the member must use the minimum offering percentage); FINRA’s First Response Letter (extending the effective date to provide industry participants sufficient time to make adjustments to product structures and any necessary operational changes, as well as to limit the impact of the amended proposal on current offerings); and proposed NASD Rule 2340(c)(1)(B) (stating that the valuation expert or service must be a third-party).

³⁸ FINRA’s Second Response Letter.

³⁹ Id.

⁴⁰ In approving the proposal, as amended, the Commission has considered the impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

See, e.g., Proceedings Order at 7 (noting commenters’ concern about the potential economic impact of the proposal, as originally proposed; also FINRA’s First Response Letter, which provided a detailed economic impact statement in response to those commenters). The Commission has received no additional public comment on the potential economic impact of the proposed rule change, as amended.

prevent fraudulent and manipulative acts and practices; promote just and equitable principles of trade; and, in general, protect investors and the public interest.⁴¹

The proposal, as amended, is designed to address longstanding concerns with the current industry practice of displaying a DPP or REIT security's immutable offering price as its per share estimated value on customer account statements throughout the offering period (which can last several years),⁴² despite the fact that the value of the DPP or REIT security fluctuates. FINRA's proposed rule change would require members to include in customer account statements per share estimated values of unlisted DPP and REIT securities that are developed in a manner reasonably designed to ensure they are reliable. The Commission believes that the proposal would, therefore, greatly improve the accuracy and transparency of the value of DPP and REIT securities and, in turn, better protect the investing public.

As discussed above, the Commission received eighteen (18) comment letters in response to the Notice of Filing, six (6) comment letters in response to the Proceedings Order, six (6) comment letters in response to the Notice of Amendment, and two (2) response letters from FINRA. The Commission appreciates the points raised by the commenters, and the Commission believes that FINRA responded appropriately to their concerns.⁴³ The Commission notes that,

⁴¹ 15 U.S.C. 78o-3(b)(6).

⁴² See Notice of Filing at note 8 and surrounding text (stating that "Rule 415(a)(5) under the Securities Act of 1933 ('Securities Act') provides that certain types of securities offerings, including continuous offerings of DPPs and REITs, may continue for no more than three years from the initial effective date of the registration statement. Under Rule 415(a)(6), the SEC may declare another registration statement for a DPP or REIT effective such that an offering can continue for another three-year offering period").

⁴³ FINRA did not directly respond to the commenter's recommendation to require disclosure of the name of the third-party expert or service for purposes of proposed NASD Rule 2340(c)(1)(B). The Commission notes, however, that this information may be available in an issuer's prospectus.

while one commenter on the amended proposal suggested market forces should be sufficient to drive improvements in the unlisted DPP and REIT industry,⁴⁴ given current industry practice with respect to disclosure of DPP and REIT values, the Commission believes that FINRA's amended proposal is warranted.

Also, given commenters' concern regarding the complexity of calculating over-distributions, the Commission supports FINRA's amended approach of requiring enhanced disclosure surrounding them. More specifically, the Commission believes that, at this time, this approach would improve investor awareness and understanding in a practical manner.

In addition, one commenter on the amended proposal expressed concern that members could use the net investment methodology's requirements concerning offering and organization expenses to manipulate DPP and REIT values.⁴⁵ Under the amended proposal, however, if a member has reason to believe a calculation of the offering and organization expenses using the maximum offering percentage is unreliable, the member must use the minimum offering percentage.⁴⁶

The same commenter further recommended that FINRA require disclosure of the identity of the service used to obtain a valuation under the appraised value methodology and clarify that such service must be independent.⁴⁷ Regarding disclosure of the valuation service's identity, the Commission notes that this information may be available through an issuer's prospectus. Regarding the independence of the service, the amended proposal requires the use of a "third-

⁴⁴ AOG Letter.

⁴⁵ NASAA Letter.

⁴⁶ See FINRA's First Response Letter.

⁴⁷ Id.

party valuation expert,” which both the Commission and FINRA interpret as being an independent entity.⁴⁸

Finally, the commenter opposed the extension of the effective date under the amended proposal, stating that investors should not have to wait for more transparent price reporting.⁴⁹ FINRA extended the effective date, however, to provide industry participants sufficient time to make adjustments to product structures and any necessary operational changes, as well as to limit the impact of the amended proposal on current offerings.⁵⁰

In sum, the Commission believes that the proposal, as amended, represents a significant improvement to current industry practice concerning the disclosure of the value of unlisted DPP and REIT securities. As amended, the proposal would help ensure that investors receive more accurate information regarding the nature and worth of their holdings of DPP and REIT securities. While the Commission believes that this outcome would improve accuracy and transparency and, consequently, investor protection, it will continue to monitor the activity in this market for potential abuses.

For the reasons stated above, the Commission finds that the proposed rule change, as amended, is consistent with the Act and the rules and regulations thereunder.

⁴⁸ See, e.g., FINRA’s First Response Letter (discussing the economic impact of requiring “independent valuations”).

⁴⁹ NASAA Letter.

⁵⁰ FINRA’s First Response Letter.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁵¹ that the proposed rule change (SR-FINRA-2014-006), as modified by Amendment No. 1, be, and hereby is, approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.⁵²

Kevin M. O'Neill
Deputy Secretary

⁵¹ 15 U.S.C. 78s(b)(2).

⁵² 17 CFR 200.30-3(a)(12).