

Notice to Members

FEBRUARY 2004

REQUEST FOR COMMENT

ACTION REQUESTED BY MARCH 12, 2004

SUGGESTED ROUTING

Legal & Compliance
Operations
Senior Management

Regulation of Compensation, Fees, and Expenses in Public Offerings of Real Estate Investment Trusts; Direct Participation Programs, Including Commodity Pools; and Closed-End Funds

NASD Requests Comment on Proposed Amendments to Rules 2710 (Corporate Financing) and 2810 (Direct Participation Programs); **Comment Period Expires March 12, 2004**

KEY TOPICS

Closed-End Funds
Commodity Pools
Compensation Limitations
Due Diligence
Loads on Reinvested Dividends
Non-Cash Compensation
Trail Fees
Rule 2710
Rule 2810

Executive Summary

This *Notice* addresses the regulation of certain pooled investment vehicles under NASD Rule 2710 (the Corporate Financing Rule)¹ and NASD Rule 2810 (the Direct Participation Programs Rule or DPP Rule). These pooled investment vehicles include publicly offered limited partnership securities, real estate investment trusts (REITs), and closed-end investment companies. This *Notice* proposes amendments to the Corporate Financing Rule and DPP Rule (together, the Rules), and describes policies in the Corporate Financing Department's Public Offering Review program that will clarify the Rules' application to these products. This *Notice*:

- ◆ Requests comment on the rescission of an NASD interpretive policy regarding trail commissions charged by commodity DPPs;
- ◆ Requests comment on proposed amendments to prohibit sales loads on reinvested dividends in REITs, DPPs, and closed-end funds;

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- ▶ Requests comment on proposed amendments to the non-cash compensation provisions in the Rules regarding the “appropriate location” for training and education meetings;
 - ▶ Requests comment on proposed amendments to the non-cash compensation provisions in the Rules to include “equal weighting” and “total production” limitations for internal sales contests;
 - ▶ Addresses due diligence practices and disclosure in connection with DPP and REIT programs; and
 - ▶ Addresses the allocation of compensation and organization and offering expenses in the review of DPP and REIT programs by NASD’s Corporate Financing Department (Department).

Action Requested

NASD encourages all interested parties to comment on the proposal. Comments must be received by March 12, 2004. Members and interested persons can submit their comments using the following methods:

- ▶ mailing in written comments;
- ▶ e-mailing written comments to *pubcom@nasd.com*; or
- ▶ submitting comments online at the NASD Web Site (*www.nasd.com*).

Written comments submitted via hard copy should be mailed to:

Barbara Z. Sweeney
NASD
Office of the Corporate Secretary
1735 K Street, NW
Washington, DC 20006-1500

Important Notes: The only comments that will be considered 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 NASD Web Site. Generally, comments will be posted on the NASD Web Site one week after the end of the comment period. See *Notice to Members 03-73*.

Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

Questions/Further Information

As noted on the previous page, written comments should be submitted to Barbara Z. Sweeney. Questions concerning this *Notice* should be directed to Joseph E. Price, Vice President, or Minh Le, Assistant Supervisor, Corporate Financing Department, NASD, at (240) 386-4623.

1. Background

The Corporate Financing and DPP Rules require that, prior to participating in a public offering of securities, the participating member, or a participating member that files on behalf of other members, must file information regarding the offering with the Department and receive a “no objections” opinion regarding the proposed terms and arrangements in the offering.

The Rules impose three limitations on compensation and expenses with respect to REIT and DPP programs:

- ▶ Underwriting compensation may not exceed 10 percent of the gross proceeds of the offering, regardless of the source from which it is derived. This limitation applies to all forms of underwriting compensation, including so-called “trail commissions.”²
- ▶ An additional .5 percent may be reimbursed to members or independent due diligence firms for *bona fide* due diligence expenses.
- ▶ Total issuer organization and offering expenses (O&O expenses) are limited to 15 percent of offering proceeds for programs in which the member is affiliated with the program sponsor. This provision allows an additional 4.5 percent for issuer O&O expenses above the 10 percent underwriting compensation and .5 percent due diligence limitations.³ (North American Securities Administrators Association guidelines also limit total O&O expenses paid out of offering proceeds to 15 percent.)

Trail commissions for REITs and DPPs are included as part of the 10 percent underwriting compensation. Once members have been paid compensation that reaches this limitation, either in the form of front-end commission payments, trail commissions, loads on reinvested dividends, fee reimbursements, or a combination of these payments, then no member may receive additional compensation.

2. Commodity Pool Trail Commissions

Since 1982, the Department has had a policy to exclude trail commissions from the 10 percent limitation as it applies to commodity DPPs if: (1) the member is registered with the Commodity Futures Trading Commission as a Futures Commission Merchant; (2) the associated person receiving the trail commissions has passed the Series 31 Futures Managed Funds examination; and (3) the associated person receiving the trail commissions provides ongoing investor relations services to investors. NASD did not publish this policy, and the DPP Rule was not amended to exclude these payments from the compensation limitations. NASD proposes to rescind this policy. NASD requests comment on rescission. Commenters should address the following questions:

- ▶ For all DPPs, except commodity DPPs, the Department views trail commissions for servicing securities accounts to be compensation in connection with the public offering. Do Series 31 associated persons who provide commodity-related services to securities accounts that hold commodity DPPs provide services that are significantly different than those provided by associated persons who are not Series 31 registered? For example, in some commodity DPPs, Series 31 associated persons receive "uncapped" trail commissions, while associated persons who have not passed the examination receive trail commissions that are subject to the 10 percent limitation. What additional services are provided by the Series 31 associated persons? If these are necessary services, why are non-Series 31 associated persons permitted to sell shares in such programs?
- ▶ Trail commissions in commodity DPPs often are significantly higher than the trail commissions in any other DPPs, including real estate, oil and gas, and equipment leasing partnerships. The Department has reviewed commodity DPPs with trail commissions as high as four percent. By contrast, Rule 12b-1 fees permitted for mutual funds under NASD Rule 2830 (the Investment Company Rule) may not exceed one percent. Are the higher trail commissions in commodity DPPs justified by the quality and level of service provided to accounts that hold these investments?
- ▶ The 10 percent limitation terminates trail commissions in connection with securities sold in all DPP offerings, except commodity DPPs, after the limitation is reached. For example, in a \$500 million DPP offering, \$40 million (eight percent) may initially be paid out of the offering proceeds, leaving an additional \$10 million (two percent) that may be paid as trail commissions.⁴ What effect would this trail commission termination feature have on a commodity DPP?

3. Loads on Reinvested Dividends

NASD proposes to amend the DPP and Corporate Financing Rules to prohibit commissions (sales loads) on reinvested dividends in DPPs, REITs, and closed-end funds. In April 2000, NASD amended the Investment Company Rule to prohibit members from offering or selling shares of an investment company if it has a front-end or deferred sales charge imposed on shares purchased through the reinvestment of dividends.⁵ Loads on reinvested dividends may be opaque or confusing to investors and, in certain circumstances, may cause an investor to pay a charge twice on the same assets. For example, an investor who pays a load at the time of purchase based on a net asset value that includes undistributed income or capital gains may pay a second charge on the same assets when those earnings are distributed and reinvested. Although NASD proposes to prohibit loads on reinvested dividends, NASD requests comment on whether less liquid DPP and REIT programs may require members to provide more ongoing services in connection with dividend reinvestment programs than those required for a mutual fund and whether these services justify a sales load on reinvested dividends. NASD requests comment on the extent to which any such services are financed by commissions on reinvested dividends and whether it is appropriate to charge sales commissions in programs in which investors choose to have their dividends automatically reinvested. NASD also requests comment on whether it is appropriate to charge a commission on a dividend reinvestment when the dividend is a return or partial return of the investor's capital.

4. Non-Cash Compensation

In April 2003, NASD amended the Corporate Financing Rule and the DPP Rule to codify certain exceptions from the non-cash compensation provisions in the Rules,⁶ while maintaining the prohibitions on the receipt of gifts with more than a *de minimis* value from DPP and REIT sponsors, the prohibition of payments or reimbursements preconditioned on the achievement of a sales target, and the prohibition of payments and reimbursements for travel and meetings that are not *bona fide* due diligence meetings or training and education meetings.

NASD has been concerned about conflicts of interest in the retail brokerage business created by a broad range of compensation practices whereby program sponsors provide incentives or rewards to individual broker/dealers and their registered representatives for selling the issuer's products. The use of non-cash compensation can create significant point-of-sale incentives that may compromise suitability determinations and heighten the potential for loss of supervisory control over sales practices.

A. Location of Training and Education Meetings

The non-cash compensation provisions in the DPP and Corporate Financing Rules permit payments and reimbursements by an offeror in connection with training and education meetings, if the conditions of the Rules are met. Among those conditions is the requirement that:

The location is appropriate to the purpose of the meeting, which shall mean an office of the offeror or the member, or a facility located in the vicinity of such office, or a regional location with respect to regional meetings.⁷

NASD proposes to amend the Rules to provide that an “appropriate location” for a training and education meeting may include a location at which a significant DPP or REIT asset is located. Members have informed NASD that an important part of a *bona fide* training and education meeting for REITs and DPPs may be inspecting real estate, oil and gas production facilities, and other types of assets that will be held and managed by the program. NASD requests comment on how difficult it typically is to determine whether an asset is “significant” to a program and whether this determination might complicate the ability of a member’s legal and compliance staff to decide whether associated persons should attend a particular meeting. In addition, commenters should address whether such an amendment would provide a significant risk that locations would be chosen in order to provide incentives or rewards to associated persons for selling the issuer’s products.

B. Total Production and Equal Weighting Requirements

The Investment Company Rule and Rule 2820 (Variable Contracts Rule) non-cash compensation provisions are similar, and, in most cases, identical to the Corporate Financing and DPP Rules. In excepting certain internal sales contests from the general prohibition, however, they impose two limitations that do not appear in the Corporate Financing and DPP Rules. First, the internal sales contest must be based on the total production of associated persons with respect to all variable contracts or investment company securities distributed by the member. Second, the sales contest must require that the credit received for each security be equally weighted. These provisions are designed to prohibit internal non-cash sales contests that encourage associated persons to favor one fund or variable contract over another based on non-cash benefits.

NASD proposes to amend the Rules to add the equal weighting and total production limitations. The proposed amendments would apply to all public offerings governed by the Rules, including DPPs, REITs, closed-end funds, and debt and equity securities. The equal weighting and total production limitations, however, would apply according to the type of securities offered. For example, internal sales contests with respect to DPPs would have to be based on total production of associated persons with respect to all DPP securities distributed by the member, but not all DPP and REIT securities combined.

NASD requests comment on these limitations. Would they better ensure that improper sales incentives do not favor certain securities, such as proprietary securities of the member or its affiliates?

5. Public Offering Review Issues

As discussed above, the Corporate Financing and DPP Rules impose three limitations on compensation and expenses with respect to REIT and DPP programs: (i) underwriting compensation may not exceed 10 percent of the gross proceeds of the offering, regardless of the source from which it is derived; (ii) an additional .5 percent may be reimbursed to underwriters for *bona fide* due diligence expenses; and (iii) total issuer organization and offering expenses are limited to 15 percent of offering proceeds for programs in which the member is affiliated with the program sponsor, which permits an additional 4.5 percent for issuer O&O expenses above the 10 percent underwriting compensation and .5 percent due diligence limitations.

A. Due Diligence

The Department reminds members that for purposes of the .5 percent allowance for *bona fide* due diligence expenses, "due diligence expenses" relate only to those expenses incurred when the member affirmatively discharges its responsibilities to ensure that all material facts pertaining to a program are adequately and accurately disclosed in the offering document. The Department reminds members of the following principles:

- ▶ For purposes of the .5 percent allowance, members may include only their actual costs incurred for due diligence expenses. Any reimbursement that includes a profit margin to the member will be deemed to be underwriting compensation subject to the 10 percent limitation, whether or not the member claims that the reimbursement was for "due diligence" expenses.⁸
- ▶ The .5 percent allowance applies only to *bona fide* due diligence activities. A sponsor may not pay for activities that are inconsistent with the due diligence objective, such as golf outings, cruises, tours, and other forms of entertainment. Members should expect the Department to request a copy of any due diligence meeting agenda to verify that the meeting served a *bona fide* due diligence purpose.

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- ▶ If a member asserts that a meeting was intended for both due diligence and training and education, the member must be prepared to demonstrate which part of the meeting served each purpose. If the meeting agenda does not clearly delineate between the two, then members should expect the Department to consider whether the *entire* meeting should be designated as one or the other. If meetings include training and education, the meeting must be held at an appropriate location consistent with Rules 2710(d)(2)(C)(ii) and 2810(c)(2)(C)(ii). As discussed in Section 4A above, NASD is proposing to amend the Rules with regard to what constitutes an “appropriate location” under the Rules.
 - ▶ Members should ensure that the persons responsible for conducting due diligence have appropriate training and skills to evaluate the terms of the investment as well as the potential risks and benefits. Only the appropriate personnel with relevant background and training should travel to inspect properties or facilities as part of the due diligence review for member firms.
 - ▶ Any due diligence reimbursement that is mischaracterized as “actual *bona fide* due diligence expenses” in a filing with 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. Moreover, such reimbursement could violate the non-cash compensation prohibitions in the DPP and Corporate Financing Rules.

Some members have inquired about whether reimbursements for *bona fide* due diligence may exceed .5 percent of the offering amount if actual costs exceed .5 percent. Consistent with the DPP and Corporate Financing Rules, members may be reimbursed amounts in excess of the .5 percent limitation when actual costs incurred for *bona fide* due diligence activities exceed that limitation. Due diligence expenses that exceed .5 percent may be allocated to O&O expenses, subject to the 4.5 percent limitation on O&O expenses, but only if the members or due diligence firms have presented the REIT or DPP sponsor with a detailed and itemized invoice for the due diligence expenses.

B. Allocation of Compensation and Organization and Offering Expenses

(i) Dual Employees

Many DPPs and REITs are structured so that a holding company controls other affiliated entities, including the program sponsor, the securities dealer/manager, equipment leasing or property management entities, and financial advisory service providers. When employees of the securities dealer/manager are registered persons and dual employees of the other entities with multiple job responsibilities, determining whether payments in connection with those job responsibilities should be allocated as underwriting compensation or issuer O&O expenses is very burdensome.

Members have urged the Department not to allocate automatically all payments (e.g., salaries, bonuses, and expense reimbursements) to registered persons as underwriting compensation because their primary or secondary job responsibilities may involve providing non-distribution related services to the sponsor. Accordingly, when the Department reviews DPP and REIT programs for compliance with the compensation guidelines, it analyzes information about the job functions, time spent on those functions, and compensation of these registered persons.

The Department is modifying its review procedures so that any salary, bonus, or other form of compensation paid to the dual employee, and any expense associated with the dual employee, would be allocated to the 10 percent underwriting compensation limitation if any of the employee's compensation is contingent on or varies depending on how much money is raised or the number of securities that are sold in the public offering (transaction-based compensation). In general, if the employee's remuneration is not based on the success of the offering, all payments and expenses associated with the dual employee would be allocated to the issuer's O&O expenses. The exclusion from this general rule is that employees of a member engaged in wholesaling functions will always be deemed to be engaged in underwriting activities. Accordingly, all payments and expenses associated with such a dual employee will be included in the 10 percent underwriting compensation limitation regardless of whether the employees are paid transaction-based compensation.

(ii) Legal Fees

Some DPP and REIT programs use the same attorneys or law firm as issuer's counsel and as counsel for the affiliated dealer/manager. The fees paid for legal services provided to the securities dealer/manager must be separately identified as an item of value in filings with the Department. These fees will be allocated to the dealer/manager and included in the 10 percent underwriting compensation limitation. Legal services on behalf of the dealer/manager typically include filing the offering with NASD and responding to the Department's comments and drafting and reviewing dealer agreements, marketing agreements, and due diligence agreements. Legal services on behalf of the issuer will be allocated to O&O expenses.

(iii) Training and Education Meetings

The fees and expenses paid in connection with *bona fide* training and education meetings or for participation in meetings held by broker/dealers that are not affiliated with the program sponsor must be identified as an item of value in filings with the Department. These fees and expenses will be considered underwriting compensation and included in the 10 percent limitation.

(iv) Advertising and Sales Material

Costs associated with advertising and sales material generated by a program sponsor will be allocated to the issuer's O&O expenses. Material generated by the dealer/manager will be allocated to the 10 percent underwriting compensation limitation.

Endnotes

- 1 The Corporate Financing Rule applies to real estate investment trust (REIT) and closed-end fund offerings.
- 2 See *Notice to Members (NtM) 82-50* (providing that underwriting compensation in connection with DPPs may not exceed NASD guidelines); *NtM 82-51* (announcing the NASD guidelines); and *NtM 85-29* (clarifying the 10 percent guideline for underwriting compensation and .5 percent for due diligence expenses in connection with DPPs). Since REITs and real estate limited partnership are competing alternative forms of investing in real estate securities with equivalent costs of distribution, the Corporate Financing Department has applied the same underwriting compensation and due diligence guidelines to both DPPs and REITs since the early 1980s.
- 3 The 10 percent limitation is applied to all public DPPs and REITs, while the 15 percent limitation on organization and offering expenses is applied only to sponsors that are affiliated with NASD members.
- 4 Some DPPs and REITs conduct registered offerings every year or every other year. New compensation calculations and limitations apply to each offering.
- 5 See *NtM 99-103*.
- 6 See *NtM 03-53*. NASD filed the amendments for immediate effectiveness to codify existing staff interpretations.
- 7 NASD interprets the clause “regional location with respect to regional meetings” in the Corporate Financing and DPP Rules to permit regional meetings held for the convenience of local broker/dealers and their associated persons, not national meetings held in regional locations.
- 8 See *NtM 86-66*. *NtM 86-66* also provides that a member’s actual, reimbursable expenses for due diligence can include the fees charged to the member by an independent due diligence firm that is not a member, or an affiliate of a member, even though the independent due diligence firm includes a profit margin in the fees it charges to the member.

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ATTACHMENT A

Text of Proposed Amendments to Rules 2710 and 2810
Proposed additions are underlined; proposed deletions are in brackets.

Rule 2710. Corporate Financing Rule – Underwriting Terms and Arrangements

(a) - (e) No Change

(f) Unreasonable Terms and Arrangements

(1) General

No member or person associated with a member shall participate in any manner in a public offering of securities after any arrangement proposed in connection with the public offering, or the terms and conditions relating thereto, has been determined to be unfair or unreasonable pursuant to this Rule or inconsistent with any By-Law or any Rule or regulation of NASD.

(2) Prohibited Arrangements

Without limiting the foregoing, the following terms and arrangements, when proposed in connection with a public offering of securities, shall be unfair and unreasonable.

(A) – (M) No Change.

(N) For a member to participate in a public offering of the securities of any real estate investment trust or closed-end investment company that charges a sales load or commission on securities that are purchased through the reinvestment of dividends, unless the registration statement registering the securities under the Securities Act of 1933 became effective prior to (the effective date of this rule amendment).

(g)-(h) No Change

(i) Non-Cash Compensation

(1) No Change

(2) Restrictions on Non-Cash Compensation

In connection with the sale and distribution of a public offering of 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. Non-cash compensation arrangements are limited to the following:

(A) – (B) No Change

(C) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(i) No Change

(ii) the location is appropriate to the purpose of the meeting, which shall mean an office of the issuer or affiliate thereof, the office of the member, [or] a facility located in the vicinity of such office, [or] a regional location with respect to regional meetings, or a location at which a significant asset of the program is located;

(iii) – (iv) No Change

(D) Non-cash compensation arrangements between a member and its associated persons or a company that controls a member company and the member's associated persons, provided that:

(i) the member's or non-member's non-cash compensation arrangement is based on the total production of associated persons with respect to all securities within respective product types distributed by the member;

(ii) the non-cash compensation arrangement requires that the credit received for each security within a security product type is equally weighted; and

(iii) no unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or non-member's organization of a permissible non-cash compensation arrangement; and

(E) No Change

(j) No Change

Rule 2810. Direct Participation Programs

(a) No Change

(b) Requirements

(1) – (3) No Change

(4) Organization and Offering Expenses

(A) No member or person associated with a member shall underwrite or participate in a public offering of a direct participation program if the organization and offering expenses are not fair and reasonable, taking into consideration all relevant factors.

(B) In determining the fairness and reasonableness of organization and offering expenses for purposes of subparagraph (A) hereof, the arrangements shall be presumed to be unfair and unreasonable if:

(i) – (iii) No Change

(iv) commissions or other compensation are to be paid or awarded either directly or indirectly, to any person engaged by a potential investor for investment advice as an inducement to such advisor to advise the purchaser of interests in a particular program, unless such person is a registered broker/dealer or a person associated with such a broker/dealer; [or]

(v) the program provides for compensation of an indeterminate nature to be paid to members or persons associated with members for sales of program units, or for

services of any kind rendered in connection with or related to the distribution thereof, including, but not necessarily limited to, the following: a percentage of the management fee, a profit sharing agreement, brokerage commissions, and overriding royalty interest, a net profits interest, a percentage of revenues, a reversionary interest, a working interest, a security or right to acquire a security having an indeterminate value, or other similar incentive items; provided however, that an arrangement which provides for continuing compensation to a member or person associated with a member in connection with a public offering shall not be presumed to be unfair and unreasonable if all of the following conditions are satisfied:

a. – c. No change

d. if any portion of the continuing compensation is to be derived from the limited partners' interest in the program cash distributions, the percentage of the continuing compensation shall be no greater than the percentage of program cash distributions to which limited partners are entitled at the time of the payment; or

(iv) the program charges a sales load or commission on direct participation securities that are purchased through the reinvestment of dividends, unless the registration statement registering the securities under the Securities Act of 1933 became effective prior to (the effective date of this rule amendment).

(C) – (E) No Change

(5) – (6) No Change

(c) Non-Cash Compensation

(1) No Change

(2) Restrictions on Non-Cash Compensation

In connection with the sale and distribution of direct participation 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. Non-cash compensation arrangements are limited to the following:

(A) – (B) No Change

(C) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(i) No Change

(ii) the location is appropriate to the purpose of the meeting, which shall mean an office of the offeror or the member, [or] a facility located in the vicinity of such office, [or] a regional location with respect to regional meetings, or a location at which a significant asset of the program is located;

(iii) – (iv) No Change

(D) Non-cash compensation arrangements between a member and its associated persons or a company that controls a member company and the member's associated persons, provided that:

(i) the member's or non-member's non-cash compensation arrangement, if it includes direct participation program securities, is based on the total production of associated persons with respect to all direct participation program securities distributed by the member;

(ii) the non-cash compensation arrangement requires that the credit received for each direct participation program security is equally weighted; and

(iii) no unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or non-member's organization of a permissible non-cash compensation arrangement; and

(E) No Change

(d) No Change