

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-72193; File No. SR-FINRA-2014-006]

### Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Instituting Proceedings To Determine Whether To Approve or Disapprove a Proposed Rule Change Relating to per Share Estimated Valuations for Unlisted DPP and REIT Securities

May 20, 2014.

#### I. Introduction

On January 31, 2014, the 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”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> 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. The proposed rule change was published for comment in the **Federal Register** on February 19, 2014.<sup>3</sup> The Commission received eighteen (18) comment letters in response to the proposed rule change.<sup>4</sup> 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. The Commission is publishing this order to institute proceedings pursuant to Section 19(b)(2)(B) of the Act<sup>5</sup> to determine whether to approve or disapprove the proposed rule change.

Institution of proceedings does not indicate that the Commission has reached any conclusions with respect to the proposed rule change, nor does it mean that the Commission will ultimately disapprove the proposed rule change. Rather, as discussed below, the Commission seeks additional input from interested parties on the issues presented by the proposal.

#### II. Description of the Proposed Rule Change

##### *NASD Rule 2340 (Customer Account Statements)*

NASD Rule 2340 generally requires that general securities members<sup>6</sup> 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. As further described in the Notice of Filing, FINRA proposes to amend NASD Rule 2340 to eliminate the requirement contained in paragraph (c) that a general securities member disclose in a customer’s account statement a per share estimated value of the customer’s unlisted DPP or REIT securities holdings, provided that such a value is reflected in the DPP’s or REIT’s annual report. Thus, under the proposal, a general securities member would no longer be required to include a per share estimated value for an unlisted DPP or REIT security in a customer account statement, but any member may do so

Investors Arbitration Bar Association, dated March 11, 2014; Mark Kosanke, President, Real Estate Investment Securities Association, dated March 12, 2014 (“REISA Letter”); Thomas Price, Managing Director, Securities Industry and Financial Markets Association, dated March 12, 2014; David Hirschmann, President and CEO, U.S. Chamber of Commerce, Center for Capital Markets Competitiveness, dated March 12, 2014 (“Chamber of Commerce Letter”); Jacob Frydman, Chairman and CEO, United Realty Trust Incorporated, dated March 12, 2014.

<sup>5</sup> 15 U.S.C. 78s(b)(2)(B).

<sup>6</sup> NASD Rule 2340(d)(2) defines “general securities member” as any member that conducts a general securities business and is required to calculate its net capital pursuant to the provisions of Rule 15c3-1(a) under the Act. A member that does not carry customer accounts and does not hold customer funds or securities is exempt from the definition.

if the value has been developed in a manner reasonably designed to ensure that it is reliable, the member has no reason to believe that it is unreliable, and the account statement includes certain disclosures. FINRA proposes two methodologies under which an estimated value would be presumed to have been developed in a manner reasonably designed to ensure that it is reliable: (1) The net investment methodology; and (2) the independent valuation methodology.

The net investment methodology would reflect the “net investment” disclosed in the issuer’s most recent periodic or current report. The “net investment” would be based on the “amount available for investment” percentage in the “Estimated Use of Proceeds” section of the offering prospectus or, where “amount available for investment” is not provided, another equivalent disclosure.<sup>7</sup> The per share estimated value also must deduct the portion, if any, of cumulative distributions per share that exceeded Generally Accepted Accounting Principles (“GAAP”) net income per share for the corresponding period, after adding back depreciation and amortization or depletion expenses. Moreover, the deduction for each distribution would be limited to the full amount of the distribution.

The independent valuation methodology would consist of the most recent valuation disclosed in the issuer’s periodic or current reports. It would also require that a third-party valuation expert or experts determine, or provide material assistance in the process of determining, the valuation.<sup>8</sup>

##### *FINRA Rule 2310 (Direct Participation Programs)*

FINRA Rule 2310 generally provides that no member is permitted to participate in a public offering of DPP or REIT securities unless the general partner or sponsor will disclose in each annual report distributed to investors

<sup>7</sup> FINRA states that 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). FINRA states that it would permit the use of equivalent disclosure in DPP offerings if the disclosure provides a percentage amount available for investment by the issuer after deduction of organizational and offering expenses.

<sup>8</sup> According to FINRA, valuation definitions and methodologies for real estate investments generally use GAAP (ASC 820) as a standard. Performance reporting for institutional real estate investments also relies on GAAP as its foundational basis. See Investment Program Association Practice Guidelines 2013-01, entitled “Valuations of Publicly Registered Non-Listed REITs” (Apr. 29, 2013).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Release No. 34-71545 (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.

<sup>4</sup> Letters to Elizabeth Murphy, Secretary, SEC, from Mark Goldberg, Chairman, Investment Program Association, dated February 5, 2014; David Bellaire, 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 Wechsler, President and CEO, National Association of Real Estate Investment Trusts, dated February 14, 2014; Kirk Montgomery, Head of Regulatory Affairs, CNL Financial Group, LLC, dated March 12, 2014; Dechert LLP, dated March 12, 2014 (“Dechert Letter”); Jeff Johnson, CEO, Dividend Capital Diversified Property Fund Inc., dated February 28, 2014; David Bellaire, Executive Vice President and General Counsel, Financial Services Institute, dated March 12, 2014 (“FSI Letter”); Mark Goldberg, Chairman, Investment Program Association, dated March 12, 2014 (“IPA Letter”); Michael Crimmins, CEO and Managing Director, KBS Capital Markets Group, dated February 28, 2014; Steve Morrison, Senior Vice President and Associate Counsel, LPL Financial, dated March 12, 2014; Steven Wechsler, President and CEO, National Association of Real Estate Investment Trusts, dated March 12, 2014 (“NAREIT Letter”); Martel Day, Principal, NLR Advisory Services, LLC, dated March 12, 2014; Scott Igerfritz, Immediate Past-President, Public

pursuant to Section 13(a) of the Act: (1) A per share estimated value of the securities; (2) the method by which the estimated value was developed; and (3) the date of the data used to develop the estimated value.<sup>9</sup>

As further described in the Notice of Filing, FINRA proposes to amend FINRA Rule 2310 to provide that a member may not participate in a public offering of a DPP or REIT security unless: (A) A per share estimated value is calculated on a periodic basis in accordance with a methodology disclosed in the prospectus, or (B) the general partner or sponsor has agreed to disclose in the first periodic report filed pursuant to Section 13(a) or 15(d) of the Act after the second anniversary of breaking escrow: (1) A per share estimated value of the DPP or REIT calculated by, or with the material assistance of, a third-party valuation expert; (2) an explanation of the method by which the per share estimated value was developed; (3) the date of the valuation; and (4) the identity of the third-party valuation expert used. In addition, the general partner or sponsor of the DPP or REIT must have agreed to ensure that the valuation is conducted at least once every two years; is derived from a methodology that conforms to standard industry practice; and is accompanied by a written opinion to the general partner or sponsor of the DPP or REIT that explains the scope of the review, the methodology used to develop the valuation, and the basis for the per share estimated value.

### III. Summary of Comments

While the commenters to the Notice of Filing generally expressed support for the goals of the proposed rule change, they raised a number of concerns regarding various aspects of the proposal. For instance, several commenters opposed the deduction of offering and organizational costs from the share price under the net investment methodology, citing difficulties in accurately determining those expenses.<sup>10</sup> A number of commenters also opposed the net investment methodology's deduction of "over-distributions" from the share value, arguing, among other things, that such a requirement was unprecedented and would have severe implementation challenges, as well as unintended negative consequences, such as actually reducing the level of investor

understanding regarding the sources of distributions.<sup>11</sup>

Many commenters opposed the elimination of any requirement to include a per share valuation of unlisted DPP or REIT securities in customer account statements. Commenters stated that FINRA, in its proposal, put forth two valuation methodologies that it deems presumptively reliable, and allowing an unlisted DPP or REIT security to nevertheless be shown as "not priced" in customer account statements would deprive investors of useful information and be viewed as a retreat from a policy of transparency.<sup>12</sup>

In addition, some commenters raised concerns about the proposed rule change's anticipated implementation period.<sup>13</sup> These commenters favored a longer period in order to minimize investor confusion and avoid market disruption as the industry develops the appropriate controls and procedures to comply with the rule.

Commenters further questioned, among other things, the timing of the initiation of valuations for unlisted DPP and REIT securities under FINRA Rule 2310;<sup>14</sup> the frequency with which valuations are estimated under FINRA Rule 2310;<sup>15</sup> the effect of the proposed rule change on business development companies and daily NAV REITs;<sup>16</sup> and the lack of an economic analysis.<sup>17</sup>

On May 16, 2014, FINRA noted that it is still considering the points raised by commenters and anticipates filing an official response in the near future.<sup>18</sup>

### IV. Proceedings To Determine Whether To Approve or Disapprove SR-FINRA-2014-006 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Act to determine whether the proposed rule change should be approved or disapproved.<sup>19</sup>

<sup>11</sup> See, e.g., IPA Letter.

<sup>12</sup> *Id.*

<sup>13</sup> See, e.g., NAREIT Letter.

<sup>14</sup> See, e.g., IPA Letter.

<sup>15</sup> See, e.g., FSI Letter.

<sup>16</sup> See, e.g., Dechert Letter.

<sup>17</sup> See, e.g., Chamber of Commerce Letter.

<sup>18</sup> See Letter from Matthew Vitek, Assistant General Counsel, FINRA, to Kevin O'Neill, Deputy Secretary, SEC, dated May 16, 2014. Any FINRA response will be included in the comment file for this rule filing.

<sup>19</sup> 15 U.S.C. 78s(b)(2). Section 19(b)(2)(B) of the Act provides that proceedings to determine whether to disapprove a proposed rule change must be concluded within 180 days of the date of publication of notice of the filing of the proposed rule change. The time for conclusion of the proceedings may be extended for up to an additional 60 days if the Commission finds good cause for such extension and publishes its reasons for so finding or if the self-regulatory organization consents to the extension.

Institution of such proceedings appears appropriate at this time in view of the legal and policy issues raised by the proposal. As noted above, institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, the Commission seeks and encourages interested persons to comment on the issues presented by the proposed rule change and provide the Commission with arguments to support the Commission's analysis as to whether to approve or disapprove the proposal.

Pursuant to Section 19(b)(2)(B) of the Act,<sup>20</sup> the Commission is providing notice of the grounds for disapproval under consideration. In particular, Section 15A(b)(6) of the Act<sup>21</sup> requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. In addition, Section 15A(b)(9) of the Act<sup>22</sup> requires that FINRA rules not impose any unnecessary or inappropriate burden on competition.

The Commission believes FINRA's proposed rule change raises questions as to whether it is consistent with the requirements of Section 15A(b)(6) and 15A(b)(9) of the Act.

### V. Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the issues raised by the proposed rule change. In particular, the Commission invites the written views of interested persons concerning whether the proposed rule change is inconsistent with Sections 15A(b)(6) and 15A(b)(9), or any other provision, of the Act, or the rules and regulations thereunder.

Although there do not appear to be any issues relevant to approval or disapproval which would be facilitated by an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4, any request for an opportunity to make an oral presentation.<sup>23</sup> Interested persons

<sup>20</sup> 15 U.S.C. 78s(b)(2)(B).

<sup>21</sup> 15 U.S.C. 78o-3(b)(6).

<sup>22</sup> 15 U.S.C. 78o-3(b)(9).

<sup>23</sup> Section 19(b)(2) of the Act, as amended by the Securities Acts Amendments of 1975, Public Law 94-29, 89 Stat. 97 (1975), grants the Commission flexibility to determine what type of proceeding—either oral or notice and opportunity for written comments—is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Acts Amendments of 1975, Report of the Senate Committee on Banking,

<sup>9</sup> FINRA Rule 2310(b)(5) (Valuation for Customer Account Statements).

<sup>10</sup> See, e.g., REISA Letter.

are invited to submit written data, views, and arguments by June 26, 2014 concerning whether the proposed rule change should be approved or disapproved. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by July 11, 2014. Comments may be submitted by any of the following methods:

#### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-FINRA-2014-006 on the subject line.

#### Paper Comments

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2014-006. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principle office of FINRA. All comments received will be posted without change. The Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

All submissions should refer to File Number SR-FINRA-2014-006 and should be submitted on or before July 11, 2014. If comments are received, any

rebuttal comments should be submitted by July 11, 2014.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>24</sup>

**Kevin M. O'Neill,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-72191; File No. SR-FINRA-2014-024]

### Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to the Definition of "Reporting Member" in the Order Audit Trail System Rules

May 20, 2014.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on May 12, 2014, Financial Industry Regulatory Authority, Inc. ("FINRA") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by FINRA. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to amend FINRA Rule 7410 to permit members to route orders to two Reporting Members for a defined period of time provided certain conditions are met without losing the exception from the definition of "Reporting Member" in the Order Audit Trail System ("OATS") rules.

Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

\* \* \* \* \*

#### 7000. CLEARING, TRANSACTION AND ORDER DATA REQUIREMENTS, AND FACILITY CHARGES

\* \* \* \* \*

<sup>24</sup> 17 CFR 200.30-3(a)(12); 17 CFR 200.30-3(a)(57).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

## 7400. ORDER AUDIT TRAIL SYSTEM

### 7410. Definitions

(a) through (n) No Change.

(o) "Reporting Member" shall mean a member that receives or originates an order and has an obligation to record and report information under Rules 7440 and 7450.

(1) A member shall not be considered a Reporting Member in connection with an order, if the following conditions are met:

(A) the member engages in a non-discretionary order routing process, pursuant to which it immediately routes, by electronic or other means, all of its orders to:

(i) a single receiving Reporting Member; or

(ii) two receiving Reporting Members, provided:

(a) orders are routed by the member to each receiving Reporting Member on a pre-determined schedule approved by FINRA; and

(b) orders are routed to two receiving Reporting Members pursuant to the schedule for a time period not to exceed one year; and

(B) the member does not direct and does not maintain control over subsequent routing or execution by the receiving Reporting Member(s);

(C) the receiving Reporting Member(s) record(s) and report(s) all information required under Rules 7440 and 7450 with respect to the order; and

(D) the member has a written agreement with the receiving Reporting Member(s) specifying the respective functions and responsibilities of each party to effect full compliance with the requirements of Rules 7440 and 7450.

(2) No Change.

\* \* \* \* \*

#### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.