Regulatory Notice 09-09

Unlisted REITs and DPPs

Customer Account Statements and Due Diligence Requirements for Unlisted Real Estate Investment Trusts (REITs) and Direct Participation Programs (DPPs)

Executive Summary

FINRA is issuing this *Notice* to address certain requirements that apply to the per-share customer account statement values and dividend distributions of REITs and DPPs (collectively, "real estate investment programs") that are sold through broker-dealers, invest in real estate and do not trade on a national securities exchange.[1]

Questions regarding this *Notice* may be directed to:

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Background and Discussion

Responsibility of Firms Concerning "Par Value"

NASD Rule 2340 (Customer Account Statements) requires a general securities member firm to include in a customer's account statement an estimated value for a real estate investment trust (REIT) or direct participation program (DPP) security if the annual report of the security that is held in the customer's account includes a per-share estimated value (and provided certain conditions set forth in the rule are met).[2] The rule permits a firm to use an estimated value disclosed in the program's annual report, and in practice, that is the value typically used. During the offering period, the estimated value included in the annual report usually is the value at which securities are being offered to the public, commonly known as "par value."

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Notice Type

- Guidance

Suggested Routing

- Compliance
- Legal
- Senior Management

Key Topic(s)

- Customer Account Statements
- Due Diligence
- Unlisted Real Estate Investment Trusts (REITs)
- Direct Participation Programs (DPPs)

Referenced Rules & Notices

- NASD Rule 2340
- NASD Rule 2810

Financial Industry Regulatory Authority

NASD Rule 2340(c)(2) prohibits a firm from using a per-share estimated value that has been developed from data that is as of a date more than 18 months prior to the customer account statement's date. The 18-month requirement was designed to ensure that investors are provided with reasonably current valuations of these illiquid securities. In addition, by providing firms with an 18-month window in which to rely on the data, the rule ensures that either they or the sponsors have adequate time to appraise the program's assets and operations and calculate an estimated value.

During the offering period, it may be reasonable to determine that the estimated value is the value at which the shares are being offered to the public. However, 18 months after the conclusion of the offering, that value would be aged data and should not be the basis for the valuation provided on a customer's account statement. Thus, in accordance with NASD Rule 2340(c)(2), firms must not use par value in a customer account statement more than 18 months following the conclusion of an offering, unless an appraisal of the program's assets and operations yields the same value.

Responsibility of Firms Concerning Expected Dividend Distributions[3]

NASD Rule 2810 (Direct Participation Programs) regulates public offerings of real estate investment programs. Rule 2810(b)(3) requires that firms, prior to participating in a public offering of a real estate investment program, have reasonable grounds to believe that all material facts are adequately and accurately disclosed and provide a basis for evaluating the program.[4] To determine the adequacy of the disclosed facts, a firm shall obtain information on material facts relating to, among other things, the financial stability and experience of the sponsor and the program's risk factors. Analysis of these factors should include an inquiry into the amount or composition of a real estate investment program's dividend distributions.[5] As part of its inquiry, a firm should determine the amount of the distributions that represents a return of investors' capital and whether that amount is changing.[6] In addition, firms should consider whether there are impairments to the real estate investment program's assets or other material events that would affect the distributions and whether disclosure regarding dividend distributions needs to be updated to reflect these events.

For example, firms should obtain information regarding whether there have been unscheduled cancellations of existing leases that impair or materially affect a real estate investment program's operating cash flows. If operating cash flows decline substantially, the program may decide to lower the dividend distributions or try to maintain historic dividend payments by borrowing funds or returning investors' capital. Paying dividend distributions that are unsustainable over the long term due to cash flow difficulties presents a significant risk to investors' future returns and to the long-term viability of the program.

Endnotes

1 Generally, REITs are pass-through entities governed in part by Section 856 of the U.S. Internal Revenue Code that offer investors an equity interest in a pool of real estate assets, including land, buildings, shopping centers, hotels and office properties. Some DPPs also invest in real estate. Similar to REIT investments, these DPPs typically offer investors an equity interest in an entity such as a limited partnership that provides flow-through tax consequences and distributes income generated from underlying real estate assets.

2 *See Notice to Members 01-08* (January 2001) and "DPP and REIT Valuations on Customer Account Statements," *Regulatory & Compliance Alert* (Summer 2001). *See also generally Regulatory Notice 08-77* (December 2008) (providing guidance on estimated annual income and estimated yield on customer account statements for certain products, including REITs and DPPs).

3 As used in this *Notice*, "dividend distributions" or "distributions" refer to the periodic distributions by the real estate investment program to shareholders or limited partners in the form of cash or securities. These distributions generally consist of dividend income, and may include capital gains and some return of capital. Distributions to shareholders are declared by the REIT's board of directors and usually paid on a monthly or quarterly basis.

4 "Participating" in a best-efforts offering includes participation in each offer or sale made pursuant to a registration statement. Accordingly, the Rule 2810(b)(3) requirements apply prior to participating in every sale in which prospectus delivery is required. *See also, In re Worldcom, Inc.* 346 F. Supp. 2d 628, 670 (S.D.N.Y. 2004) (noting that in adopting rules relating to shelf offerings the SEC stressed the use of "anticipatory and continuous due diligence programs" to augment underwriters' fulfillment of their due diligence obligations); and Securities Act Rule 430B (providing that the effective date for a shelf registration statement for liability purposes for takedowns is the date a prospectus supplement is filed in connection with each takedown).

5 FINRA recently reminded firms of their sales practice obligations and related requirements regarding sales of securities in a high-yield environment. *See Regulatory Notice 08-81* (December 2008). The *Notice* generally addresses firms' sale practice obligations with regard to the sale of securities in a high-yield environment and provides comparable guidance to firms concerning other fixed income and other securities products.

6 Many factors may influence the degree to which a distribution comprises a return of capital. For example, in a newer program a high proportion of the distributions to shareholders may consist of a return of capital until the proceeds raised from the real estate investment program's initial public offering are generating cash flows from operations.