

# Public Investors Arbitration Bar Association

November 11, 2011

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**Via Email Only**  
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Marcia E. Asquith  
Office of the Corporate Secretary  
FINRA  
1735 "K" Street, N.W.  
Washington, DC 20006-1506

**Re: Regulatory Notice 11-44 – Proposed Amendments to NASD  
Rule 2340**

Dear Ms. Asquith:

On behalf of the Public Investors Arbitration Bar Association ("PIABA"),<sup>1</sup> I thank FINRA for the opportunity to comment on the proposed amendments to NASD Rule 2340. We believe some provisions of the proposed amendments may benefit investors by causing general securities members to provide investors with more accurate valuation information concerning unlisted direct participation program ("DPP") and unlisted REIT shares on account statements. We also write to point out that the provisions of the amended rule allowing general securities members to not provide valuation information to investors if the most recent annual report of a DPP or REIT does not contain per share estimated value in compliance with the amended rule is a step backwards.

Rule 2340 was previously amended in late 2000. The amended rule required general securities members to make certain disclosures about DPP and REIT securities and to require the inclusion on account statements of a per share estimated value for DPP or REIT securities if the annual report filed by a DPP or REIT sponsor with the Securities and Exchange Commission ("SEC") included a per share estimated value. Coincident with the amendment of NASD Conduct Rule 2340, the SEC approved amendments to NASD Conduct Rules 2710 and 2810 with respect to REIT and DPP securities.

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<sup>1</sup> PIABA is a national, not-for-profit bar association comprised of attorneys, including law professors and regulators, both former and current, who devote a significant portion of their practice to representation of public investors in securities arbitrations.

## **Background Concerning Amendments to NASD Conduct Rules 2340, 2710, and 2810**

On November 29, 2000, the SEC issued Release No. 34-34601, announcing amendments to NASD Conduct Rules 2340, 2710 and 2810 (the "SEC Release"). The SEC Release makes clear that the genesis of the amendments to the above-referenced rules was a March 9, 1994, letter from Representative Edward J. Markey, Chairman, and Representative Jack Fields, Ranking Republican Member, of the Subcommittee on Telecommunications and Finance, U.S. House of Representatives, to Joseph R. Hardiman, then President and Chief Executive Officer of the National Association of Securities Dealers, Inc. ("NASD") (hereinafter the "1994 Letter"). See SEC Release at p. 71169, FN 8. According to the SEC Release, Rep. Markey and Rep. Fields "expressed concern to the NASD regarding the sufficiency of information provided on customer account statements with respect to the current value of illiquid partnership securities. The House Subcommittee noted that investors in non-traded partnerships should be able to know how their investments are performing and expressed a belief that their [sic] might be shortcomings in current valuation reporting to that group of investors." Id.

The comments of Rep. Markey and Fields followed closely the limited partnership debacle of the late 1980's and early 1990's. For years, broker/dealers carried limited partnership units at cost basis on customers' monthly statements, or customers' monthly statements indicated that valuation of their limited partnership units was not available.

In response to the 1994 Letter, the NASD proposed and the SEC approved amendments to NASD Conduct Rules 2340, 2710, and 2810.

NASD Conduct Rule 2340 was amended to include subsection (b) (currently subsection (c)). Subsection (b)(1)(B) of the Rule required members, which carry customer accounts and hold customer funds or securities, to provide on customer statements a per share estimated value for any DPP or REIT security held in a customer's account, if the annual report for a DPP or REIT included a per share estimated value for a DPP or REIT security and if certain conditions were met. The estimated value stated in the annual report or derived from an independent valuation service or another source was required to be included on the first customer account statement issued after the annual report became available, provided the member met the conditions of subsections (b)(2) and (3). See SEC Release at p. 71170. Subsection (b)(2) dictated that a member could provide a per share estimated value for a DPP or REIT security on an account statement only if the estimated value had been developed from data that is of a date no more than eighteen months prior to the date of the statement. Subsection (b)(3) was added to require that any account statement providing an estimated value for a DPP or REIT security include a brief description of the estimated value, its source, and the method by which it was developed. Subsection (b)(3) also required that the account statement disclose that DPP or REIT securities are generally illiquid and the estimated value may not be the actual liquidation value of the security.

The SEC Release stated that during the course of the amendment process, NASD Regulation revised Rule 2340(b)(4) to prohibit a member from including estimated per share value for a DPP or REIT security on a customer account statement if the member was able to demonstrate that the value was inaccurate as of the date of valuation or later became inaccurate. The SEC Release further stated that NASD Regulation had noted that the revision of NASD Rule 2340(b)(4) did not relieve a member of its obligation to provide an alternative per share estimated value when the member's obligation was triggered by NASD Rule 2340(b)(1)(B). See SEC Release at p. 71171.

The SEC Release stated the rationale for the eighteen month time period for the use of the per share estimated value information provided in a sponsor's annual report. The SEC Release stated, in pertinent part:

NASD Regulation believe that the 18-month standard provides sufficient time for the member and for an independent valuation source to develop an estimated value for DPP and REIT securities based on the audited financial statements contained in the Form 10-K of the DPP or REIT. For example, an estimated value based on December 31, 1999, financial statements could be used from January 1, 2000, through June 30, 2001, thereby allowing time between April and June, 2001, for a new estimated value to be developed based on the December 31, 2000, financial statements.

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The Commission believes that NASD Rule 2340(b)(2) will help ensure the reliability of estimated valuations provided on customer account statements by requiring the valuations to be based on relatively recent data. In addition, as NASD Regulation noted in its proposal, the 18-month period should provide a member or an independent valuation source with sufficient time to develop a new valuation based on audited financial statements provided in a DPP or REIT's most recent Form 10-K.

See SEC Release at pp. 71170 and 71172 (emphasis supplied).

The SEC Release also explained the rationale for the amendments to NASD Conduct Rules 2710 and 2810. The SEC Release stated, in pertinent part:

NASD Regulation believe that the amendments to NASD Rule 2710, "Corporate Financing Rule – Underwriting Terms and Arrangements," and NASD Rule 2810, "Direct Participation Programs," will help

ensure that DPP general partners or sponsors and REIT trustees provide estimated per share values in their annual reports. NASD Rule 2710(c)(6), as amended, states that, when proposed in connection with the distribution of a public offering of securities, it shall be unfair and unreasonable for a member or associated person to participate in a public offering of REIT securities unless the trustee will disclose in each annual report distributed to investors pursuant to Section 13(a) of the Act a per share estimated value of the trust securities, the method by which it was developed, and the date of the data used to develop the estimated value.

See SEC Release at p. 71171 (emphasis supplied).

NASD Regulation announced the changes to Rules 2340, 2710, and 2810 in NASD Notice to Members 01-08. The amendments became effective on April 16, 2001. In announcing the changes to Rules 2710 and 2810, NASD Regulation incorporated the rationale set forth in the SEC Release. NASD NTM 01-08 stated, in pertinent part:

**Rules 2710 And 2810** – NASD Regulation has also adopted amendments to Rule 2710, "Corporate Financing Rule – Underwriting Terms and Arrangements," and Rule 2810, "Direct Participation Programs," that are intended to help ensure that DPP general partners or sponsors and REIT trustees provide estimated per share values in their annual reports. Rule 2710(c)(6) and Rule 2810(b)(5), as amended, prohibit a member or associated person from participated in a public offering of DPP or REIT securities unless the general partner or trustee, as applicable, agrees to disclose in each annual report distributed to investors pursuant to Section 13(a) of the Securities Exchange Act of 1934 a per share estimated value of the securities, the method by which it was developed, and the date of the data used to develop the estimated value.

See NASD NTM 01-08 at p. 2.

Section 2710(a)(4) broadly defined "participation or participating in a public offering." Subsection (c)(6) of the July, 2001, Conduct Rules set forth a list of terms and arrangements which the NASD had determined were unfair or unreasonable with respect to publicly offered securities. Subsection (c)(6) also prohibited members or associated persons from participating in any way in the public offering of securities after any arrangement, term, or condition proposed in

connection with the public offering had been determined to be unfair or unreasonable. Subsection (c)(6)(A) provided as follows:

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.

Subsection (c)(6)(B) set forth the terms and arrangements proposed in connection with the distribution of a public offering of securities which NASD Regulation had determined to be unfair and unreasonable.

The amendment to Rule 2710 with respect to publicly offered, non-traded REIT securities announced in the SEC Release and NASD Regulation NTM 01-08 was set forth in subsection (xiv) of NASD Conduct Rule 2710(c)(6)(B). Subsection (c)(6)(B)(xiv) provided that it was an unfair or unreasonable term or arrangement of a public offering of non-traded REIT securities as follows:

For a member or person associated with a member to participate in a public offering of real estate investment trust securities, as defined in Rule 2340(c)(4), unless the trustee will disclose in each annual report distributed to investors pursuant to Section 13(a) of the Act a per share estimated value of the trust's securities, the method by which it was developed, and the date of the data used to develop the estimated value. (emphasis supplied)

This amendment to Rule 2710 remained in Rule 2710 until FINRA adopted Rule 5110. The amendment remains unchanged in Rule 5110(f)(2)(M) and is also set forth in FINRA Rule 2310(b)(5).

### **Comments on Proposed Amendments**

The proposed replacement of subsection (c)(4) of Rule 2340 with subsection (c)(2)(A) is certainly an improvement of the rule for the benefit of investors. The proposed amendment changes the basis on which a member must refrain from including a per share estimated value for a DPP or REIT security on an account statement as follows: from the ability of the member to demonstrate that the value is inaccurate or later becomes inaccurate to a member knowing or having reason to know based on information from any source that the value provided by the sponsor in its annual report is unreliable. The broadening of the standard under which a member must refrain from providing an inaccurate per share estimated value on an account statement is certainly beneficial to investors.

However, the proposed amendment set forth in subsection (c)(2)(B) is troubling and is contrary to the interests of investors. Under current subsections (c)(1)(B) and subsection (c)(4), if a member can demonstrate that the value of a DPP or REIT security set forth in the annual report filed by the sponsor with the SEC is inaccurate or later becomes inaccurate, the member is still obligated to include an estimated value from an independent valuation service or another source.

Under the proposed amended subsection (c)(2)(B), a member may refrain from including a per share estimated value if the most recent annual report of a DPP or REIT does not contain a per share estimated value in compliance with the requirements of subsections (c)(1)(B) or (C). The proposed amendment in subsection (c)(2)(B) allows a member to refrain from providing a per share estimated value, so long as the member makes the disclosures set forth in subsection (c)(3).

Under the existing rule, a member still must provide an estimated value from a source other than the annual report for a DPP or REIT if the member can demonstrate the value set forth in the annual report is inaccurate or has become inaccurate as a result of material changes in the operations or assets of the program or trust. Relieving members of their obligation to provide per share estimated value of DPP or REIT securities if a member knows or has reason to know that the value stated in the annual report is inaccurate is a disservice to investors and is contrary to the intent of the previous changes to NASD Conduct Rules 2340, 2710, and 2810.

The proposed amendments to subsections (c)(1)(B) and (C) are both potentially beneficial to investors and detrimental to investors. In proposed subsection (c)(1)(B), FINRA gives its express approval of the use of offering price or cost basis, reduced by the amount of organization and offering expenses, as a permissible estimated value during the Initial Offering Period. Certainly, the requirement that organization and offering expenses be deducted from per share estimated value based upon the offering price of the securities, is beneficial to investors. However, allowing offering price or cost basis during the Initial Offering Period to be utilized as the basis for an estimated value is a disservice to investors and is contrary to the intent and express provisions of FINRA Rules 2310(b)(5) and 5110(f)(2)(M).

Subsection (b)(5) of Rule 2310 prohibits members from participating in a public offering of DPP or REIT securities unless the general partner or sponsor of the program or REIT will disclose in each annual report distributed to investors a per share estimated value of the securities, the method by which that value was developed, and the date of the data used to develop the estimated value. Subsection (f)(2)(M) of Rule 5120 contains the same prohibition with respect to REIT securities. The intent of the 2000 amendments to NASD Conduct Rules 2340, 2710, and 2810, as stated in the SEC Release, was to help ensure that general partners and sponsors of DPPs and REITs would provide per share valuation information based upon financial statements contained in annual reports. We submit that reporting offering price or cost basis as the estimated value of DPP or REIT securities is not a "method" by which a per share estimated value is

"developed" and is not based on anything in the financial statements set forth in an annual report.

In Regulatory Notice 09-09, FINRA provided guidance with respect to the use of "Par Value" as estimated value. The notice stated: "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." (emphasis supplied)

In proposed subsection (c)(1)(B), FINRA gives its express authorization to use offering price or cost basis, reduced by the amount of organization and offering expenses, as per share estimated value. Per share estimated value based upon offering price, reduced by organization and offering expenses, may well bear little, if any, relationship to an accurate estimated value of shares.

In FINRA's allegations in its May, 2011, enforcement complaint against David Lerner & Associates, FINRA documents that the Apple REIT sponsor paid distributions to shareholders during the offering period from borrowed funds and investors' capital. Information available from the financial statements of other REIT sponsors indicates that several other REIT sponsors have paid and are paying distributions with borrowed funds and investors' capital. The only manner in which a reasonably accurate estimated value may be obtained during the Initial Offering Period, and thereafter, is from an appraisal of the assets, liabilities, and operations of a REIT.

The requirement of proposed subsection (c)(1)(C) that per share estimated value be calculated based on appraisal of the assets, liabilities, and operations of a DPP or REIT after the Initial Offering Period is clearly beneficial to investors. However, such appraisals should be required as the basis for per share estimated values of DPP or REIT securities during the Initial Offering Period, as well.

Whatever beneficial effects the proposed amendments in subsections (c)(1)(B) and (C) may have for investors are vitiated by proposed subsection (c)(2)(B). Under that subsection, a member may refrain from providing a per share estimated value on investor account statements if the annual report of a DPP or REIT does not contain a per share estimated value that complies with the requirements of sections (1)(B) or (1)(C). All general partners or sponsors have to do to avoid a member reporting a per share estimated value on investor account statements which is lower than offering price is to fail to provide per share estimated values in annual reports in compliance with subsections (c)(1)(B) or (C).

Per share estimated values should be required to be based upon appraisals of the assets, liabilities, and operations of a DPP or REIT beginning with the first annual report filed with the SEC. If general partners or sponsors fail to provide per share estimated values based upon such appraisals, members should be required to report per share estimated value based upon an analysis of the financial statements in an annual report by an independent valuation service or another source.

There is an alternative available to place the burden of providing per share estimated values on general partners or sponsors, rather than FINRA members. To

ensure that general partners and sponsors provide per share estimated values based upon an analysis of the assets, liabilities, and operations of DPPs and REITs, FINRA could and should propose amendments to subsection (b)(5) of FINRA Rule 2310 and subsection (f)(2)(M) of Rule 5110. Those proposed amendments should provide that members are barred from participating in a public offering of DPP or REIT securities unless the general partner or sponsor of the program or REIT will disclose in each annual report a per share estimated value based upon an annual appraisal of the assets, liabilities, and operations of the program or REIT.

Respectfully submitted,



Ryan K. Bakhtiari  
Aidikoff, Uhl & Bakhtiari  
9454 Wilshire Blvd., Suite 303  
Beverly Hills, California 90212  
Telephone (310) 274-0666  
Fax (310) 859-0513  
[rbakhtiari@aol.com](mailto:rbakhtiari@aol.com)