December 15, 2023

Via electronic submission to rule-comments@sec.gov

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number SR-FINRA-2023-016 (the "FINRA Proposal")[1]

Dear Ms. Countryman:

The Institute for Portfolio Alternatives appreciates the opportunity to comment on the Financial Industry Regulatory Authority ("FINRA") Proposal, which would create a new, narrowly tailored exception to the general prohibition of projections in FINRA Rule 2210, consistent with FINRA's mission of investor protection.[2]

The Institute supports the FINRA Proposal, and respectfully recommends that the United States Securities and Exchange Commission (the "Commission") and FINRA consider a modest extension of its scope.

1. The FINRA Proposal Reflects Recent Regulatory and Market Developments.

On August 7, 2023, the Institute commented on FINRA's Regulatory Notice 23-09, in which FINRA solicited suggestions for how it might improve capital formation. (We have attached a copy of our comment letter.)

As we stated in our August 7th comment letter, recent regulatory and market developments justify reconsideration of the prohibition on performance projections in FINRA Rule 2210(d)1)(F). For example, the Commission and FINRA have imposed stricter regulations on the distribution of privately

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[1] *See* 88 Federal Register 82482 (November 24, 2023).

[2] For more than 35 years, the Institute has advocated for increased investor access to portfolio diversifying investment strategies, accompanied by straightforward disclosure about their risks and benefits and strong investor protection from inappropriate sales practices. Our members include the asset management companies that sponsor diversifying investments, wirehouse broker-dealers, independent broker-dealers, regional broker-dealers, registered investment advisers, law firms, accounting firms, transfer agents, valuation firms, due diligence firms, and technology firms.

placed securities by broker-dealers. The best interest standard and the Care, Disclosure, Conflict of Interest, and Compliance Obligations in Regulation Best Interest ("Reg BI") demand that broker-dealers bring a higher level of scrutiny and supervision to their securities recommendations. FINRA and the Commission have backed up these sales practice requirements with vigorous inspection, examination and enforcement programs.

FINRA's extensive guidance concerning the distribution of private placements, such as in Regulatory Notice 23-08 and Regulatory Notice 20-21, has clarified the obligations of broker-dealers that distribute privately placed securities. FINRA's filing program under Rules 5122 and 5123 ensures that its Corporate Financing Department has a window into the sale of private placements by broker-dealers. This innovative program has improved FINRA's oversight of broker-dealers who recommend privately placed securities and their compliance with the obligation to conduct a reasonable investigation of the issuer under Reg BI and FINRA rules.

The markets have changed in recent years, too. As the Commission is aware, much of the wealth management business has migrated to the investment adviser channel. Fifty percent of FINRA-registered individuals are dually licensed investment adviser representatives.[3] Forty-five percent of all securities industry registered individuals are dually licensed, and another 11% are only licensed investment adviser representatives.[4]

This convergence between the broker-dealer and investment advisory businesses means that dually licensed representatives are more likely to emphasize portfolio construction and asset allocation. As a result, their recommendations are better aligned to the long-term interests of the client, under a best interest or fiduciary standard of care. Moreover, while not identical to the fiduciary standard in the Investment Advisers Act, the requirements of Reg BI are substantially similar to the fiduciary standard applicable to investment advisers.[5]

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[3] *See* FINRA Industry Snapshot 5 (Figure 1.4) (2022), https://www.finra.org/sites/default/files/2022-03/2022-industry-snapshot.pdf.

[4] *Id.*

[5] *See, e.g.,* Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations, https://www.sec.gov/tm/standards-conduct-broker-dealers-and-investment-advisers (April 20, 2023):

> Although the specific application of Reg BI and the IA fiduciary standard may differ in some respects and be triggered at different times, in the staff's view, they generally yield substantially similar results in terms of the ultimate responsibilities owed to retail investors.

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These regulatory and market developments justify the adoption of carefully-crafted measures to improve capital formation. The FINRA Proposal represents such a measure.

2. The FINRA Proposal Would Appropriately Allow Limited Use of Projected Performance and Targeted Returns, Subject to Important Investor Protections.

The FINRA Proposal would permit broker-dealers to use performance projections and targeted returns in communications with "projection eligible investors." Projections and targeted returns would be permitted for (1) institutional communications and for (2) communications distributed or made available to qualified purchasers, as defined in the Investment Company Act of 1940, that promote or recommend a private placement made only to qualified purchasers (a "QP Private Placement").

We agree with FINRA that the proposed rule change could "better inform Projection-Eligible Investors about the individual security and the underlying assumptions upon which the recommendations are based."[6] Broker-dealer customers request other types of projected performance and targeted returns than FINRA rules currently allow. For example, they may seek their broker-dealer's views regarding the projected performance of an investment strategy or single security for their own information or to help them evaluate performance projections they have received from the issuer.[7]

The FINRA Proposal would impose a variety of conditions to protect investors. For example, the broker-dealer would have to adopt written policies and procedures reasonably designed to ensure that the communication is relevant to the likely financial situation and investment objectives of the investor receiving the communication and to ensure compliance with all applicable requirements and obligations. The broker-dealer would need a reasonable basis for the criteria used and assumptions made in calculating the performance projections or targeted returns and would have to provide sufficient information to enable the investor to understand those criteria and assumptions and the risks and limitations of using the performance projections or targeted returns in making investment decisions. The communication would have to prominently disclose that the performance projection or targeted return is hypothetical in nature and that there is no guarantee that the projection or targeted return will be achieved.

These conditions resemble the requirements of the Commission's marketing rule for investment advisers. Indeed, "FINRA anticipates that it would interpret requirements in the proposed rule change that align with similar requirements in the IA Marketing Rule consistently with how the Commission has

[6] FINRA Proposal at 82489.

[7] FINRA Proposal at 82483.

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interpreted those IA Marketing Rule requirements."[8] As a result of these conditions, the FINRA Proposal would better inform investors, confer important investor protections, and harmonize communications requirements that apply to the broker-dealer and investment adviser businesses of dually-registered firms.

For these reasons, the Institute supports the FINRA Proposal.

3. The Commission's Adoption of Reg BI and Other Commission and FINRA Requirements Could Justify Broader Relief.

If a communication is provided to retail customers of a broker-dealer, the FINRA Proposal would permit it to include a performance projection or targeted return only if the retail customer has at least $50 million in total assets, or $5 million in investments when the communication concerns a QP Private Placement.

The FINRA Proposal probably would provide little benefit to the vast majority of retail customers. The median value of household wealth in the United States is $166,900. Ninety percent of American households have wealth of less than $1,623,000.[9] This data implies that under the FINRA Proposal few retail investors would receive information that, in FINRA's rules, could "better inform" them "about the individual security and the underlying assumptions upon which the recommendations are based."[10] Moreover, due to the relatively limited scope of the FINRA Proposal, issuers would be less likely to offer their securities through regulated broker-dealers, contrary to a laudable objective of the FINRA Proposal of encouraging distribution through regulated broker-dealers .[11]

The Institute recognizes FINRA's longstanding concern with the use of performance projections in a manner that could mislead investors. We also appreciate that FINRA and other regulators have had to address by enforcement action and rulemaking the poor sales practices of some broker-dealers when conducting private placements. Nevertheless, there is room for sensible accommodation of the need for broker-dealers and their customers to consider performance projections and targeted returns of private investment programs.

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[8] FINRA Proposal at 82487.

[9] *See* "The Wealth of Households: 2021," https://www.census.gov/content/dam/Census/library/publications/2023/demo/p70br-183.pdf (United States Census Bureau).

[10] FINRA Proposal at 82489.

[11] FINRA Proposal at 82488.

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For the reasons stated below, the Institute respectfully recommends that FINRA and the Commission consider a modest extension of the FINRA Proposal's scope to include broker-dealer communications distributed or made available only to accredited investors under Regulation D that *recommend* (and not merely promote) private placements offered only to accredited investors ("Accredited Investor Private Placements"), and that comply with the FINRA Proposal's other requirements.

A. Reg BI Justifies More, Not Less Information.

We respectfully suggest that the investor protections in Reg BI give the Commission and FINRA reasonable latitude to allow the increased flow of useful information to retail customers. As we explained in our August 7th letter to FINRA, the Commission's adoption of Reg BI should justify permitting communication of fair, balanced and not misleading performance projections and targeted returns in communications concerning a broker-dealer's recommendation of a security, such as securities offered in a private placement. Under Reg BI, a broker-dealer's securities recommendation must be in the retail customer's best interest. The broker-dealer must exercise reasonable diligence, care and skill and must disclose the material facts about the brokerage relationship and conflicts of interest associated with the recommendation. The broker-dealer must adopt policies and procedures reasonably designed to address conflicts of interest related to the recommendation and must adopt reasonably designed compliance procedures. The requirements of Reg BI are substantially similar to the fiduciary standard applicable to investment advisers.

If a performance projection or targeted return concerns a recommendation as opposed to merely promoting a security or investment strategy, then Reg BI would help ensure that the resulting recommendation is in the retail customer's best interest. Reg BI would provide an added substantive protection beyond the requirements that the FINRA Proposal would impose on the communication itself. For this reason, Reg BI should give FINRA more latitude to permit performance projections and targeted returns in communications that make a securities recommendation. The Institute does recommend that these performance projections and targeted returns comply with the other requirements of the FINRA Proposal.

B. Other Requirements Justify an Extension of the Scope of the FINRA Proposal.

Other Commission and FINRA requirements also justify a modest extension of the scope of the FINRA Proposal. For example, members participating in a private placement must file the private placement memorandum and retail communications with FINRA under Rules 5122 and 5123. FINRA's Corporate Financing Department considers whether the member appears to have conducted a reasonable investigation of the issuer. FINRA expects its members to adopt supervisory procedures that are "reasonably designed to ensure that each private placement offering is properly supervised before

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it is marketed to other members or sold directly to customers."[12] A positive consequence of this regulatory oversight has been FINRA's observation that some broker-dealers have adopted good practices by which they discharge their responsibilities when recommending private placements.[13]

Finally, many retail investors in private placements are accredited investors under Regulation D. Accredited investors are held by the Commission to possess the financial sophistication and ability to sustain the risk of loss for an investment in a Regulation D offering, or to have the ability to make their own determinations regarding such an investment.

A FINRA member that conducts rigorous due diligence about an Accredited Investor Private Placement and concludes that purchase of the security would be in the best interest of a retail customer who is an accredited investor, should be permitted to provide reasonable performance projections and targeted returns to the retail customer in a communication that recommends the Accredited Investor Private Placement – and complies with the FINRA Proposal's other conditions.

* * *

For these reasons, the Institute respectfully recommends that FINRA and the Commission consider a modest extension of the FINRA Proposal's scope to include communications distributed or made available only to accredited investors that recommend Accredited Investor Private Placements and that comply with the FINRA Proposal's other requirements.

The Institute appreciates the opportunity to comment on the FINRA Proposal. Should you have any questions about our comments, please feel free to contact me or Gina Gombar at (617) 710-7272.

Sincerely,

Anya Coverman
President and CEO

Attachment

[12] Regulatory Notice 23-08, https://www.finra.org/rules-guidance/notices/23-08.

[13] *Id.*

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IPA
Institute for Portfolio Alternatives

August 7, 2023

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506
PubCom@finra.org

Re: Regulatory Notice 23-09 (the "Notice")

Dear Ms. Mitchell:

The Institute for Portfolio Alternatives commends FINRA for its successful measures to improve capital formation for businesses of all sizes.[1] We also appreciate the opportunity to provide suggestions for other steps that could facilitate capital raising. The Institute represents the sponsors and distributors of alternative investments, including net asset value ("NAV") REITs and business development companies ("BDCs"), lifecycle REITs and BDCs (i.e., REITs and BDCs that are not continuously offered but do maintain share repurchase programs),[2] interval funds, tender offer funds, and regulated distributors of private placement securities.

1. FINRA's Rules Should Reflect Improvements in the Distribution and Structure of Alternative Investments.

The distribution and structure of alternative investments have evolved from the days when FINRA adopted many of its rules. FINRA and the Securities and Exchange Commission (the "Commission") have intensified their regulation of alternative products and the distribution of alternative investments through the broker-dealer channel. The best interest standard and the Care, Disclosure, Conflict of Interest, and Compliance Obligations in Reg BI demand that broker-dealers bring a higher level of scrutiny and supervision to the recommendation of complex

[1] For over 35 years, the Institute has advocated for increased investor access to alternative investment strategies with low correlation to equity markets, as part of a diversified portfolio. These strategies include real estate, public and private credit and other real assets through investment vehicles such as REITs, BDCs, closed-end funds, interval funds and private placements. With nearly $300 billion in capital investments, these portfolio diversifying investments are a critical component of an effectively balanced investment portfolio and serve an essential capital formation function for our national, state and local economies.

[2] While no lifecycle REITs and BDCs are currently being offered, many are still in an operational phase and continue to be regulated by the Commission.

products, including alternative investments offered by the Institute's members.[3] FINRA and the Commission have backed up these sales practice requirements with vigorous inspection, examination and enforcement programs.

FINRA's extensive guidance concerning the distribution of private placements, such as in the companion notice Regulatory Notice 23-08 and Regulatory Notice 20-21, has clarified the obligations of broker-dealers. FINRA's filing program under Rules 5122 and 5123 ensures that its Corporate Financing Department has a window into the sale of private placements by broker-dealers. This innovative program has improved FINRA's oversight of broker-dealers who recommend privately placed securities and their compliance with the obligation to conduct a reasonable investigation of the issuer under Reg BI and FINRA rules.

FINRA also amended Rule 2230 to require more transparency in the valuation of nonlisted REITs and BDCs. These amendments forced dramatic changes in the structure of these products, from lifecycle REITs and BDCs to perpetual life NAV REITs and BDCs that provide more valuation transparency, lower fees and expenses, and enhanced liquidity options for investors. NAV REITs and BDCs are managed by some of the most reputable global asset management companies and they are distributed by fiduciary investment advisers, wirehouses, and independent dealer firms.

Of course, the Investment Company Act of 1940 continues to apply to interval funds and tender offer funds and many provisions of the Act apply to NAV BDCs.

As FINRA is aware, much of the wealth management business has migrated to the investment adviser channel. Fifty percent of FINRA-registered individuals are dually licensed investment adviser representatives.[4] Forty-five percent of all securities industry registered individuals are dually licensed, and another 11% are only licensed investment adviser representatives.[5] The historical concern that brokers will flack risky securities to earn high commissions has been ameliorated by the new emphasis by dually-licensed representatives on portfolio construction, asset allocation, and fee-based wealth management. Their recommendations are better aligned to the long-term interests of the client, under a best interest or fiduciary standard of care. The adoption of Reg BI has also raised the standards for broker-dealers making recommendations to purchase securities, including alternative investments. While not identical to the fiduciary standard in the Investment Advisers Act, the

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[3] *See, e.g.,* Securities Exchange Act Release No. 86031 (June 5, 2019), 84 FR 33318, 33376 (July 12, 2019) (Reg BI Adopting Release) (''reasonable-basis'' component of the Care Obligation especially important when broker-dealers recommend securities and investment strategies that are "complex or risky"); FINRA Regulatory Notice 22-08 (March 8, 2022) (complexity of a product "often necessitates more member firm scrutiny and supervision"), https://www.finra.org/rules-guidance/notices/22-08.

[4] *See* FINRA Industry Snapshot 5 (Figure 1.4) (2022), https://www.finra.org/sites/default/files/2022-03/2022-industry-snapshot.pdf.

[5] *Id.*

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requirements of broker-dealers in making investment recommendations to customers are substantially similar to the fiduciary standard applicable to investment advisers.[6]

If FINRA and the Commission believe, as we do, that these new regulatory programs better protect the customers of broker-dealers, then they might consider how this improved protection has made other strictures superfluous or unnecessary. We encourage FINRA, as it develops new ways to facilitate capital formation, to consider how alternative investments have evolved to better suit the needs of retail customers. Within the context of these improvements, FINRA could adopt the following modest recommendations to improve capital formation by American business.

2. The Institute Recommends that FINRA Allow Limited Use of Projected Performance.

FINRA Rule 2210 generally prohibits the presentation of performance projections. Paragraph (d)(1)(B) prohibits the presentation of any "promissory" statement or claim in any communication. Under paragraph (d)(1)(F), communications may not "predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast."

Retail communications may not project target returns, yields, income, dividends, capital appreciation, percentages or any other future investment performance.[7] Internal rates of return for privately placed new investment programs that have no operations are projections prohibited by paragraph (d)(1)(F).[8] Unrealized holdings for an investment may not be shown under paragraph (d)(1)(F).[9] Retail communications -- and any type of communication concerning unlisted real estate investment programs -- may not include an annualized

[6] *See, e.g.,* Staff Bulletin: Standards of Conduct for Broker-Dealers and Investment Advisers Care Obligations, https://www.sec.gov/tm/standards-conduct-broker-dealers-and-investment-advisers (April 20, 2023):

> Although the specific application of Reg BI and the IA fiduciary standard may differ in some respects and be triggered at different times, in the staff's view, they generally yield substantially similar results in terms of the ultimate responsibilities owed to retail investors.

[7] *See* Regulatory Notice 20-21, https://www.finra.org/rules-guidance/notices/20-21; https://www.finra.org/rules-guidance/guidance/faqs/advertising-regulation (D.7.1.).

[8] *See* Regulatory Notice 20-21, https://www.finra.org/rules-guidance/notices/20-21; https://www.finra.org/rules-guidance/guidance/faqs/advertising-regulation (D.6.1.). Although the answer refers to Regulatory Notice 20-21, which only applies to retail communications, the answer itself seems to apply to all communications.

[9] *See* https://www.finra.org/rules-guidance/guidance/faqs/advertising-regulation (D.6.2.).

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distribution rate until the program has paid stated distributions, on an annualized basis, at a minimum equal to that rate for at least two consecutive quarterly periods.[10]

Over time, FINRA has provided the following limited exceptions to these prohibitions:

- hypothetical illustrations of mathematical principles that do not project the performance of an investment or investment strategy;[11]
- investment analysis tools under Rule 2214;[12]
- certain price targets in research reports;[13]
- certain GIPS-compliant internal rates of return for investment programs with ongoing operations;[14] and
- reasonable forecasts of issuer operating metrics.[15]

As this description makes apparent, Rule 2210 does not apply neatly to communications about private placement securities. Some of these prohibitions apply to all communications, and some apply only to retail communications. A FINRA member may not present distribution rates in retail communications -- but for unlisted real estate investment programs in *any* communication -- unless the program has maintained the stated distributions rate for two quarters. A communication may present a forecast of the issuer's operating metrics, but apparently may not combine those metrics into a single return number such as net operating income divided by amount invested. A member may present GIPS-compliant IRR for an ongoing program, but not for one that is being launched. A communication may present performance from realized holdings but not from unrealized holdings, even when the valuation of those unrealized holdings can be estimated.

The expected or targeted return from a private investment program is material to an investor. It essentially represents the "price" of the deal. The projected cash-on-cash return for

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[10] *See* Regulatory Notice 20-21, https://www.finra.org/rules-guidance/notices/20-21; Regulatory Notice 13-18, https://www.finra.org/rules-guidance/notices/13-18.

[11] Rule 2210(d)(1)(F).

[12] *Id.*

[13] *Id.*

[14] https://www.finra.org/rules-guidance/guidance/faqs/advertising-regulation (D.6.1).

[15] *See* Regulatory Notice 20-21, https://www.finra.org/rules-guidance/notices/20-21; https://www.finra.org/rules-guidance/guidance/faqs/advertising-regulation (D.7.1.).

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a business investment, the distribution yield for a real estate program, and the internal rate of return for private equity funds are vital to any understanding of these programs. They help investors evaluate the benefits of the program, the nature of the issuer's projections, and whether the program can accommodate the investor's needs. In fact, they are useful to evaluate the *risk* of a product. A higher-than-average distribution yield, for example, could imply that a higher risk premium has been imbedded into the calculation of projected yield.

The Institute recognizes FINRA's longstanding concern with the use of performance projections in a manner that could mislead investors. We also appreciate that FINRA and other regulators have had to address by enforcement action and rulemaking the poor sales practices of some members when conducting private placements. Nevertheless, there is room for sensible accommodation of the need for members and their customers to consider projected returns of private investment programs.

As FINRA is aware, Reg BI imposes an obligation on FINRA members to act in their retail customer's best interest when recommending a security. Under Reg BI, the member must exercise reasonable diligence, care and skill and must disclose the material fees and costs associated with a recommended transaction. Members participating in a private placement must file the private placement memorandum and retail communications with FINRA under Rules 5122 and 5123. FINRA's Corporate Financing Department considers whether the member appears to have conducted a reasonable investigation of the issuer. FINRA expects its members to adopt supervisory procedures that are "reasonably designed to ensure that each private placement offering is properly supervised before it is marketed to other members or sold directly to customers."[16] A positive consequence of this regulatory oversight has been FINRA's observation that some broker-dealers have adopted good practices by which they discharge their responsibilities when recommending private placements.[17]

Rule 2210 operates as if these regulatory programs do not exist. A FINRA member who conducts rigorous due diligence, concludes that the investment would be in the customer's best interest, and discloses the costs, fees and risks to the customer, may not present reasonable issuer projections in any written communication to the customer (outside of FINRA's limited exceptions).

We recommend that FINRA adopt modest changes to Rule 2210 to allow broker-dealers who recommend private placements and other investments under Reg BI or FINRA Rule 2111 (Suitability), to provide the customer with performance projections in a way that is fair, balanced and not misleading. FINRA would retain its existing prohibition of performance projections in situations that present the greatest risk: broadly circulated marketing material

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[16] Regulatory Notice 23-08, https://www.finra.org/rules-guidance/notices/23-08.

[17] *Id.*

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that is unrelated to a member's best interest determination.[18] Moreover, registered principals would have to approve communications with projected performance under Rule 2210(b)(1). Retail communications that promote or recommend private placements still would have to be filed under Rules 5122 and 5123.

We thus recommend that FINRA permit performance projections to potential and existing customers in any correspondence, institutional communication[19] or template that might be classified as a "retail communication" under Rule 2210, when:

- the projection has a reasonable basis and meets the other content standards of Rule 2210(d)(1)(A) and (B);[20]

- the broker-dealer has adopted policies and procedures reasonably designed to ensure that the projected performance is relevant to the potential and existing customers receiving the recommendation;

- the communication provides sufficient information for the potential and existing customers to understand the criteria and assumptions in the projected performance; and

- the communication provides sufficient information to enable the potential and existing customers to understand the risks and limitations of using the projected performance in making investment decisions.

We provide suggested text in the Attachment.

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[18] We thus recommend that FINRA retain the existing prohibitions on performance projections for most retail communications, which by definition are written communications to more than 25 retail investors. Retail communications are less likely to be associated with a recommendation subject to Reg BI or FINRA Rule 2111 (Suitability). We do recommend one exception to the exclusion of retail communications, however. Performance projections should be permitted in a template that updates more recent statistical or other non-narrative information, similar to previously-filed templates under paragraph (c)(7)(B)(i), when the information is provided in connection to a recommendation. The projected performance within the communication, which would not be part of the template, is relevant to particular customers even if the template information is provided to more than 25 retail investors.

[19] We recommend that FINRA permit the use of projected performance in institutional communications, including those delivered to institutional accounts under Rule 4512(c). FINRA might consider broadening its permission of projected information to other sophisticated investors, such as qualified purchasers under the Investment Company Act of 1940.

[20] For example, the presentation would have to be fair and balanced, provide a sound basis for evaluating the recommended security, could not omit material information, and could not be false, exaggerated, unwarranted, promissory, or misleading.

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Our recommendation is even more restrictive than the Commission's marketing rule for investment advisers, Rule 206(4)-1 under the Investment Advisers Act. For example, we do not recommend that FINRA permit other performance that the Commission defines as "hypothetical performance," such as model or back-tested performance.[21] We also recommend that FINRA exclude most retail communications, unlike the Commission's marketing rule, which allows performance projections in widely-circulated advertisements.[22] FINRA has been most concerned with performance of projections in retail communications related to private placements.[23]

This carefully crafted change to Rule 2210 would be consistent with the principles of Reg BI, it would preserve important investor protections, and it would help small businesses raise their needed capital through the broker-dealer channel.

3. The Institute Recommends that FINRA Amend Rule 5110(h)(2).

The Institute recommends that FINRA amend Rule 5110 to treat publicly registered NAV REITs and BDCs the same as tender offer funds. Rule 5110(h)(2)(L) provides that tender offer funds are not subject to Rule 5110, Rule 2310 and Rule 5121, "including not being required to file documents and information for review." Paragraph (L) restricts this exception to tender offer funds that (1) make continuous offerings under Securities Act Rule 415, (2) price their securities at least quarterly, (3) limit the total amount of compensation paid to participating members to the amount permitted by the sales charge limitations of Rule 2341, (4) make at least two repurchase offers per calendar year for their securities under Securities Exchange Act Rule 13e-4 and Schedule TO under the Securities Exchange Act, and (5) do not list their securities on a national securities exchange.

Tender offer funds that invest in real estate assets directly compete with NAV REITs, and those that invest in small business debt or equity directly compete with NAV BDCs. The compliance costs that NAV REITs and BDCs incur in complying with Rule 5110 and Rule 2310 are not justified by any perceptible benefit to their shareholders. In order to create an even playing

[21] *See* Rule 206(4)-1(e)(8)(i).

[22] Rule 206(4)-1 includes targeted or projected performance within its definition of "hypothetical performance." *See* Rule 206(4)-1(e)(8)(i)(C). The rule restricts the use of performance projections in "advertisements," which includes "any direct or indirect communication an investment adviser makes to . . . one or more persons if the communication includes hypothetical performance, that offers the investment adviser's investment advisory services with regard to securities to prospective clients." *See* Rule 206(4)-1(e)(1)(i). The rule permits the presentation of hypothetical performance when the adviser (1) has adopted policies and procedures reasonably designed to ensure that it is relevant to the intended audience (2) provides – or for a private fund, offers to provide promptly -- sufficient information for the intended audience to understand the criteria and assumptions, and (3) provides sufficient information to enable the intended audience to understand the risks and limitations of using the hypothetical performance in making investment decisions. *See* Rule 206(4)-1(d)(6).

[23] See Regulatory Notice 20-21, https://www.finra.org/rules-guidance/notices/20-21.

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field and to encourage capital formation by NAV REITs and BDCs, FINRA should treat NAV RETs and BDCs the same as tender offer funds under paragraph (h)(2).

Most publicly registered NAV REITs and BDCs are able to satisfy conditions similar to those for tender offer funds in paragraph (h)(2)(L). They continuously offer their shares under Rule 415. They price their shares at least quarterly, with many pricing more frequently, on either a monthly or daily basis. They can comply with the caps applied under Rule 5110, and perhaps could comply with sales charge limitations similar to those in Rule 2341. They make regular repurchases of their shares on at least a quarterly basis, with many repurchasing shares more frequently, on either a monthly or daily basis.[24] Finally, their shares are not listed on a national securities exchange.

For competitive fairness and to encourage capital formation, the Institute recommends that FINRA amend Rule 5110(h)(2) to include NAV REITs and BDCs. We provide suggested text in the Attachment.

4. Alternatively, the Institute Recommends that FINRA Clarify Rule 5110.

Should FINRA not accept our recommendation to amend Rule 5110(h)(2) to include NAV REITs and BDCs and chooses to maintain the disparity between FINRA's treatment of these funds and competing tender offer funds, the Institute recommends that FINRA interpret Rule 5110 to address two issues presented by its application to NAV REITs and BDCs.

First, we respectfully recommend that FINRA clarify that any shares received for a seed investment by the sponsor of a NAV REIT or BDC before the offering – even if the sponsor made the investment during the review period -- is excluded from the definition of "underwriting compensation." Sponsors often provide a seed investment, much like the sponsors of registered investment companies, in order to permit the acquisition of assets and the calculation of a net asset value on the underlying portfolio. When the sponsor purchases shares with cash, the cash constitutes the only asset in the fund and the shares are valued according to the number of shares issued and the cash provided. For example, if the sponsor contributes $10 million to a REIT and receives 1,000,000 shares, each share has an initial value of $10. The REIT's subsequent use of that cash to purchase properties or other assets is a transaction separate and distinct from the sponsor's cash seed investment.

It is possible that the NAV REIT or BDC will purchase assets at a discount to the market value or will earn income from any assets that it purchases, in which case the NAV first calculated by the fund will be greater than $10 per share in our example. This fact does not

[24] Their share repurchases are not required to comply with Rule 13e-4 and Schedule TO, pursuant to Commission staff no-action positions. *See, e.g., Blackstone Real Estate Income Trust, Inc.*, https://www.sec.gov/divisions/corpfin/cf-noaction/2016/blackstone-real-estate-income-trust-091216-13e-4.pdf (September 12, 2016).

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imply that the sponsor purchased the initial shares at a discount. In our example, $10 million in cash went into the REIT, and the REIT issued 1,000,000 shares worth $10 per share.

In short, the initial seed investment does not constitute a "payment, right, interest, or benefit received or to be received by a participating member from any source for underwriting, allocation, distribution, advisory and other investment banking services in connection with a public offering."[25] The Institute therefore respectfully recommends that FINRA clarify that under Rule 5110 these shares are excluded from the definition of "underwriting compensation."

Second, we recommend that the Corporate Financing Department streamline its process for reviewing NAV REIT and BDC filings under Rule 5110 and Rule 2310. Today, outside counsel to sponsors must submit an itemized list of all possible sources of underwriting compensation, including sales charges, ongoing servicing fees, reimbursement of travel and entertainment expenses, payment of compensation to the registered representatives of the dealer manager who act as wholesalers, gifts and expenses associated with hosting and attending broker-dealer and investment adviser conferences and events.

With the advent of the NAV REIT and BDC, the total amount of compensation from these items rarely exceeds the caps on underwriting compensation. NAV REITs and BDCs typically provide in their charter that if the total underwriting compensation paid ever equals ten percent of the gross proceeds of the primary portion of the offering, all shares with respect to which an ongoing stockholder servicing fee is charged will convert to a class of no-load shares for which no such fee is charged.

In order to simplify the Department's review of these offerings and to reduce filing costs to sponsors, we respectfully recommend that, in lieu of the requirement that sponsors provided an itemized list of underwriting compensation sources, the Department permit sponsors of NAV REITs and BDCs simply to provide a statement that (1) acknowledges the existence of the underwriting caps in Rule 5110 and Rule 2310, (2) states that the REIT or BDC has a charter provision designed to ensure that it does not breach those caps, and (3) states that the sponsor will promptly notify the Department if the caps are breached.[26]

5. The Institute Recommends that FINRA Clarify Rule 2310.

The Institutes recommends that FINRA clarify that Rule 2310(b)(2)(C) does not apply to a FINRA member who only executes the purchase of an offered direct participation program ("DPP") upon the order of another financial intermediary without recommending the purchase to the intermediary's customer.

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[25] Rule 5510(j)(22) (definition of "underwriting compensation").

[26] Our recommendation should not represent a significant departure from, and would resemble, the Department's limited review program.

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FINRA Rule 2310(b)(2)(A) prohibits any member or associated person from underwriting or participating in a public offering of a DPP unless the DPP has established suitability standards under paragraph (B). Paragraph (B) elucidates the suitability standards applicable to a member or associated person "recommending" a DPP transaction to a "participant," which the rule separately defines to be one who purchases the DPP.[27]

FINRA Rule 2310(b)(2)(C) states, "[n]otwithstanding the provisions of subparagraphs (A) and (B) hereof, no member shall execute any transaction in direct participation program in a discretionary account without prior written approval of the transaction by the customer." This provision requires that for discretionary accounts, the member have prior written approval of the transaction by the customer before it can complete the purchase of a DPP interest.

Paragraph (C) should not be read in isolation as pertaining to *any* member, even one who does not recommend that DPP purchase. Rather, the text, purposes, and history of this provision imply that paragraph (C) is related to paragraphs (A) and (B). This reading is indicated by the prefatory language in paragraph (C), "notwithstanding the provisions of subparagraphs (A) and (B) hereof." Paragraph (C) is an exception to paragraphs (A) and (B), which concern only members who recommend DPP securities. Neither paragraph (A) nor paragraph (B) refers to a broker-dealer who does no more than execute the transaction.[28]

The history of Rule 2310 supports this reading. A predecessor to this rule was Appendix F to Article III, Section 34 of the Rules of Fair Practice, adopted in 1982, which applied only to a member "recommending" a DPP interest.[29]

Nevertheless, we understand that the FINRA staff interprets paragraph (C) to generally prohibit a member's execution of any DPP transaction in a discretionary account. This reading prevents "turnkey" platforms such as those offered by Charles Schwab, TD Ameritrade, NFS, and Pershing, from acting solely as the broker-dealer of record to execute a DPP transaction on behalf of registered investment advisers. These FINRA members must obtain written documentation with express affirmative instructions from the shareholder to purchase the DPP securities before the platforms could process the DPP trade, even when the investment adviser's customer has already contractually given discretionary trading authority to the investment adviser.

This application of paragraph (C) provides no additional investor protection, since the investment adviser that recommends that DPP security is under a fiduciary standard under federal or state regulation. Under FINRA's interpretation of paragraph (C), registered

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[27] Rule 2310(a)(13).

[28] If paragraph (A) refers to an execution-only broker, then its reference to paragraph (B) makes no sense, since paragraph (B) refers only to broker-dealers who recommend DPP securities.

[29] *See, e.g.,* NASD Notice to Members 84-53, https://www.finra.org/rules-guidance/notices/84-53.

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investment advisers (whom FINRA does not regulate, of course) must disregard the previously expressed intentions of their clients, that the adviser act in a discretionary capacity on their behalf, and must obtain new written client authorization before every DPP purchase. This expectation creates confusion for investors who have granted discretionary investment authority to investment advisers and are accustomed to having the investment adviser execute transactions without specific notice or execution of documents.

The Institute respectfully recommends that FINRA clarify that Rule 2310(C) applies only to members who recommend DPP securities under paragraph (B), and not to execution-only broker-dealers. If FINRA does not believe that it can issue such an interpretation, then we respectfully recommend that FINRA amend the rule accordingly. This recommendation will reduce unnecessary compliance costs and facilitate capital formation by DPPs.

* * *

The IPA appreciates the opportunity to comment on the Notice. Should FINRA have any questions about our comments, please feel free to contact me or Gina Gombar, Associate General Counsel, at (202) 548-7190.

Sincerely,

Anya Coverman
President & CEO
Institute for Portfolio Alternatives

Attachment

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ATTACHMENT

Suggested Amendment of Rule 2210

Add paragraph (d)(1)(F)(iv) as follows:

(iv) any prediction or projection of performance in any correspondence, institutional communication, or template providing for updates of more recent statistical or other non-narrative information, to prospective and existing customers in connection with the recommendation of a securities transaction or investment strategy involving securities, provided:

a. the prediction or projection complies with paragraphs (d)(1)(A) and (B);

b. the member has adopted and implemented policies and procedures reasonably designed to ensure that the prediction or projection is relevant to the likely financial situation and investment objectives of the prospective or existing customer;

c. the communication provides sufficient information to enable the prospective or existing customer to understand the criteria used and assumptions made in calculating the predicted or projected performance; and

d. the communication provides sufficient information to enable the prospective or existing customer to understand the risks and limitations of using the prediction or projection in making investment decisions.

Suggested Amendment of Rule 5110

Add paragraph (h)(2)(M) as follows:

(M) offerings of securities by a REIT or business development company ("BDC") that:

(i) makes continuous offerings pursuant to Securities Act Rule 415;

(ii) prices its securities at least quarterly;

(iii) limits the total amount of underwriting compensation paid to participating members to the amount permitted by the sales charge limitations of Rule 2341 as if the REIT or BDC were a registered investment company;

(iv) makes at least two repurchase offers per calendar year for its securities pursuant to SEA Rule 13e-4 and Schedule TO under the Exchange Act or pursuant to a no-action

letter or exemptive order issued by the Securities and Exchange Commission or its staff; and

(v) has not begun to list its securities on a national securities exchange.

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