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August 22, 2006

Via E-mail: rule-comments@sec.gov

Ms. Nancy Morris, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: Proposed Rule Change by the NASD Relating to the Regulation of Underwriting Compensation in Public Offerings of Real Estate Investment Trusts and Direct Participation Programs
File No. SR-NASD-2005-114

Dear Ms. Morris:

This letter is submitted on behalf of the Committee on Federal Regulation of Securities of the American Bar Association's (the "ABA") Section of Business Law[1] (the "Committee") in response to the request of the Securities and Exchange Commission ("SEC" or "Commission") for comments on the above-identified rule proposal by the National Association of Securities Dealers, Inc. (the "NASD") published for comment on July 17, 2006 (the "Proposal").[2] It was prepared by the Committee's Subcommittee on NASD Corporate Financing Rules.

The comments expressed in this letter represent the views of the Committee only and have not been approved by the American Bar Association's House of Delegates or Board of Governors and, therefore, do not represent the official position of the ABA. In addition, they do not represent the official position of the ABA Section of Business Law, nor do they necessarily reflect the views of all members of the Committee.

We welcome the opportunity to comment on the Proposal and support the initiative of the NASD to amend the procedures for the review of public offerings of

[1] References herein to "we" and "our" refer to the Committee.

[2] SEC Release No. 34-54118 (July 10, 2006); 71 F.R. 40569 (July 17, 2006).

direct participation programs ("DPP" or "DPPs") and real estate investment trusts ("REIT" or "REITs") under NASD Conduct Rule 2810 ("Rule 2810") in order to clarify and codify the policies of the NASD with respect to the treatment of compensation, fees and expenses. As the NASD recognizes in its Proposal, it is particularly necessary for the NASD to amend Rule 2810 to reflect the NASD's long-time policy of applying the requirements of Rule 2810 to the underwriting terms and arrangements of certain REITs, even though REITs are specifically excluded from the definition of a DPP.

We commend the NASD for proposing to eliminate the .5% cap on the reimbursement of due diligence expenses, allocating to issuer expenses the costs of issuer-generated advertising and sales material and including in underwriting compensation the non-transaction-based compensation of an NASD member's dual-employed associated persons only in the case of persons who receive transaction-based compensation. We also support the NASD's proposal to clarify and expand the exception from the prohibition on non-cash compensation that allows training and education meetings at an appropriate location. We are, however, concerned about some aspects of the Proposal, particularly those that relate to:

(1) the apparent allocation to underwriting compensation of all compensation paid to employees of an NASD member for clerical, administrative and ministerial functions that are deemed to be "wholesaling," even though such employees do not receive transaction-based compensation; and

(2) the inability of NASD members to be reimbursed for due diligence expenses on a non-accountable basis as part of a non-accountable expense allowance.

This submission makes a number of recommendations to revise the Proposal and, in certain cases, to adopt an alternative approach to certain of the regulations proposed by the NASD that we believe will nonetheless achieve the NASD's goal of providing greater clarity and a more objective standard for the review of DPP and REIT offerings and to reduce the review burden on NASD staff and NASD members affiliated with sponsors and issuers.

Comments on the NASD Proposal to Amend Rule 2810

Definition of REIT

The Proposal would amend Rule 2810 to apply specific provisions of paragraph (b) to REITs. However, the proposed incorporation into Rule 2810(b)(1) of the definition of "real estate investment trust" from Rule 2340(c)(4) is confusing, since that definition was intended to identify illiquid REIT securities for purposes of regulating customer account statement disclosures. We believe, in particular, that the NASD does not intend to exclude from the definition of "real estate investment trust" those REIT securities that are "on deposit in a registered securities depository and settled regular way or securities listed on a national securities exchange or The Nasdaq Stock Market," as set forth in Rule 2340(c)(4). Instead of the reference to Rule 2340(c)(4), we believe that new Rule

2810(a)(16) should include a definition of a "real estate investment trust" that references the Internal Revenue Code definition as follows:

> (16) real estate investment trust (REIT) – a real estate investment trust as defined in Section 856 of the Internal Revenue Code.[3]

Reference to Exceptions

The Proposal would also amend Rule 2810(b)(1) to clarify that paragraph (b) does not apply to an initial or secondary public offering of or secondary market transaction in any interest in a DPP that complies with subparagraph (b)(2)(D). We believe that the reference to subparagraph (b)(2)(D) of Rule 2810 is confusing and that it would be better for subparagraph (b)(1) to incorporate the text of the exceptions to the application of Rule 2810(b). Further, we believe that the exceptions in Rule 2810(b)(2)(D) should be revised to be available for REITs, as well as DPPs. Finally, we note that the separate reference to The Nasdaq Stock Market ("NASDAQ") in Rule 2810(b)(2)(D)(i) is no longer necessary since the registration of NASDAQ as a national securities exchange under Section 6 of the Securities Exchange Act of 1934, as amended ("Exchange Act") was implemented on August 1, 2006 and believe, moreover, that it is unnecessary to specify the classes of the types of securities that may be issued by a DPP or REIT. We therefore recommend that Rule 2810(b)(2)(D) be deleted and that Rule 2810(b)(1) be revised as follows:

> (1) No member or person associated with a member shall participate in a public offering of a direct participation program or a limited partnership rollup transaction or, where expressly provided below, a ~~real estate investment trust as defined in Rule 2340(c)(4) ("~~REIT~~")~~, except in accordance with this paragraph (b), provided however that ~~this paragraph (b)~~ subparagraphs (b)(2)(A) and (B), and, in situations where the member is not affiliated with the sponsor, issuer or other affiliate thereof (C), shall not apply to an initial or secondary public offering of or a secondary market transaction in ~~a unit, depositary receipt or other interest in a~~ the securities of a direct participation program or a REIT that ~~complies with subparagraph (2)(D)~~ is listed on, or for which an application for listing has been approved by, a registered national securities exchange and, with respect to an application for listing, the applicant makes a good faith representation that it believes that such listing on an exchange will occur within a reasonable amount of time following the formation of the program or REIT.

Liquidity Track Record

The NASD is proposing to amend Rule 2810(b)(3)(D) to require that NASD

[3] For purposes of all recommended changes to the Proposal, new text is underlined and deleted text is overstruck.

members[4] and their associated persons inform prospective investors in a DPP or REIT whether the sponsor has offered prior programs for which the prospectus disclosed a date or time period when the program might be liquidated, and what percentage of the prior programs in fact liquidated on or around that date or time period (the "liquidity track record"). The NASD states in the Proposal that the prospectuses for DPPs and REITs typically establish a date or time period when the investment will become liquid through a liquidity event or liquidation and also disclose that the liquidity event or liquidation may be delayed due to market conditions or other factors.

We do not support adoption of the liquidity track record requirement because, among other things, prospectus disclosure has typically included a warning that the liquidity event or liquidation may be delayed due to market conditions and other factors and the NASD recognizes that such delays may be to the benefit of investors. For the reasons set forth below, we believe that the recordkeeping burdens of this Proposal and the, often, unwarranted negative implications of such disclosure far outweigh the benefit of merely emphasizing that the sponsor may, in fact, actually delay the liquidity event or liquidation due to market conditions and other factors beyond the initial estimated time period in the interest of investors. To the extent that the NASD nonetheless believes that the proposed track record disclosure is necessary, we believe that any such disclosure should be adopted by the SEC in the form of an amendment to the section on "Prior Performance of the General Partner and Affiliates" in Item 8 of Guide 5. As set forth below, we also believe that, should the SEC propose such a disclosure requirement, the required disclosure should be narrower than that proposed by the NASD in Rule 2810(b)(3)(D).

Our concerns about the liquidity track record proposal arise in particular from the fact that, although the NASD states in the Proposal that it recognizes there are circumstances where investors may benefit from delays in the implementation of the liquidity event or liquidation, the required disclosure would unfairly characterize all situations where the liquidity event was delayed as "a failure" or "inappropriate." Thus, even though investors in prior programs may have benefited from a delay in a liquidity event or liquidation, investors in the current program will be misled by the proposed disclosure to believe that the sponsor acted contrary to investors' interests. We also believe that the liquidity track record information to be disclosed would be meaningless due to the different factors that can affect the results, the differences between offering structures and the breadth of the NASD's proposed disclosure requirement.[5] The liquidity track record disclosure requirement is overbroad in that it would require liquidity track record disclosure for both private and public offerings, offerings that have both a finite date and those that have only an expected or estimated date for the

[4] Broker/dealers that sell DPP and REIT securities are registered as members of the NASD. This submission refers to broker/dealers either as "NASD members" or as "broker/dealers," depending on the context.

[5] Statistically, the information would also be meaningless in the case of sponsors of very few programs.

occurrence of a liquidity event or liquidation, and offerings that have different investment objectives from the current program. Furthermore, the proposed disclosure requirement does not include a time limitation on the required "look back." Thus, a sponsor may be faced with having to uncover information on public and private offerings that have no similarity to the current program and to programs that may be decades old.

If the NASD determines, nonetheless, to adopt a liquidity track record disclosure requirement as part of NASD Rule 2810, we recommend that the requirement only apply in the case of a DPP or REIT that has established a fixed date for the occurrence of a liquidity event or the liquidation of the DPP or REIT. Thus, the disclosure requirement would not be required with respect to DPPs or REITs that disclose only a present expectation or estimate of the time when a liquidity event or liquidation may occur and that the board of directors or manager/general partner has the authority and obligation to make a determination of whether to initiate a liquidity event or liquidation based on market conditions and in the best interests of investors.[6]

Due Diligence Expense Reimbursement

The Proposal: The Proposal would amend Rule 2810(b)(4)(B)(i) and (ii) to eliminate the current .5% limit on due diligence expense reimbursements and would include the issuer expenses, underwriting compensation and due diligence expense reimbursements within the 15% limitation on organization and offering ("O&O") expenses, if the sponsor is affiliated with a participating member. The Proposal also includes new Rule 2810(b)(4)(B)(vii), which would require that a member may only be reimbursed for due diligence expenses that are included in a detailed and itemized invoice. Finally, the Proposal includes new Rule 2810(b)(4)(C)(iii), which would clarify that O&O expenses, in the case of an offering where a participating broker/dealer is affiliated with the sponsor, include "due diligence expenses incurred when a member affirmatively discharges its responsibilities to ensure that all material facts pertaining to a program or REIT are adequately and accurately disclosed in the offering document."

Current Requirements: Currently, NASD members are permitted to receive underwriting compensation up to 10% of the gross proceeds of the offering and may also (on an aggregate basis) receive reimbursement for due diligence expenses up to an additional .5% of the gross offering proceeds. The separate .5% due diligence expense guideline was intended to allow an additional payment to participating members above the 10% guideline in order to pay the expenses incurred by members in fulfilling their obligation to conduct due diligence with respect to an offering under Rule 2810(b)(3), which requires that the member "shall have reasonable grounds to believe . . . that all material facts are adequately and accurately disclosed and provide a basis for evaluating the program."

[6] If, moreover, the SEC should propose to amend Guide 5 to require disclosure of the sponsor's liquidity track record, we recommend that any such requirement should be similarly limited.

Clarify the Due Diligence Expense Guideline: We commend the NASD for its proposal to allow reimbursement for bona fide due diligence expenses in excess of the .5% guideline, but believe that the text of Rule 2810(b)(4)(B)(i) should be amended to make clear that payments for due diligence expense reimbursements that are paid pursuant to an itemized invoice will not be included in the 10% underwriting compensation guideline as follows:

> (i) the total amount of all items of compensation . . . exceeds an amount that equals ten percent of the gross proceeds of the offering, which shall not include reimbursement of bona fide due diligence expenses that are included in a detailed and itemized invoice.

Non-Accountable Due Diligence Expense Reimbursements: Moreover, we recommend that the Proposal be revised to allow due diligence expense reimbursements that are without a "detailed and itemized invoice" to be included in the 10% underwriting compensation guideline. NASD Rule 2710(f)(2)(B), which is applicable to DPP and REIT offerings, allows members to receive a non-accountable expense allowance of up to "3% of offering proceeds." We recommend that the Proposal be amended to be consistent with this provision and allow members to receive reimbursement of due diligence expenses as a non-accountable expense allowance of up to 3% of the offering proceeds[7] as part of the compensation that is subject to the 10% compensation guideline. Therefore, we recommend that proposed Rule 2810(b)(4)(B)(vii) be revised as follows:

> (vii) the member has received reimbursement for due diligence expenses that are not included in a detailed and itemized invoice, unless the amount of the reimbursement is included in the calculation of underwriting compensation as a non-accountable expense allowance that shall not, in the aggregate, exceed the three percent non-accountable expense allowance that is permitted by Rule 2710(f)(2)(B).

Due Diligence Principles: The NASD's rule filing publishes a number of principles regarding the treatment of due diligence expenses under Rule 2810, which were previously outlined in Notice to Members 04-07 (February 2004) (the "2004 Notice") and are based on principles published in Notice to Members 86-66 (September 19, 1986) (the "1986 Notice"). In general, we recommend that the NASD modify the published principles to be consistent with clarifying interpretations that were contained in the 1986 Notice and to make other recommended changes, as discussed below.

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[7] The term "offering proceeds" is defined in Rule 2710(a)(3) to mean the gross offering proceeds, without consideration of the proceeds of the over-allotment option shares or deduction of any underwriting fees or costs of the offering. Thus, any reference to "offering proceeds" herein is intended to be consistent with this definition.

The first principle states that "[a]ny due diligence payment . . . that is mischaracterized . . . would be deemed to be undisclosed underwriting compensation, and the mischaracterization would violate NASD rules and the federal securities laws." We believe that this principle should be revised, consistent with our prior recommended changes to the due diligence expense reimbursement provisions, to state that this principle applies "only to those due diligence expense reimbursements that are not included in underwriting compensation." Moreover, we believe that this principle should address the distinction between inadvertent and intentional mischaracterizations by stating that only "an intentional mischaracterization would violate NASD rules and the federal securities laws."

We also recommend that the second principle, which states that "any reimbursement that includes a profit margin to the member will be deemed to be underwriting compensation . . .," be revised to include the clarification provided in Footnote 1 to the 1986 Notice that this principle will not prohibit the inclusion of a profit margin in the due diligence expense bill of a due diligence firm that is not a member or an affiliate of a member. Further, we believe that the principle should be revised to clarify that it is the profit margin that will be deemed to be underwriting compensation, not the entire amount of the due diligence expense reimbursement.

Consistent with the 1986 Notice, we further recommend that the NASD modify the second principle or adopt a new principle to state that a broker/dealer's bill for due diligence may include a reasonable allocation of the broker/dealer's overhead, including salaries and office overhead, in order to clarify that such overhead is not considered by the NASD to be an impermissible profit margin.

Finally, we recommend that the NASD's principles reflect that due diligence expenses may include the broker/dealer's travel expenses, if travel is necessary to discharge the broker/dealer's due diligence obligations. In comparison, expenses of the issuer in traveling to due diligence meetings and otherwise responding to the due diligence efforts of members are properly allocated to the issuer expenses and included in the O&O expense calculation, if the issuer is affiliated with an NASD member participating in the offering.

Offering Proceeds and Trail Commissions

The Proposal would amend Rule 2810(b)(4)(B)(i) to state that it shall be presumed to be unfair and unreasonable if "the total amount of all items of compensation from whatever source, including offering proceeds and 'trail commissions' payable to underwriters, . . . exceeds an amount that equals ten percent of the gross proceeds of the offering . . . ." The Proposal indicates that the NASD intended to clarify that the 10% limitation on underwriting compensation applies to any item of compensation that is deducted from the offering proceeds and to compensation that is paid in the form of "trail commissions." However, the additional language appears to indicate that the member's underwriting compensation is composed of the "offering proceeds." Further, we suggest

that the term "gross proceeds of the offering" should be revised to use the defined term "offering proceeds" in Rule 2710(a)(3). We suggest that the provision be revised as follows:

> (i) The total amount of all items of compensation from whatever source, including compensation payable from offering proceeds and paid in the form of "trail commissions" ~~payable~~ to underwriters, broker/dealers, or affiliates thereof, which are deemed to be in connection with or related to the distribution of the public offering, exceeds an amount that equals ten percent of the ~~gross~~ offering proceeds ~~of the offering~~;

Sales Loads on Reinvested Funds

The Proposal would adopt new Rule 2810(b)(4)(B)(vi) to prohibit a "sales load" or commission on reinvested dividends in a DPP or REIT for offerings that are effective with the SEC after the effective date of the amendments adopted by the NASD. In general, we are not opposed to this new requirement, but recommend that it be clarified in three respects. We recommend that the NASD delete the reference to a "sales load" from this provision, as this term is normally used in connection with a mutual fund. We believe that it is sufficient to refer to a "commission."

In its discussion of this new provision in the 2004 Notice, the NASD's explanation of the proposal appeared to prohibit only a commission that would be charged to the investor on the reinvestment of dividends. Further, the NASD indicates in the Proposal that it does not object to an NASD member receiving trail commissions for on going services, so long as such trail commissions are included in the 10% compensation limitation under NASD Rule 2810(b)(4)(B)(i), as proposed to be amended. Therefore, we also recommend that the provision be revised to clarify that the prohibition only applies to any direct payment of a commission by the customer to an NASD member and would not prohibit an indirect payment of a commission by the sponsor or affiliate of the sponsor (*e.g.*, the advisor or managing dealer) as follows:

> (vi) the program or REIT charges a ~~sales load or~~ direct commission to purchasers on securities that are purchased through the reinvestment of dividends . . . .

Organization and Offering Expense Guideline

Text of Guideline: The Proposal would amend Rule 2810(b)(4)(B)(ii) to state that it shall be presumed to be unfair and unreasonable if "organization and offering expenses, which include all items of compensation, paid by a program or REIT in which a member or an affiliate of a member is a sponsor exceed an amount that equals fifteen percent of the gross proceeds of the offering." We recommend that the NASD amend this provision to modify the reference to "items of compensation," because we believe that such term could be read to include only underwriting compensation under Rule 2810(b)(4)(C)(ii), whereas the purpose of the provision is to set a cap on all items of O&O expenses,

including issuer expenses, underwriting compensation, and due diligence expense reimbursements. We recommend that the rule be amended as follows:

> (ii) Organization and offering expenses, ~~which include all items of compensation~~ as set forth in subparagraph (4)(C), that are paid by a program or REIT in which a member or an affiliate of a member is a sponsor exceed an amount that equals fifteen percent of the gross proceeds of the offering.

NASD Review Process: We agree with the NASD's concern, expressed in the 2004 Notice, that the NASD review process to allocate the sponsor's estimate of its future expenses between the issuer expense and underwriting compensation categories is burdensome to NASD staff. Similarly, the review process is also burdensome to affiliated broker/dealers that endeavor to satisfy the NASD's concerns regarding their estimates of the allocation of various compensation and expense items between issuer expenses, underwriting compensation and unrelated activities over the typical two-year offering period of a DPP or REIT. In many cases, broker/dealers affiliated with sponsors and issuers have made a business determination to include all issuer expenses other than traditional issuer expenses[8] in the 10% guideline, whether or not appropriate, in order to avoid extensive delays in obtaining the NASD's "no-objection" letter.

We are concerned that the review policy of the NASD may not always recognize that it is the sponsor's responsibility to operate the primary business of offering and managing DPP and REIT assets and that the affiliated broker/dealer provides only ancillary services to that primary business.[9] The changes to the Proposal that we recommend in the discussion below are intended to reduce the burdens of the allocation process on NASD staff and on NASD members. We urge the NASD to amend the Proposal to reflect that:

(1) sponsors incur expenses for the preparation and distribution of a DPP or REIT offering that are properly allocated to issuer expenses; and

(2) dual-employed persons by the sponsor and its affiliated NASD member may receive compensation for providing non-distribution services to the sponsor and its affiliates that are properly excluded from the calculation of issuer expenses and underwriting compensation.

We are also concerned that the NASD's review policy to require that broker/dealers and their affiliated sponsors and issuers provide estimates of each itemized category of underwriting compensation and issuer expenses may reflect a desire that the

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[8] These items are specified in proposed subparagraphs (C)(1)(b), (d), and (e).

[9] We are pleased to note, however, that the Proposal reflects comments that stated that such dual-employee's "primary or secondary job responsibilities may involve providing non-distribution related services to the sponsor."

DPP or REIT comply with the estimates at all times. Nonetheless, NASD staff have occasionally accepted estimates of each category that in the aggregate exceeded the applicable 10% or 15% guideline, so long as the NASD member also provided a representation that the aggregate of the actual compensation and expenses would not exceed the applicable guideline at the conclusion of the offering. The NASD member's good-faith representation reflects that sponsors and their affiliated broker/dealers will monitor such items over the life of the offering to ensure compliance with the NASD's limitations on underwriting compensation and O&O expenses, which compliance is subject to NASD examination. We would appreciate the NASD's confirmation that it will adhere to this preferable review policy, which reflects that the 10% underwriting compensation and 15% O&O expense limitations apply on an aggregate basis at the conclusion of the offering.

Issuer Expenses

Proposed Rule 2810(b)(4)(C)(i)

Term "Issuer Expenses": The NASD proposes Rule 2810(b)(4)(C)(i) to include in the calculation of issuer expenses the expenses incurred by the sponsor in preparing and offering the DPP or REIT. The language of the provision refers to "issuer organization and offering expenses," which we believe is confusing because the term "organization and offering expenses" includes "issuer expenses," "underwriting compensation," and "due diligence expenses." We recommend that meaning of this subparagraph be clarified by deleting the words "organization and offering" so that the provision applies solely to "issuer expenses" as follows:

> (i) issuer ~~organization and offering~~ expenses, which include, but are not limited to . . . .

Reimbursement of Issuer Expenses from DPP/REIT or Offering Proceeds: We also recommend that subparagraph (i) be revised to clarify that the calculation of issuer expenses only includes those expenses that are to be paid by the DPP or REIT or from the offering proceeds. This change would reflect the historical policy of the NASD to exclude from the 15% guideline on O&O expenses issuer expenses that are reimbursed by the sponsor, advisor or another affiliate. This policy is set forth in NASD Notice to Members 85-29 (April 19, 1985) (the "1985 Notice"), which states that "[o]rganization and offering expenses in excess of 15 percent may be paid from sources other than the program or its offering proceeds." [10] The recommended change would also be consistent with the definition of "organization and offering expenses" in the *Statement of Policy Regarding Real Estate Investment Trusts*, adopted by the North

[10] The NASD's policy on calculating the issuer's expenses to include only those expenses that are paid by the DPP or REIT or from the offering proceeds is different than the policy for calculating underwriting compensation, which looks to payments from any source.

American Securities Administrators Association ("NASAA REIT Guidelines"), which limits O&O expenses to "all expenses incurred by and to be paid from the assets of the REIT." We recommend that proposed subparagraph (i) be revised as follows:

> (i) issuer ~~organization and offering~~ expenses that are to be paid by the program or REIT or from the offering proceeds . . . .

Issuer's Overhead Expenses: We are opposed to the NASD's proposal to include the sponsor's overhead expenses in the calculation of issuer expenses, as set forth in proposed subparagraph (i). "Business overhead" is generally considered to be the expenses of a business that are not directly associated with production, such as rent, telephone, insurance, employee benefits, property taxes and utilities. Thus, overhead costs occur without regard to level of production, or whether production exists at all, and are incurred by a business just to maintain its existence. We believe, therefore, that the inclusion of the sponsor's overhead expenses in the calculation of issuer expenses would not comply with the NASD's historical standard[11] of including only those expenses and payments that are incurred "in connection with the public offering."[12]

We also believe that the NASD's proposal is not consistent with the treatment of issuer expenses by the SEC or the states, as neither Item 511 of SEC Regulation S-K nor the definition of "organization and offering expenses" in the NASAA REIT Guidelines requires that overhead expenses be included in the calculation of issuer or O&O expenses. Therefore, we urge the NASD to amend proposed Rule 2810(C)(i) as follows:

> (i) issuer ~~organization and offering~~ expenses that are to be paid by the program or REIT or from the offering proceeds, which include, but are not limited to~~:~~, expenses~~, including overhead expenses,~~ for:[13]

Relationship of Issuer Expense to the Public Offering: The subprovisions of proposed subparagraph (i) set forth a number of categories of expenses that are intended to be included in the calculation of issuer expenses incurred in

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[11] Rule 2810(b)(4)(B)(i) is clear in only including in the calculation of underwriting compensation all items of compensation that are "deemed to be in connection with or related to the distribution of the public offering . . . ." While Rule 2810(b)(4)(B)(ii) has not included similar language with respect to the treatment of the issuer expense portion of O&O expenses, we believe that that the NASD's long-standing review policy has been to include only those items in issuer expenses that are deemed to be in connection with or related to the distribution of the public offering.

[12] In making this recommendation, we distinguish the principle contained in the 1986 Notice that allows a broker/dealer to include a reasonable allocation of overhead in an itemized statement for reimbursement of due diligence expenses from the Proposal to require that the sponsor's related overhead expenses be included in the calculation of issuer expenses.

[13] The language of this subparagraph also includes, we believe in error, a colon after "but are not limited to . . ." We believe that the NASD may have intended the colon to be a comma.

connection with the public offering under review. However, neither subparagraph (i) nor the subprovisions thereof limit the calculation of issuer expenses to only those expenses that are related to the specific public offering being reviewed by the Department. We are concerned that, absent limiting language in the text of the rule, the calculation of issuer expenses would encompass all the enumerated types of expenses generated by the sponsor with respect to its business, including expenses not associated with the specific public offering (*e.g.*, the sponsor's corporate legal fees and generic and employment advertising).[14]

We note that the NASAA REIT Guidelines define O&O expenses as "[a]ll expenses incurred by and to be paid from the assets of the REIT in connection with and in preparing a REIT for registration and subsequently offering and distributing it to the public . . . ." Based on this language, we recommend that proposed subparagraph (i) be revised as follows:

> (i) issuer ~~organization and offering~~ expenses related to the preparation and subsequent offering of the program or REIT that are to be paid from the assets of the program or REIT or from the offering proceeds, which include, but are not limited to~~:~~, expenses~~, including overhead expenses,~~ for:

Proposed Rule 2810(b)(4)(C)(i)c.: The Proposal would include in the calculation of issuer expenses under subprovision c. the "salaries and non-transaction-based compensation paid to employees or agents of the sponsor for performing services for the sponsor . . . ." This category of expense would apparently cover all salaried employees of the sponsor, regardless of whether the employee performed any services related to the specific offering. Moreover, to the extent that an employee of the sponsor is dual-employed as an associated person of an affiliated NASD member, this provision appears to conflict with proposed Rule 2810(b)(4)(C)(ii).

However, the NASD's description of subprovision c. indicates that it would encompass only the "salaries and non-transaction-based compensation paid to employees or agents of the sponsor or issuer for performing such services . . . " (emphasis provided) as set forth in subprovisions a. and b. Since subprovision b. relates to the sponsor's legal expenses, we believe that the NASD intended for subprovision c. to cover only the salaries of those of the sponsor's employees who are engaged in the activities referred to in subprovision a., (*i.e.*, assembling and mailing offering materials, etc.). In order to clarify the NASD's intention, we recommend that subprovision c. be deleted and subprovision a. be amended as follows:

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[14] As discussed in a prior footnote, Rule 2810(b)(4)(B)(i) is clear in only including in the calculation of underwriting compensation all items of compensation that are "deemed to be in connection with or related to the distribution of the public offering . . . ." whereas Rule 2810(b)(4)(B)(ii) does not include similar language. However, we believe that that the NASD's long-standing review policy has been to include only those items in issuer expenses that are deemed to be in connection with or related to the distribution of the public offering.

> a. assembling and mailing offering materials, processing subscription agreements, and generating advertising and sales materials, including the salaries and non-transaction-based compensation paid to employees and agents of the sponsor for performing these services . . . .

This provision does not address, however, the allocation of the salaries and other non-transaction-based compensation of dual-employees of an affiliated broker/dealer and the sponsor to issuer expenses, but deals with such allocation issues only in the context of the calculation of underwriting compensation. We also recommend that the NASD further revise this provision or adopt a separate provision in Rule 2810(b)(4)(C)(i) to reference Rule 2810(b)(4)(C)(ii)b., in order to clarify that issuer expenses include the allocable amount of the non-transaction-based compensation of dual-employees as determined pursuant to that provision.

Proposed Rule 2810(b)(4)(C)(i)b., d. and e.: The Proposal would clarify a number of the items of expenses normally borne by the issuer. We recommend that the NASD amend these provisions to also refer to or include those items set forth in Rule 2710(c)(3)(B)(i) related to printing costs and accountant's fees, in order to be consistent with Rule 2710.

Underwriting Compensation

Proposed Rule 2810(b)(4)(C)(ii)a.

Wholesaler Compensation: The Proposal would include in the calculation of underwriting compensation payments "to any wholesaler that is engaged in the solicitation, marketing, distribution or sales of the program or REIT securities . . ." ("Subprovision a."). We have no objection to this clarification that the sponsor's payment of compensation to a dealer-manager or wholesaler should be included in the calculation of underwriting compensation, although such payments are already specifically encompassed in NASD Rule 2710(c)(3)(A)(v).[15]

However, we recommend that the provision be revised to clarify that, in referring to a "wholesaler," the NASD is only intending to reference an NASD member and not an employee of a member and that the specified wholesaling functions relate to the solicitation, marketing, distribution or sales of DPP or REIT securities through other NASD members (*i.e.*, not direct sales to investors).[16] We also believe that the term

[15] Rule 2710(c)(3)(A)(v) lists "wholesaler's fees" as an "item of value" that is used to determine the amount of underwriting compensation.

[16] Our recommendation for this and other revisions to Subsection a. are set forth at the end of this part of our comments on Subprovision a.

"marketing" may be confusing since it can refer to advertising functions not specifically related to the wholesaling function. Therefore, we request that the NASD confirm that the term "marketing" is intended to relate to the offer and sale of DPP or REIT securities as part of an NASD member's wholesaling activities.

Employee Compensation: The Proposal in Subprovision a. also would require that underwriting compensation include payments from any source directly to "any employee of the wholesaler involved in the solicitation, development, maintenance and monitoring of selling agreements and relationships with broker/dealers and accounts and account holders at broker/dealers." We have some trouble understanding the application of this provision to the employees of NASD members not affiliated with the sponsor and also to the full-time employees of NASD members affiliated with the sponsor.[17] In general, registered associated persons of an NASD member are prohibited from accepting payments of compensation from any source other than the NASD member.[18] Based on the discussion in the Proposal that links the wholesaling provision to the allocation of the compensation of dual-employees,[19] we believe that the NASD is intending to cover the sponsor's direct payments to dual-employees in their role as an employee of the sponsor – which is also covered in proposed Rule 2810(c)(4)(C)(ii)b. ("Subprovision b.") – when such persons perform the enumerated functions.

We do not believe that the NASD should include in the calculation of underwriting compensation payments by a sponsor or an issuer to dual-employees of an affiliated broker/dealer and the sponsor who perform what we believe to be clerical functions that would not require registration under Section 15(a) of the Exchange Act or NASD Rule 1031, as further discussed below. We also believe that the treatment of the compensation of dual-employees would be inherently inconsistent under both Subprovisions a. and b.[20] Therefore, we recommend that the second part of Subprovision

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[17] We believe that the NASD is not proposing to include in the calculation of underwriting compensation the NASD member-employer's payment of any form of compensation to its full-time employees, as this would involve double-counting the payment of the dealer manager's fee from the proceeds of the offering and the dealer manager's payment of some part of that fee to its employees.

[18] NASD Rule 2810(c)(2) prohibits associated persons from directly or indirectly accepting payments of any non-cash compensation, except as permitted by that provision, which requires that the NASD member-employer maintain records of all non-cash compensation received by the associated person.

[19] The Proposal states that the 2004 Notice described this specific proposal that is in proposed Rule 2810(b)(4)(C)(ii)a. We do not find that the 2004 Notice included a discussion of payments to wholesalers, except as part of the discussion of the allocation of the compensation of dual-employees. 2004 Notice, at 77. Thus, we believe that the focus of this provision is, in fact, on the allocation of the salaries of dual-employees of affiliated broker/dealers.

[20] The entire compensation of dual-employees would be included in underwriting compensation under Subprovsion a, regardless of whether such employees receive transaction-based compensation. In comparison, Subprovision b. would include in underwriting compensation only the non-transaction-based compensation of dual-employees that receive transaction-based compensation and in certain cases would allow non-transaction-based compensation be allocated to either issuer expenses or non-offering expenses.

a. be deleted and that the treatment of the compensation of dual-employees solely be addressed in proposed Subprovision b., which is discussed later in this submission.

Disparate Impact on Unaffiliated and Affiliated Wholesalers: In the case of an unaffiliated NASD member acting as a dealer-manager or wholesaler, the wholesaling firm will always be paid a fixed rate of compensation from the sponsor or from the proceeds of the offering for the period of time that the DPP or REIT offering is being distributed. Thus, even if the associated persons or other unregistered employees of an unaffiliated wholesaler maintain and monitor selling agreements and relationships with retail broker/dealer firms during and between offerings of securities, it is unlikely that an unaffiliated sponsor would make separate payments to an unaffiliated NASD member for such services, in addition to paying a fixed wholesaling fee during the conduct of the public offering.

However, in the case of an NASD member affiliated with the sponsor, this provision would encompass the full amount of any compensation paid by the sponsor to dual-employees who have any responsibility for "maintaining and monitoring . . . selling agreements and relationships with broker/dealers and accounts and account holders at broker/dealers," regardless of whether the employee performs such services for the sponsor (or other non-broker/dealer affiliate) or the affiliated NASD member and regardless of whether the employee only performs such services on a part-time basis. Since these are activities that occur during and between offerings of securities, we are concerned that NASD members would have difficulty allocating an appropriate part of the compensation of dual-employees to the specific DPP or REIT offering under review and that, in any event, these are clerical and administrative functions that should not be subject to the restriction on underwriting compensation. We have concluded that, in general, proposed Rule 2810(b)(4)(C)(ii)a. unfairly imposes a burden on competition by affiliated NASD members and by sponsors that wholesale a DPP or REIT through affiliated NASD members (in comparison to the application of the rules to unaffiliated NASD members) that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. In particular, we believe that the burden on competition is greatest with respect to sponsors of smaller DPPs and REITs, as the size of the offering may not be sufficient to absorb the additional cost of the payment of the salaries of the dual-employees that are not engaged in solicitation, distribution, marketing and sales activities related to the wholesaling of a DPP or REIT.

Payments Related to Clerical Functions***:*** We believe that the activities of "development, maintenance and monitoring of selling agreements and relationships with broker/dealers and accounts and account holders at broker/dealers" are functions that are clerical and ministerial in nature and, as such, do not require registration of an employee as an associated person of a broker/dealer, pursuant to the exemption from associated person registration that is available under NASD Rule 1060(a)(1). We believe that the NASD should not

include in the calculation of underwriting compensation the compensation of any dual-employee of an affiliated NASD member (including unregistered employees[21] and registered associated persons[22] of the broker/dealer) who does not perform functions that would require such person to be registered under Section 15(a) of the Exchange Act. In order to remain consistent with the 1985 Notice, which focused on those wholesaling functions that would trigger broker/dealer registration under the Exchange Act, we believe that underwriting compensation should only include an allocable portion of a dual-employee's compensation that is paid for the "solicitation, marketing distribution, or sales of the program or REIT securities." If this provision were so limited, then such payments to dual-employees should be regulated by Rule 2810(b)(4)(C)(ii)b., which is proposed to address the allocation of compensation of dual-employees.

Recommended Revision: Based on the foregoing discussion, we recommend that the NASD revise proposed Rule 2810(b)(4)(C)(ii)a. as follows:

a. to any NASD member acting as a wholesaler that is engaged in the solicitation, marketing, distribution or sales of the program or REIT securities through other NASD members ~~and any employee of the wholesaler involved in the solicitation, development, maintenance and monitoring of selling agreements and relationships with broker/dealers and accounts and account holders at broker/dealers~~.

Proposed Rule 2810(b)(4)(C)(ii)b.: The NASD's Proposal would require in Rule 2810(b)(4)(C)(ii)b. that any payments from any source to any employee of a member and any dual-employee of a member, sponsor, issuer or other affiliate, whether registered as an associated person or not, be included in the calculation of underwriting compensation if the employee receives transaction-based compensation. Thus, Subprovision b. would include in the calculation of underwriting compensation all salaries and bonuses paid to such persons that are in addition to the transaction-based compensation received by such

[21] Employees of a NASD member who are not registered as associated persons with the NASD are those that are, among other things, exempt from registration as an associated person under NASD Rule 1061(a)(1), which would include the administrative and secretarial staff of the firm. The concerns of the NASD in the 1985 Notice with respect to unregistered persons performing wholesaling functions only related to the unregistered persons employed by the sponsor. Even in the case of such unregistered persons performing wholesaling functions, the policy discussed in the 1985 Notice only included in underwriting compensation the salaries and expense reimbursements of persons whose activities would require registration as a broker/dealer under the Exchange Act.

[22] With respect to registered associated persons, we understand that affiliated broker/dealers of sponsors of DPPs and REITs will sometimes register administrative staff as registered representatives who might otherwise qualify for the clerical and ministerial exception in NASD Rule 1060(a)(1) and have primary job responsibilities with the sponsor, because such persons from time-to-time may fall within the registration requirement in NASD Rule 1031 when the person "performs compliance, . . . back-office operations or similar responsibilities for the member, or . . . performs administrative support functions for registered personnel . . ."

persons.[23] The provision provides an exception for DPPs and REITs that employ fewer than 10 people engaged in wholesaling, which allows the member to present information to the NASD that the non-transaction-based compensation is made as consideration for non-broker/dealer services.

Application to Unregistered Employees of Broker/Dealers and Sponsors/Issuers: The 2004 Notice proposed to regulate the underwriting compensation of dual-employees only with respect to "registered persons . . . [who are] dual-employees of the other entities with multiple job responsibilities."[24] However, as discussed above, the NASD has expanded this concept and proposes in Subprovision b. to include in underwriting compensation the non-transaction based compensation paid to unregistered persons that are full-time employees of a broker/dealer and dual-employees of a broker/dealer and the sponsor, issuer or other affiliate, if the person receives transaction-based compensation. As discussed above with respect to Subprovision a., we believe that full-time employees of a NASD member are unlikely to receive direct payments from any source other than the NASD member-employer. Further, although we understand the NASD's concerns regarding the receipt of transaction-based compensation by unregistered employees, we believe that the use of the term "employee," instead of "associated person," may expand the scope of this provision further than intended by the NASD, even though the provision is limited to employees who receive transaction-based compensation.[25]

We recommend that Subprovision b. be simplified to apply, as we believe was intended by the NASD, only to the situation of dual-employed associated persons of a NASD member affiliated with the sponsor, as it is such dual-employed associated persons who may receive compensation from a source other than the broker/dealer for securities-related activities, including wholesaling activities involving the "solicitation, marketing, distribution or sales of the program or REIT securities." Therefore, we recommend that Subprovision b. be revised to delete the reference to "any employee of a member" and to only apply to associated persons of an NASD member that are registered

[23] We believe, as with Subprovision a., that the NASD is not proposing to include in the calculation of underwriting compensation the NASD member-employer's payment of any form of compensation to its full-time employees, as this would involve double-counting the payment of the dealer manager's fee from the proceeds of the offering and the dealer manager's payment of some part of that fee to its employees.

[24] 2004 Notice, at 77.

[25] The term "associated persons of a member" is defined in Article I of the NASD By-Laws to include any person who is "engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by the member, whether or not such person is registered or exempt from registration with the NASD . . . ." We believe that this term is, therefore, more appropriate than the term "employee" in only encompassing registered persons and other persons "engaged in the investment banking or securities business."

or are required to be registered and who receive transaction-based compensation.[26]

The Exception for Fewer Than 10 Wholesale Staff: We also find that the exception language of Subprovision b. that permits "a program or REIT with fewer than 10 people engaged in wholesaling" to present information to the NASD upon which the "Corporate Financing Department can readily conclude that the payments are made in consideration for non-broker/dealer services provided to the sponsor, issuer or other affiliate" does not take into account that a portion of the compensation of dual-employees may be for non-distribution related activities. We recommend that Subprovision b. be revised to make clear that the information presented to the Corporate Financing Department would allow the Department to determine whether the dual-employee's non-transaction-based compensation should be included in the calculation of issuer expenses or underwriting compensation or is for activities unrelated to the preparation or distribution of the DPP or REIT.

We also believe that the language of the exception does not take into account that the compensation payments are in the future over the two or more years that the DPP or REIT will be offered. Thus, an affiliated NASD member can only provide an estimate of the future allocation of a person's compensation with respect to the current DPP or REIT offering based on its records of the person's prior allocation of time.

Recommended Revision: Based on the foregoing discussion, we recommend that the NASD revise proposed Rule 2810(b)(4)(C)(ii)b. as follows:

> b. to any ~~employee~~ registered associated person of a member ~~and any dual-employee of a member~~ and any associated person required to be so registered that is also employed by the sponsor, issuer or other affiliate who receives transaction-based compensation, unless information has been provided to the NASD, with regard to a program or REIT with fewer than ten ~~people~~ persons engaged in wholesaling, from which the Corporate Financing Department can readily ~~conclude that~~ determine the portion of the non-transaction-based compensation ~~payments~~ that ~~are made~~ will be paid to each person in consideration for ~~non-broker/dealer services provided to the sponsor, issuer or other affiliate~~ (i) the preparation of and subsequent offering of the program or REIT for the sponsor or other affiliate other than the member; (ii) solicitation, marketing, sales and distribution of the program or REIT for the member; and (iii) services unrelated to the preparation and distribution of the program or REIT;

Alternative Approach to Allocation of Compensation of Dual-Employees: The Proposal would sweep into the calculation of underwriting

[26] We commend the NASD for proposing to limit the scope of this provision to dual-employees that receive transaction-based compensation, as transaction-based compensation is prime indicia of a person engaging in activities that would require registration under Section 15(a) of the Exchange Act.

compensation all payments (including salaries, bonuses and expense reimbursements) to any dual-employee of the NASD member and a sponsor, issuer or other affiliate who receives transaction-based compensation. The rationale provided by the NASD for this simplified allocation process is that ". . . determining whether payments in connection with those job responsibilities should be allocated as underwriting compensation or issuer O&O expenses is very burdensome."[27] We agree that the review process has been burdensome for the staff of the NASD and that the NASD's approach is one solution. However, we would like the NASD to consider an alternative approach that would provide a procedure for the allocation of payments to dual-employees between issuer expenses, underwriting compensation and non-distribution related expenses. As set forth in the 1985 Notice, the better policy is to include only the allocable portion of the dual-employed person's compensation in the calculation of underwriting compensation.

We recommend that Subprovision b. be amended (and similarly the issuer expense provisions) to reflect that the NASD will accept a good-faith estimated allocation of the non-transaction-based-compensation of each dual-employee between:

(1) distribution related services for the issuer;
(2) solicitation, sales and distribution services for the affiliated NASD member; and
(3) non-distribution-related services, if the affiliated NASD member maintains procedures applied on a consistent basis[28] for allocating the time of each dual-employee.[29]

It is our intent to reduce the pre-offering review burden on NASD staff by establishing a structure that would allow NASD examination staff to examine for compliance with the member's estimated allocation based on the actual time allocation for each dual-employed person at the end of the program. To the extent that an NASD member believes it to be burdensome to maintain the required procedures to provide a good-faith estimated allocation, the member can chose to include all non-transaction-based compensation in the calculation of underwriting compensation for the DPP or REIT. This same choice is also available in the case of the exception for fewer than 10 persons engaged in wholesaling,

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[27] NASD Notice to Members 04-07 (February 2004), at 77.

[28] We note that the SEC has recognized, for purposes of compliance with SEC Rules 17a-3(a)(1) and (a)(2) that a member may use a reasonable cost allocation method that is applied on a consistent basis. NASD Notice to Members 03-63 (October 2003), at 667. We believe that members should similarly be allowed to use a consistently-applied cost allocation method with respect to the non-transaction-based compensation of dual-employed associated persons.

[29] In light of this recommendation, the proposed exception for a wholesaler with less than 10 persons engaged in wholesaling should be deleted, as such a small wholesaler would be able to easily monitor the time of any dual-employed associated persons.

Alternative Recommended Revision: Therefore we recommend that the NASD revise proposed Rule 2810(b)(4)(C)(ii)b. as follows:

> b. to any ~~employee~~ registered associated person of a member ~~and any dual-employee of a member~~ and any associated person required to be so registered that is also employed by the sponsor, issuer or other affiliate who receives transaction-based compensation, unless ~~information has been provided to the NASD, with regard to a program or REIT with fewer than ten people engaged in wholesaling, from which the Corporate Financing Department can readily conclude that~~ the NASD is provided a good-faith estimated allocation of the non-transaction-based compensation ~~payments~~ that ~~are made~~ will be paid to each person in consideration for ~~non-broker/dealer services provided to the sponsor, issuer or other affiliate~~ (i) the preparation of and subsequent offering of the program or REIT for the sponsor or other affiliate other than the member; (ii) solicitation, marketing, sales and distribution of the program or REIT for the member; and (iii) services unrelated to the preparation and distribution of the program or REIT, which estimated allocation is based on a procedure of the member applied on a consistent basis that monitors and allocates annually the time of each dual-employed person;

Reimbursement of Fees for Legal Services– Rule 2810(b)(4)(C)(ii)c.: The NASD proposal to include payments for "legal services provided to a member in connection with the offering" in the calculation of underwriting compensation is duplicative of NASD Rule 2710(c)(3)(iii), which includes in underwriting compensation "fees and expenses of underwriter's counsel (except for reimbursement of 'blue sky' fees)." Although the latter provision references the legal expenses of "underwriter's" counsel, the NASD has treated all participating members as "underwriters" pursuant to the definition of "underwriter and related persons" in Rule 2710(a)(6). Therefore, we recommend that the reference to "legal services" be deleted from this provision.

Miscellaneous

Definition of REIT: In addition to our proposal that Rule 2810 be amended to include in new Rule 2810(a)(16) a definition of a REIT, we also recommend that the definition of "sponsor" in current Rule 2810(a)(18) (renumbered (19)) be amended to reference REITs, as follows:

> (~~18~~ 19) Sponsor – a person who directly or indirectly provides management services for a direct participation program or REIT whether as a general partner, pursuant to contract or otherwise.

Comment Period

The SEC afforded a 21-day period for the submission of comments with respect to the Proposal in conformance with the 35-day statutory time period for final action by

the SEC regarding rule changes filed by a self-regulatory organization ("SRO") pursuant to Section 19(b)(2) of the Exchange Act. The comment period for the Proposal expired on August 7, 2006. Although we worked diligently to submit this comment letter by August 7, we were unable to do so. The Proposal represents a major revision to NASD Rule 2810 that will have a significant impact on the NASD's regulation of DPP and REIT offerings. The development of detailed comments with respect to such a significant proposal is time-consuming and will always take longer than 21 calendar days.

We urge the SEC to consider that any substantive rule proposal of an SRO should be afforded a comment period of at least 60 days, similar to the comment period provided by the SEC with respect to substantive rule proposals related to SEC rules and regulations. An extended time period for comment beyond 21 days can be achieved with respect to SRO rule filings in conformance with Section 19(b)(2) of the Exchange Act by the SRO agreeing to an extension of the time period for SEC action in Item 6 of the SEC Form 19b-4 filed with the SEC with respect to the rule change.

* * *

We hope that these comments will be helpful to the Commission in its consideration of the Proposal. We would be pleased to discuss any aspects of these comments with the staffs of the NASD or SEC. Questions may be directed to Suzanne E. Rothwell (202) 371-7216, Chair, NASD Corporate Financing Rules Subcommittee.

Respectfully submitted,

/s/ Keith F. Higgins

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