

INFORMATIONAL

## Customer Account Statements

NASD Adopts Amendments To Customer Account Statement Rule; Effective April 16, 2001

### SUGGESTED ROUTING

*The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.*

- Legal & Compliance
- Limited Partnerships
- Operations

### KEY TOPICS

- Customer Account Statements
- Direct Participation Programs
- Merchant Banking
- NASD Rule 2340

### Executive Summary

NASD Regulation, Inc. (NASD Regulation<sup>SM</sup>) has adopted amendments to National Association of Securities Dealers, Inc. (NASD<sup>®</sup>) Rule 2340 (Rule) to require general securities members to provide valuations and disclosures relating to direct participation program (DPP) and real estate investment trust (REIT) securities on customer account statements under certain circumstances.<sup>1</sup>

The text of the amendments is included with this *Notice to Members* (see Attachment A). The amendments become effective April 16, 2001.

### Questions/Further Information

Questions concerning this *Notice to Members* may be directed to Suzanne E. Rothwell, Chief Counsel, Corporate Financing Department, NASD Regulation, Inc., at (240) 386-4644.

### Description Of Amendments

**Background** – Rule 2340 of the NASD Conduct Rules requires members that conduct a general securities business to send account statements to customers on at least a quarterly basis. The statements must include a description of any securities position, money balances, or account activity since the prior account statement was sent.<sup>2</sup> A member that does not carry customer accounts and does not hold customer funds and securities is exempt from the provisions of Rule 2340. Thus, the Rule only applies to members that self-clear or that clear for other members (“general securities members”).<sup>3</sup>

**Scope Of Amendments** – NASD Regulation has adopted new requirements in Rule 2340 to

require that general securities members provide valuations and disclosures relating to DPP securities and REIT securities on customer account statements. The definitions of “DPP” and “REIT” in Rules 2340(c)(3) and (4) cover securities that are sold in a public offering. The definitions exclude securities listed on a national securities exchange or The Nasdaq Stock Market<sup>®</sup>, as well as securities that are in a depository and settle regular way. The excluded securities are more likely to trade regularly and, therefore, investors have ready access to current market value information. The definition of “DPP” also excludes any program registered as a commodity pool, since those programs generally offer investors a security that is redeemable by the issuer, at the customer’s option at regular intervals and at ascertainable values.

**Mandatory Estimated Value** – Rule 2340(b)(1)(B) requires a general securities member to include in a customer’s account statement an estimated value for a DPP or REIT security if the annual report<sup>4</sup> of a DPP or REIT that is held in a customer’s account or included on the customer’s account statement includes a per share estimated value. The estimated value must be based on recent data in compliance with Rule 2340(b)(2) and the account statement must include the disclosures required by Rule 2340(b)(3), more fully discussed below.

Although the inclusion of the estimated value in the issuer’s annual report triggers the member’s obligation to provide a valuation on the customer’s account statement, the estimated value included on the account statement can be obtained from the annual report, an independent valuation service,<sup>5</sup> or any other source.<sup>6</sup>

The estimated value must be included in the first customer account statement that is required to be sent to customers under Rule 2340(a) after the annual report is available.

**Voluntary Estimated Value** – If an issuer’s annual report does not include an estimated value, a general securities member may nonetheless voluntarily include an estimated value for DPP or REIT securities on a customer’s account statement. Rule 2340(b)(1)(A) requires that a voluntary estimated value must be based on recent data in compliance with Rule 2340(b)(2) and the account statement must include the disclosures required by Rule 2340(b)(3).

**Reliability Of Estimated Values** – The Rule does not obligate a general securities member to confirm the accuracy of an estimated value provided in a DPP or REIT’s annual report or provided by any other source external to the member. However, if a general securities member can demonstrate (i.e., to the NASD) that an estimated value was inaccurate as of the date of the valuation or is no longer accurate as a result of a material change in the operations or assets of the program or trust, Rule 2340(b)(4) requires that the member refrain from including the value on its account statements. A general securities member that can demonstrate that the estimated value in an annual report is inaccurate must, nonetheless, provide an alternative per share estimated value from another source when the member’s disclosure obligation is mandatory under Rule 2340(b)(1)(B).

**Requirement For Recent Data** – Rule 2340(b)(2) requires that an estimated value be developed from data that is of a date no more than 18 months prior to the date

that the statement is issued. The 18-month standard provides sufficient time for the general securities member or an independent valuation service to develop an estimated value for DPP and REIT securities based on the audited financial statements contained in the Form 10-K of the DPP or REIT. For example, an estimated value based on December 31, 2001 financial statements may be used from the date the annual report is available through June 30, 2003. Thus, there would be time, for example, between April when the report is available and June 2003 for a new estimated value to be developed based on the December 31, 2002 financial statements.

**Required Disclosures** – Rule 2340(b)(3) requires an account statement that provides an estimated value for a DPP or REIT security to include: (1) a brief description of the estimated value, its source, and the method by which it was developed; and (2) disclosure that DPP or REIT securities are generally illiquid, and that the estimated value may not be realized when the investor seeks to liquidate the security.

Rule 2340(b)(5) requires an account statement that does not provide an estimated value for a DPP or REIT security to include disclosure that: (1) DPP or REIT securities are generally illiquid; (2) the value of the security will be different from its purchase price; and (3) if applicable, that accurate valuation information is not available.

**Rules 2710 And 2810** – NASD Regulation has also adopted amendments to Rule 2710, “Corporate Financing Rule—Underwriting Terms and Arrangements,” and Rule 2810, “Direct Participation Programs,” that are intended to help ensure that DPP general partners or sponsors and

REIT trustees provide estimated per share values in their annual reports. Rule 2710(c)(6) and Rule 2810(b)(5), as amended, prohibit a member or associated person from participating in a public offering of DPP or REIT securities unless the general partner or trustee, as applicable, agrees to disclose in each annual report distributed to investors pursuant to Section 13(a) of the Securities Exchange Act of 1934 a per share estimated value of the securities, the method by which it was developed, and the date of the data used to develop the estimated value.

### Endnotes

- 1 Securities Exchange Act Release No. 432601 (November 21, 2000); 65 F.R. 71169 (November 29, 2000).
- 2 NASD Rule 2340(c)(1) defines “account activity” to include, but not be limited to, purchases, sales, interest credits or debits, charges or credits, dividend payments, transfer activity, securities receipts or deliveries, and/or journal entries relating to securities or funds in the possession or control of the member.
- 3 “General securities member” is defined in the rule to mean any member that conducts a general securities business and is required to calculate its net capital pursuant to the provisions of SEC Rule 15c3-1(a), except for paragraphs (a)(2) and (a)(3).
- 4 NASD Rule 2340(c)(5) defines “annual report” to be the most recent annual report of a DPP or REIT distributed to investors pursuant to Section 13(a) of the Securities Exchange Act of 1934.
- 5 The term “independent valuation service” is intended to refer to a company, independent of a member, that is in the business of providing estimated values for DPP and REIT securities.
- 6 An alternative source for an estimated value would include a valuation developed internally by the member.

## ATTACHMENT A

### Adopted Revisions

*New text is underlined; deletions are in brackets.*

#### 2340. Customer Account Statements

##### (a) General

Each general securities member shall, with a frequency of not less than once every calendar quarter, send a statement of account ("account statement") containing a description of any securities positions, money balances, or account activity to each customer whose account had a security position, money balance or account activity during the period since the last such statement was sent to the customer.

##### (b) DPP/REIT Securities

###### (1) (A) Voluntary Estimated Value

A general securities member may provide a per share estimated value for a direct participation program ("DPP") or real estate investment trust ("REIT") security on an account statement, provided the member meets the conditions of paragraphs (b)(2) and (3) below.

###### (B) Mandatory Estimated Value

If the annual report of a DPP or REIT includes a per share estimated value for a DPP or REIT security that is held in the customer's account or included on the customer's account statement, a general securities member must include an estimated value from the annual report, an independent valuation service,

or any other source, in the first account statement issued by the member thereafter, provided that the member meets the conditions of paragraphs (b)(2) and (3) below.

(2) A member may only provide a per share estimated value for a DPP or REIT security on an account statement if the estimated value has been developed from data that is as of a date no more than 18 months prior to the date that the statement is issued.

(3) If an account statement provides an estimated value for a DPP or REIT security, it must include:

(A) a brief description of the estimated value, its source, and the method by which it was developed; and

(B) disclosure that DPP or REIT securities are generally illiquid, and that the estimated value may not be realized when the investor seeks to liquidate the security.

(4) Notwithstanding the requirement in paragraph (b)(1)(B), a member must refrain from including a per share estimated value for a DPP or REIT security on an account statement if the member can demonstrate the value was inaccurate as of the date of the valuation or is no longer accurate as a result of a material change in the operations or assets of the program or trust.

(5) If an account statement does not provide an estimated value for a DPP or REIT security, it must include disclosure that:

(A) DPP or REIT securities are generally illiquid;

(B) the value of the security will be different than its purchase price; and

(C) if applicable, that accurate valuation information is not available.

##### [b](c) Definitions

For purposes of this Rule, the following terms will have the stated meanings:

(1) [the term] "account activity" includes, but is not limited to, purchases, sales, interest credits or debits, charges or credits, dividend payments, transfer activity, securities receipts or deliveries, and/or journal entries relating to securities or funds in the possession or control of the member.

[c](2) [For purposes of this rule, the term] a "general securities member" refers to any member which conducts a general securities business and is required to calculate its net capital pursuant to the provisions of SEC Rule 15c3-1(a), except for paragraph (a)(2) and (a)(3). Notwithstanding the foregoing definition, a member which does not carry customer accounts and does not hold customer funds and securities is exempt from the provisions of this [Rule] section.

(3) "direct participation program" or "direct participation program security" refers to the publicly issued equity securities of a direct participation program as defined in Rule 2810 (including limited liability companies), but does not include securities on deposit in a registered securities depository and settled regular way, securities listed on a national

securities exchange or The Nasdaq Stock Market, or any program registered as a commodity pool with the Commodities Futures Trading Commission.

(4) "real estate investment trust" or "real estate investment trust security" refers to the publicly issued equity securities of a real estate investment trust as defined in Section 856 of the Internal Revenue Code, but does not include securities on deposit in a registered securities depository and settled regular way or securities listed on a national securities exchange or The Nasdaq Stock Market.

(5) "annual report" means the most recent annual report of the DPP or REIT distributed to investors pursuant Section 13(a) of the Act.

**(d) Exemptions**

Pursuant to the Rule 9600 Series, the Association may exempt any member from the provisions of this Rule for good cause shown.

**2710. Corporate Financing Rule – Underwriting Terms and Arrangements**

**(a) - (b) No change.**

**(c) Underwriting Compensation and Arrangements**

**(1) - (5) No change.**

**(6) Unreasonable Terms and Arrangements**

(A) No change.

(B) Without limiting the foregoing, the following terms and arrangements,

when proposed in connection with the distribution of a public offering of securities, shall be unfair and unreasonable:

(i) - (xiv) No change.

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

**Rule 2810. Direct Participation Programs**

**(a) No Change.**

**(b) Requirements**

**(1) - (5) No Change.**

**(6) Valuation for Customer Account Statements**

No member may participate in a public offering of direct participation program securities unless:

(A) the general partner or sponsor of the program will disclose in each annual report distributed to investors pursuant to Section 13(a) of the Act a per share estimated value of the direct participation program securities, the method by which it was developed, and the date of the data used to develop the estimated value.

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