Institute for Portfolio Alternatives

March 20, 2025

Jennifer Piorko Mithcell
Office of the Corporate Secretary
FINRA
1700 K Street, NW
Washington, D.C. 20006
pubcom@finra.org

RE: Regulatory Notice 24-17 (Notice)

Dear Ms. Mitchell:

The Institute for Portfolio Alternatives (IPA) appreciates FINRA's efforts to improve and clarify its rules governing capital formation, as represented most recently by the Notice. The IPA represents sponsors and distributors of alternative investments, including net asset value (NAV) REITs and business development companies (BDC), lifecycle REITs and BDCs (REITs and BDCs that are not continuously offered but do maintain share repurchase programs),[1] interval funds, tender offer funds and regulated distributors of private placement securities.

EXECUTIVE SUMMARY

The IPA supports the amendments proposed in the Notice, particularly the proposed amendments to Rule 5110 and Rule 5123. We do, however, have the following additional suggestions:

- We recommend that the proposed new Supplementary Material .05 to Rule 5110, concerning capitalization transactions, be clarified to:
    - establish a self-operating safe harbor, rather than one subject to FINRA staff discretion;
    - provide that a capitalization transaction occurring before the issuer has material assets will be deemed to occur at or above NAV; and
    - provide the safe harbor for any capitalization transaction that meets the conditions of the Supplementary Material at any time during the life of the nonlisted REIT or BDC, not only capitalization transactions made before or at the time of the initial offering.

[1] While no lifecycle REITs or BDCs are currently being offered, many are still in an operational phase.

- We recommend that FINRA consider improvements to the operation of Rule 5110 and Rule 2310.
- We recommend that FINRA conduct a retrospective review of Rule 2310, to address the anachronistic and impractical features of that rule.
- We respectfully request that FINRA reconsider the dramatic increase in FINRA filing fees related to its public offering program, particularly as they apply to nonlisted REITs and BDCs.

1. The IPA Supports Proposed Supplementary Material .05

The IPA supports proposed Supplementary Material .05 to Rule 5110, which would provide a safe harbor for a transaction to capitalize a nonlisted REIT or BDC.[2] Much like the sponsors of registered investment companies, nonlisted REIT and BDC sponsors often inject capital so that the REIT or BDC can acquire assets. We agree with FINRA that the shares received by the sponsor in these capitalization transactions should not be treated as "underwriting compensation" when they meet the conditions of the Supplementary Material.

The Supplementary Material would provide a safe harbor from underwriting compensation for a capitalization transaction (1) that is disclosed in the prospectus, (2) when the securities "are valued and priced on a net asset value or NAV basis," (3) when the offering is subject to Rule 2310, and (4) when there is no economic disposition of the acquired securities for 180 days following commencement of sales.

The Supplementary Material would clarify that capitalization transactions meeting these conditions would not constitute underwriting compensation under Rule 5110. For this reason, the IPA supports the Supplementary Material. We do, however, have three recommendations to further clarify the safe harbor.

A. The Safe Harbor Should be Self-Operating

First, the Supplementary Material would provide that FINRA "may" exclude securities acquired in certain capitalization transactions. The proposed safe harbor would not foster capital formation in an efficient manner if the FINRA staff would have to approve every invocation of the safe harbor by a nonlisted REIT or BDC.

We recommend that the safe harbor be self-operating, to ensure that it will function most efficiently. We thus recommend the following changes to the introduction of the Supplementary Material:

[2] The Notice says that capitalization transactions covered by the Supplementary Material "are common in unlisted REIT and DPP offerings." Nonlisted BDCs typically are structured as "direct participation programs," as defined in Rule 2310(a)(4).

> Notwithstanding paragraph (j)(22) of this Rule, [FINRA may exclude] securities acquired by a participating member in the issuer or an affiliated entity, in connection with the investment of cash to capitalize a direct participation program or a real estate investment trust, as defined in Rule 2231(d), are excluded . . .

Our suggested change would advance the purpose of the Supplementary Material to foster capital formation by removing unnecessary impediments to legitimate capitalization transactions.

B. A NAV Determination Should not be Necessary in connection with a Seed Capital Transaction

Second, the Supplementary Material would require that the securities acquired in the capitalization be "valued and priced on a net asset value or NAV basis." The language could be read to require the sponsor to implement the procedures called for under Rule 2231 to establish a net asset value. Such an appraisal should not be required for an initial capitalization transaction as it is the initial capitalization that effectively sets the net asset value. Prior to the issuer having material assets, the shares are worth no more than what the sponsor pays for them.

We suggest the following clarification:

> (b) the securities offered to the public and the securities acquired in the capitalization transaction are valued and priced on a net asset value or NAV basis; provided that, with respect to a seed capital investment before the issuer has material assets, the securities acquired in the capitalization transaction shall be conclusively deemed to have been priced on an NAV basis.

C. The Safe Harbor Should Be Available After the Initial Offering

Third, the safe harbor would apply to any "seed capital investment or a comparable form of capitalization." The title of the Supplementary Material is "Seed Capital Investments" and the Notice refers to "investments by participating members in anticipation of, or concurrently with, a public offering." It is not uncommon for capitalization transactions to occur during the life of a continuously offered nonlisted REIT or BDC. These transactions may be necessary, for example, if the nonlisted REIT or BDC intends to acquire additional assets but is subject to legal, policy or practical limitations on its ability to do so from existing capital.

There is no reason for these capitalization transactions to be counted as underwriting compensation if they meet the conditions of the Supplementary Material – that the transaction is disclosed in the prospectus, the purchase price occurs at NAV, the

offering complies with Rule 2310, and there is no economic disposition of the securities for 180 days.

We therefore recommend that FINRA change the title of the Supplementary Material to "Capital Investments," amend paragraph (a) as follows, and make clear in the final regulatory notice that that the safe harbor would be available to any capitalization transaction that meets the safe harbor's conditions, including one occurring after the initial offering:

> (a) the acquisition of securities is disclosed in the issuer's prospectus as a [seed] capital investment or a comparable form of capitalization.

2. The IPA Recommends Improvement in the Operation of Rule 5110 and Rule 2310

In addition to the proposed amendments, FINRA has "implemented operational improvements in response to comments from members that raise capital" in exempt offerings. The IPA continues to recommend that FINRA adopt operational improvements in its review of registered offerings, too.

In particular, we recommend that the Corporate Financing Department streamline its process for reviewing nonlisted REIT and BDC filings under Rule 5110 and Rule 2310. For example, 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.[3]

3. The IPA Recommends a Retrospective Review of Rule 2310

FINRA has not taken a comprehensive look at Rule 2310 in almost two decades, and the rule is out of date.[4] For example, Rule 2310(b)(2) imposes a suitability standard on the recommendation of a direct participation program (DPP) without any recognition of the Securities and Exchange Commission's adoption of Regulation Best Interest. Moreover, as we have previously commented, the prohibition in Rule 2310(b)(2)(C) of any execution of a DPP transaction in discretionary accounts without prior written customer approval is unnecessary and unworkable, particularly when the FINRA member only executes, and does not recommend, the transaction.[5] The FINRA staff's interpretation of this provision, to cover members who merely execute a transaction recommended by a registered investment adviser, raises costs to the investor by preventing "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 are only two examples of the anachronistic features of Rule 2310. The IPA respectfully urges FINRA to conduct a retrospective review of that rule, to modernize its provisions and to ensure that the rule does not unnecessarily impede capital formation.[6]

4. The IPA Requests Reconsideration of the Dramatic Increase in Filing Fees

FINRA recently adopted an increase in many of its fees, including the filing fee related to its public offering program.[7] FINRA members participating in the public offerings of nonlisted REITs and BDCs must file under Rule 5110 and Rule 2310 and therefore will be affected by FINRA's fee increase. This fee increase is typically reimbursed by the

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

[4] *See* https://www.finra.org/sites/default/files/RuleFiling/p015082.pdf (September28, 2005) (proposed amendments to the predecessor to Rule 2310).

[5] *See* IPA Letter to Jennifer Piorko Mitchell (August 7, 2023).

[6] *Cf.* Regulatory Notice 17-15 (April 12, 2017) (comprehensive proposal to amend Rule 5110).

[7] *See* https://www.finra.org/sites/default/files/2024-11/sr-finra-2024-019.pdf at 43. (Notice of effectiveness by the Securities and Exchange Commission) ("SEC Release"). FINRA also has adopted a filing fee for its private placement program under Rule 5122 and Rule 5123. *Id.* at 42.

nonlisted REIT and BDC conducting the public offering, and ultimately by its stockholders.

The maximum fee today for FINRA members participating in nonlisted REIT and BDC public offerings is $225,500. FINRA has adopted an almost five-fold increase in the fee, effective on July 1, 2025. On the date, FINRA will raise the maximum fee for offerings other than for Well-Known Seasoned Issuers to $1,125,000.[8]

We appreciate the fact that FINRA last increased its public offering program filing fee in 2012, and that a fee increase might be justified. Nevertheless, a five-fold increase in the fee seems excessive. Such a dramatic increase will encourage nonlisted REITs and BDCs to raise capital in private placements, outside of FINRA's regulation under Rule 5110 and Rule 2310. As FINRA may be aware, nonlisted REITs and BDCs increasingly are choosing to offer their shares through private placements rather than public registrations, partially due to increasing expenses associated with the public offering of their shares.[9] Because these expenses fall particularly hard on smaller REITs and BDCs, the five-fold increase in FINRA's filing fee could discourage competition.

For these reasons, we respectfully request that FINRA reconsider the dramatic increase in FINRA filing fees related to its public offering program, particularly as they apply to nonlisted REITs and BDCs.

Thank you for the opportunity to comment on the Notice. Please send questions about our comments to Jeff Evans, IPA's director of government affairs and policy, at jevans@ipa.com.

Sincerely,

Anya Coverman
President and CEO
Institute for Portfolio Alternatives

[8] For WKSI filers the maximum fee will increase over five years from $225,000 to $560,000. SEC Release at 44.

[9] See, e.g., "Ares Management Forsakes Public Nonlisted REIT Stock Sales" (CoStar), https://www.costar.com/article/44091416/ares-management-forsakes-public-nonlisted-reit-stock-sales.