GOVERNMENT OF PUERTO RICO

Office of the Commissioner of Financial Institutions

CIRCULAR LETTER NUMBER CFI CC-18-04

TO: **ALL SECURITIES ISSUERS, BROKER-DEALERS, INVESTMENT ADVISERS AND/OR ITS AGENTS OR REPRESENTATIVES OFFERING OR SELLING DIRECT PARTICIPATION PROGRAMS ("DPPs")**

FROM: **GEORGE JOYNER, COMMISSIONER**

DATE: **OCTOBER 12, 2018**

RE: **CONCENTRATION LIMITS FOR NON-TRADED DPPs**

I. Authority

This circular letter is issued pursuant to the authority conferred by Act Number 4 of October 11, 1985, as amended, known as the "Office of the Commissioner of Financial Institutions Act" (hereinafter "Act No. 4") and Act No. 60 of June 18, 1963, as amended, known as "Uniform Securities Act" (the "Act" or "Act No. 60").

II. Legal Base and Purpose

Act No. 4 entrusts the Commissioner of Financial Institutions with the main responsibility of controlling and supervising the financial institutions that operate or do business in Puerto Rico. Also, the Act, in its Section 412, Subsection (a), provides that:

> (a) The Commissioner may issue, amend and rescind, from time to time, such regulations, forms, and orders as may be necessary to enforce the provisions of this act, including regulations and forms governing applications and reports, and defining any terms, whether or not used in this act, insofar as said definitions are not inconsistent with the provisions of this act...

In accordance with Act No. 4 and Act No. 60, the Office of the Commissioner of Financial Institutions (hereinafter "OCFI") adopted Regulation No. 6078 of January 19, 2000, as amended, known as "Regulation under the Uniform Securities Act of Puerto Rico" (hereinafter "Regulation No. 6078"). Article 25 of Regulation No. 6078 establishes the standard of business and fiduciary duties for broker-dealers and also sets out the actions that constitute dishonest or unethical practices in the securities business.

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Specifically, Section 25.1 of Regulation No. 6078 provides the following regarding the standard of business and fiduciary duties toward customers:

> "Every broker-dealer, issuer, investment adviser, investment adviser representative, federal covered adviser, investment adviser representative of a federal covered adviser, agent or any other person subject to the provisions of the Act, must observe the highest standard of fiduciary duty toward their customers and investors."

Moreover, Sections 25.2 and 25.3 of Regulation No. 6078 provide the following:

> Section 25.2. Dishonest Practices.
> The acts mentioned in the following sections of this article, among others, are practices contrary to the standards mentioned in section 25.1, above, and constitute actions sanctionable by the denial, suspension or revocation of the registration or any other remedy authorized by the Act, this regulation or any other applicable legal provision....
>
> Section 25.3. In regard to broker-dealers, investment advisers, investment adviser representatives, federal covered advisers, investment adviser representatives of federal covered advisers and agents, any of the following acts, among others, constitute dishonest or unethical practices:
> ...
>
> 25.3.4. To recommend to a customer the purchase, sale or exchange of any security without reasonable grounds to believe that such transaction or recommendation is suitable for the customer in light of the information obtained from the customer by the broker-dealer, investment adviser, investment adviser representative or agent, to verify the investment objective, economic situation and needs of the customer, which information will be used to perform the analysis about adequate transactions or recommendations for the customer ("suitability");
> 25.3.5. To execute transactions in, or for the account of a customer, without reasonable grounds to believe that such transaction is suitable for said customer in light of the information obtained from the customer by the broker-dealer, investment adviser, investment adviser representative or agent to verify the customer's investment

objectives, financial situation and needs; ...

The person or persons selling or recommending a security or investment strategy have a legal obligation to determine whether a security or strategy is appropriate for the person to whom it is being sold or recommended. This analysis is often referred to as "suitability".

NASD Rule 2340(d)(3) defines DPPs and REITS as follows:

> (3) "direct participation program" or "direct participation program security" refers to the publicly issued equity securities of a direct participation program as defined in FINRA Rule 2310 (including limited liability companies), but does not include securities listed on a national securities exchange or any program registered as a commodity pool with the Commodity 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 listed on a national securities exchange.

One of the suitability standards for Direct Participation Programs (DPPs, including non-traded Real Estate Investment Trusts (REITs)), is a concentration limit that encourages diversification in investor portfolios by limiting the percentage of the portfolio that may be allocated to a specified investment, sponsor, or asset class. The limit seeks to protect all investors, particularly elderly investors to whom DPPs are often marketed, from over-concentrating their portfolios in illiquid DPPs.

Currently, several states have concentration limits that are applicable to DPP offerings, such as non-traded REITs, business development companies, and oil and gas drilling companies, among others. DPPs are complex securities offerings, involve substantial risks, including, among others, severe restrictions on liquidity that may lock-in investors indefinitely, and high upfront sales fees and expenses of the initial offering price and substantial on-going fees thereafter.

Another source of suitability standards applicable to an offering is the Prospectus itself. Generally known as "prospectus suitability", this is where the concentration limit is incorporated into an offering during the registration process. By writing the concentration limit language into the Prospectus, the issuer adopts it as its own and should be prepared to assist securities professionals in interpreting and complying with the limit.

With this suitability framework in mind, by this Circular Letter the OCFI is determining a maximum concentration limit of ten percent (10%) of an investor's liquid net worth, applicable to their aggregate investments in securities of the issuer of a non-traded DPP, affiliates of the issuer, and other similar non-traded DPPs. Also, a requirement for disclosure of the concentration limit in the Prospectus is incorporated. These measures are aimed to ensure that the DPPs products are being marketed and sold only to appropriate investors.

III. Concentration Limit

a. Definition of DPPs and REITS

For purposes of this Circular Letter and the concentration limit herein determined, the term Direct Participation Programs will have the same definition as provided by NASD Rule 2340, cited above, but also will include non-traded Real Estate Investment Trusts as defined by NASD Rule 2340, also cited above. For purposes of this Circular Letter we shall jointly refer to the DPPs and the REITS as the "DPPs".

b. Concentration Limit

The aggregate investment in securities of the issuer of a non-traded DPP, affiliates of the issuer, and other similar non-traded DPPs shall not exceed 10% of the investor's liquid net worth. Liquid net worth is defined as that portion of net worth (total assets exclusive of primary residence, home furnishings, and automobiles minus total liabilities) consisting of cash, cash equivalents, and readily marketable securities (the "Concentration Limit").

c. Duty of broker-dealers, issuers, investment advisers, investment adviser representatives, federal covered advisers, investment adviser representatives of federal covered advisers, agents.

Every broker-dealer, issuer, investment adviser, investment adviser representative, federal covered adviser, investment adviser representative of a federal covered adviser, agent or any other person subject to the provisions of the Act (hereinafter, the "Securities Business Entity") shall implement the concentration limit, as stated above, for investors who purchase securities of the issuer of a non-traded DPP, affiliates of the issuer, and other similar non-traded DPPs for which there is not likely to be a substantial and active secondary market.

It shall be unsuitable for an investor's aggregate investment in securities of the issuer of the non-traded DPP, affiliates of the issuer, and other similar non-traded DPPs to exceed ten percent (10%) of his, her, or its liquid net worth.

Every Securities Business Entity offering or selling shares or interests on behalf of the non-traded DPP shall make every reasonable effort to assure that the investors being offered or sold the non-traded DPP interests, by reason of their educational, business, or financial experience, can be reasonably concluded to have the capacity to understand the fundamental aspects of the DPP and meet the suitability standards imposed. These Securities Business Entities shall ascertain that the investor can bear the economic risk of an investment in the program and that the program interests are appropriate for the investor's investment objectives, portfolio structure, and financial situation.

d. Issuers

If an issuer is registering or attempting to register a non-traded DPP, the registration statement must include the language below in the section for suitability standards for Puerto Rico:

> "In addition to the general suitability standards listed above, an investor may not invest, and we may not accept from an investor more than ten percent (10%) of that investor's liquid net worth in shares of us, our affiliates, and in other non-traded {program type} . Liquid net worth is defined as that portion of net worth (total assets exclusive of primary residence, home furnishings, and automobiles minus total liabilities) consisting of cash, cash equivalents, and readily marketable securities. "

Complying with the concentration limit determined in this Circular Letter does not necessarily mean that the sale or recommendation satisfies Sections 25.1, 25.2 and 25.3 of Regulation No. 6078 and the suitability provisions of the Financial Industry Regulatory Authority ("FINRA"). In order to remain in compliance with these provisions, securities professionals should be able to demonstrate that each recommendation or sale complies with all applicable rules and guidelines.

IV. Penalties

The Securities Business Entities that fail to comply with this requirement, may be subject to the applicable sanctions authorized by Act No. 4, the Act, Regulation No. 6078 or any other applicable legal provision. Failure to comply may also result in the cancellation of the

license, pursuant to the provisions of Act No. 4, after the holding of administrative hearings.

V. **Effectiveness**

This circular letter will become effective after thirty (30) days from the date of its issuance.