Direct Participation Programs (excerpt only)

Introduction and Definition

Direct Participation Program (DPP) is a general name for a type of securities product. These products can be thought of as investment vehicles through which businesses seek to raise outside funds to finance specific aspects of their business operations or plans. While from a technical and legal perspective the term DPP refers to products governed by NASD Rule 2810 ("The DPP Rule"), many industry participants use the term DPP to refer to products not encompassed by rule 2810, including non-traded REITs, which will be discussed in more detail elsewhere.

The investments are typically tied to financing the acquisition of specific hard assets. Real estate, oil, gas and equipment leasing are the most common underlying assets, although funding can be for a wide variety of other uses. The investment objectives of the investment are important factors to consider when matching potential investments to clients stated objectives, income and liquidity needs. For example, equipment leasing companies may want capital to finance the purchase or lease of transportation equipment, so they may structure a DPP with the objective of providing investors with a lease income stream and certain tax benefits. Real estate companies may similarly seek capital to buy and rent commercial or residential real estate properties, and structure investments designed to provide partially tax sheltered current income and capital appreciation. These specific projects are known as investment programs, and individual investments are commonly known as units or interests. The business managers are generally known as sponsors, issuers, managers or general partner of the program.

Investors in these programs have no decision-making authority regarding the investment, so this is known as a passive investment. They rely instead on the expertise of the sponsor to effectively manage the investment program and the underlying asset(s).

DPP projects generally have a specific projected term, which vary in length of time. This is known as the holding period. The anticipated holding period of the investment is an important criteria to consider when matching potential investments with a clients investment objectives and liquidity needs. In general, the longer the holding period the more difficult it becomes to accurately predict and project economic factors that may impact any given project or investment. As many DPPs are largely illiquid investments, a return premium may be a factor for longer holding periods.

Income and/or tax benefits are primary goals and advantages of a DPP investment. Many direct participation products are defined by their nature as 'flow-through entities', meaning that the results of the business of the entity 'flow' directly through to the investor for tax purposes. That means that there is no tax at the corporate level. Rather, income and losses generated by the underlying business are passed through to the investor on a pre-tax basis. Other tax related items, like deductible expenses and tax credits, are also passed on directly to the investor. The allocation of these benefits among investors is generally pro-rata based on their investment units. The allocation between investors and the sponsor is dictated by the disclosure and legal documents governing how the investment is to be run, and can vary substantially between different offerings and sponsors.

DPP products are generally not traded publicly. Therefore, the value of a DPP product is determined by the performance of the project in generating the anticipated benefits rather than public markets. DPP products are generally illiquid for the duration of their term (although some limited secondary market may exist). The evaluation of the product prior to investment, known as Due Diligence, is critically important. There must be a careful study of disclosure and legal documents and an evaluation of the reasonableness of the business plan and projections. How conservative or aggressive the plan is must be considered when matching a potential investment to a client's investment objectives and risk tolerance levels.