



SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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SEN. JOHN SPARKMAN

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WASHINGTON, D. C. 20510

Honorable John J. Sparkman, Chairman  
Committee on Housing, Banking and  
Urban Affairs  
United States Senate  
Washington, D. C. 20510

*J. J. Sparkman*

Dear Senator Sparkman:

This is with reference to the enclosed release of this Commission publishing for comment amendments contemplated by the National Association of Securities Dealers, Inc. ("NASD") to its Rules of Fair Practice which would provide for the regulation of distributions of tax sheltered programs.

While I believe the release is largely self-explanatory, the Commission did wish to draw your particular attention to the reference in the release and to the fact that the Commission is studying the possibility of formulating legislative proposals in this area. Following its consideration of the comments on the release, the Commission hopes to be in a position to advise you further on the matter.

I also have forwarded copies of the release to Senator Harrison A. Williams and Representatives Harley O. Staggers and John E. Moss.

For the Commission.

Sincerely,

*Hugh F. Owens*  
Hugh F. Owens  
Senior Commissioner

Enclosure

SECURITIES AND EXCHANGE COMMISSION  
Washington, D. C. 20549

SECURITIES EXCHANGE ACT OF 1934  
Release No. 10260/July 2, 1973

PROPOSED TAX SHELTER RULES OF THE NATIONAL ASSOCIATION OF SECURITIES  
DEALERS, INC. (File No. 4-168)

The Commission today announced that it is requesting public comment on proposed rules<sup>1/</sup> now being considered for adoption by the National Association of Securities Dealers, Inc. ("NASD") which would establish a system of regulation in connection with the distribution by NASD members of securities of tax sheltered programs.<sup>2/</sup>

The NASD published for comment on May 9, 1972 proposals which were substantially similar to the present proposals. The Commission has decided to supplement and update the NASD's publication by requesting all persons interested in this matter (including those who submitted comments to the NASD last May) to submit their views directly to the Commission. The Commission desires comments not only to aid in its possible consideration of the specifics of the NASD's proposed plan of regulation,

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<sup>1/</sup> The full current text of the rules is available for review or copying at the Commission's Public Reference Room, at 500 North Capitol St., Washington, D. C. 20549, or upon request from the NASD's Department of Corporate Financing, 1735 K Street, N. W., Washington, D. C. 20006, after July 5, 1973. It is suggested that persons wishing to comment on the specifics of these rule proposals utilize this text as the basis for such comments. For those who may be interested only in responding to the policy questions discussed in Section 3 of this release, the May 9, 1972 draft of the rules previously disseminated by the NASD appears to be sufficient for this purpose.

Under Section 15A(j) of the Securities Exchange Act of 1934, the NASD is required to submit any change in or addition to its rules for Commission review. Any such rule change or addition automatically takes effect thirty days after filing it with the Commission (or sooner if the Commission permits) unless the Commission enters an order disapproving it; such disapproval is given if the alterations or additions are inconsistent with the requirements of the Securities Exchange Act.

The subject rule proposals, which represent the NASD's most recent draft, are not at this stage a formal NASD filing under Section 15A(j). The Commission understands, however, that the NASD is now prepared to make such a filing.

<sup>2/</sup> Basically, a "tax shelter" is an investment in which flow-through tax benefits are a material factor affording investors relatively large deductions and lower income tax rates. Because of their tax significance these investments are usually sold to individuals who have substantial incomes.

when it is filed formally under the provisions of Section 15A(j) of the Exchange Act, but also to provide itself with a broadened basis for developing its own policy respecting an appropriate regulatory approach in the tax shelter area generally. It should be emphasized that the Commission has not yet officially reviewed the NASD rules and has suggested that the NASD defer further action to establish and implement its program until the Commission and the Association have had an opportunity to examine the responses to this release.

A. Background

For the past few years the NASD, as well as other regulatory and self-regulatory organizations, has been concerned about the expanding number of sales of tax sheltered securities which it believed were not being adequately regulated. The present NASD rule proposals reflect two years of effort on the part of the NASD and its special committees to remedy various significant problems it believes are present in many tax sheltered offerings. During this period the NASD has advised the Commission staff of its progress on a regular basis.

The Commission has also been concerned with tax sheltered programs. For example, it has initiated a proposal for federal legislation which would provide for the protection of participants in oil and gas drilling funds or programs.<sup>3/</sup> The proposal is designed to deal with oil and gas programs which provide flow-through federal tax treatment to investors and which generally offer their participation interests to the public. Its regulatory provisions would, among other things, provide controls designed to prevent conflicts of interest and unfair transactions between oil and gas programs and their managers; prohibit changes in fundamental policies of an oil and gas program without the approval of program participants; and require that persons acting as program managers do so pursuant to a written contract, material alterations of which would have to receive the participants' approval.

In another area, the Commission on May 3, 1972 appointed a Real Estate Advisory Committee to study the securities regulatory questions raised by real estate investment programs. The Committee's report which was published on October 12, 1972 emphasized the importance of certain presently regulatory tools, such as the disclosure requirements under the Federal securities laws, to ensure that adequate information is available

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<sup>3/</sup> S.-1050, 93d Cong., 2nd Session (February 28, 1973), as submitted by the Securities and Exchange Commission. This bill was originally introduced on August 7, 1972, S.-3884.

This proposed legislation was drafted by the Commission pursuant to the directive of the Managers on the part of the House in their statement appended to the Report of the Conference Committee on the Investment Company Amendment Act of 1970 (P.L. 91-547, approved December 14, 1970).

to customers; but, it also expressed caution against extending present Commission regulation over real estate securities.<sup>4/</sup> The Committee concluded, however, that if improved disclosure and enforcement policies do not adequately protect the interests of public purchasers in a competitive market, and if the state regulatory agencies and self-regulatory organizations are unable to achieve satisfactory uniformity in their regulatory programs in this regard, then a federal legislative approach may be necessary. The Committee also indicated that if legislation is deemed appropriate it might be modeled after the proposed Oil and Gas Investment Act.

Many of the states and various groups of state securities administrators have also been active in pursuing effective regulatory control over tax sheltered programs. In California, for example, the Real Estate Advisory Committee to the Commissioner of Corporations submitted its findings on February 23, 1973, and proposed rules for the offer and sale of real estate programs covering disclosure, investor suitability and management fees, among other matters. Rule proposals covering real estate syndications comparable to California's have also been adopted by the Midwest Securities Commissioners Association and we understand that they have been implemented in about 24 states represented in that group. These rules are substantially comparable to the NASD's proposals in the real estate area. The North American Securities Administrators Association also has been actively concerned with developing model rules and guidelines for use by its members within their own jurisdictions.

#### B. Nature of the NASD Proposals

The NASD rule proposals, which would prescribe standards governing tax shelters in which its members may participate, are rather lengthy (about 50 pages) and cover a great many aspects of their operations and underwriting arrangements. We have therefore prepared the following summary of them in order to facilitate discussion. The section numbers in parentheses refer to the appropriate sections of the NASD's draft.

1. Expertise (Section 2(a) and (b)) - NASD members who desire to act as sponsors of a program would be required to have a certain expertise appropriate to such a program (i.e., at least 4 years of experience in such matters).

2. Minimum Program Net Worth and Public Sales (Section 2(c) and (d)) - a sponsor would have to have a certain net worth before NASD

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<sup>4/</sup> Real Estate Advisory Committee, Report to the Securities and Exchange Commission (October 12, 1972) at pp. 5, 14 and 15.

members could underwrite or participate in the distribution of the program. 5/ In oil and gas programs, a minimum amount of public sales would have to be effected before the program could be activated. If such an amount were not raised, then all funds received from participants would have to be returned to them.

In programs other than oil and gas, there would likewise have to be minimum public sales before the program could be activated; however, unlike the oil and gas requirements, there would be no specified minimum dollar standard. Instead, this provision would require that there be sufficient funds to effect the objectives of the program.

3. Tax Benefits (Section 2(e)) - if the program could not substantiate its favorable tax benefits as described in the prospectus, by presenting a tax ruling or an opinion in respect to such matters by an independent tax counsel, an NASD member could not underwrite or participate in the distribution. Another provision of the proposed rules would require that purchasers have a right of withdrawal if the tax benefit representations in the prospectus were not accurate.

4. Subscriptions (Section 2(f)) - the amount of a subscription for an oil and gas program could not be less than \$5,000. Other types of programs would not be required to have a minimum subscription amount.

Installment Payments (Section 2(g)) - deferred subscription payments beyond a 12 month period may be permitted only in certain types of offerings, for example, in farming and real estate developments, among others.

5. Assessments<sup>6/</sup> (Section 2(j)-(p)) - proper disclosure would be required by the rules of possible assessments, mandatory or optional, which may be levied against program participants. Also, certain limitations would be placed on the maximum amount of mandatory assessments, and on the amount of certain penalties for failing to pay various assessments.

6. Reinvestment (Section 2(g)) - an investor would be provided with complete information on the amount of money to which he is entitled under a reinvestment program and with a copy of a prospectus relating to such subsequent program before deciding to participate.

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5/ It should be noted that the NASD uses the concept of net worth based on fair market value whereas the Midwest Securities Commissioners Association guidelines (as referred to above) use book value in computing net worth. Comments are invited as to the relative validity of these two methods for use by the NASD in the real estate area.

6/ Assessments, as used here, are understood to include additional amounts of capital which a participant may be required or requested to furnish beyond the subscription price.

7. Liquidation of Program Interests (Section 2(r), (s) and (t)) - programs whose sponsors are permitted to liquidate their interests would be required to allow public participants to transfer or sell their program interests on a comparable basis. When the latter possibility is provided, the rules would require that an independent appraisal be made of the liquidation values.

8. Disclosure of Certain Transactions (Section 2(u) and (v)) - in addition to requirements that all of the above information be fully disclosed in the prospectus, the rules would require specifically that information concerning business transactions of the program with any person would have to be similarly disclosed, if the aggregate amount of such transaction is at least 20 percent of the total dollar value of the participants' interest in the program.

9. Rights of Participants (Section 3) - the provisions in this area concern the legal relationships between the program and its participants. If the enumerated standards were not met, an NASD member would be prohibited from participating in the distribution of the program. Some of these requirements would be the right of participants by majority vote to remove the sponsor, to amend the partnership agreement and to dissolve the partnership; the termination of all contracts between the program and the sponsor without penalty on 60 days notice in writing; and the right of a participant to obtain a list of the names, addresses and interests held by all participants in the program (after payment of reproduction costs).

10. Conflicts of Interest (Section 4) - all potential conflicts of interest of sponsors and managers would be required to be fully disclosed in the prospectus. Also, if any property is sold to a program by its sponsor, the sale price would have to be established as fair according to the procedures established by the proposed rules; for example, the fair market value of the property would have to be determined by an independent qualified appraiser.

11. Suitability (Section 5) - a program would be required to establish and disclose in the prospectus its suitability standards for program participants. In order to determine the suitability of a program for a particular investor, the rules would establish certain minimum guidelines, among which are that the customer should be reasonably anticipated to be in at least a 50% tax bracket in certain high risk situations, and that the customer have a net worth sufficient to sustain the risk inherent in the program, including the loss of his investment.

12. Organization and Offering Expenses<sup>7/</sup> (Section 6) - the underwriting arrangements, including compensation received by NASD members for underwriting activities, would have to be fair and reasonable and fully disclosed in the prospectus. The rules also would provide that the organization and offering expenses must not exceed 15 percent of the dollar amount of the cash receipts of the offering.

13. Sponsor's Compensation (Section 7) - a summary of all compensation to the sponsor would be required to be disclosed in the prospectus and such compensation would have to be fair and reasonable. Also, the amount of compensation to sponsors would be subject to specific guidelines, with separate standards for oil and gas and real estate programs. For example, in the real estate area, the rules would require that programs prohibit the payment of rebates, concessions and comparable forms of compensation to the sponsor by a third party who has rendered services to the program for which he was compensated and would limit property management fees paid to a sponsor to an amount no higher than customary charges for similar services by a non-affiliated person engaged in property management as a regular business.

14. Periodic Reports (Section 8) - these provisions would require sponsors and programs to send specified reports to participants -- e.g., quarterly reports (by oil and gas programs during the drilling phase of operations only), containing information concerning the receipt and disbursement of revenue and other information, and annual statements after the close of the fiscal year.

15. Sales Literature (Section 9) - the proposed rules set forth detailed standards regarding the content of sales literature utilized by members and would require such literature to be filed with the NASD for review in advance of use. The rules would require that certain information be included in all sales literature; for example, a statement of the relevant factors relating to investment suitability of the program, the amount of sales charges and an accurate statement of the tax aspects of the program.

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<sup>7/</sup> Such expenses, as defined by the proposed rules, are those "charged directly to the program which are incurred in preparing a tax sheltered program for registration and subsequently offering and distributing it to the public . . ."

C. Policy Questions

While there appears to be wide support for more precise and effective regulation concerning tax sheltered distributions, and while considerable effort has already been devoted to formulating standards, the Commission believes that further discussion of some overall policy issues relating to the NASD proposals would be appropriate. Thus, the Commission requests that interested persons direct comments to the following policy questions.

1. Scope of NASD Regulation

a. In many of the areas covered by the proposed rules, the NASD has traditionally regulated the activities of its members. Among other things, it has dealt with qualification requirements for its members (under which would fall the proposed experience requirement referred to in paragraph 1 of the above summary), and it maintains standards for a review of sales literature (comparable to those discussed in paragraph 15).<sup>8/</sup> Also in this category are the provisions that would require NASD members adequately to assure themselves that purchasers of tax sheltered securities have sufficient financial resources to undertake the risks of such an investment (paragraph 11).<sup>9/</sup>

Tax shelter organization and offering expenses (paragraph 12) and the requirements concerning prospectus disclosures (paragraphs 3, 5, 6, 8, 10, and 11) are additional subjects covered by the proposed rules which are now covered under comparable present NASD provisions for other underwritings.<sup>10/</sup>

b. On the other hand, the NASD is also considering rules concerning tax shelters which may indirectly affect non-NASD members (e.g. sponsors and issuers) in ways not thought of heretofore as within the

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<sup>8/</sup> See qualification requirements under Article 1, Section 12 and Schedule C of its By-laws (CCH, NASD Manual Par. 1102A) and standards for sales literature used by member firms pursuant to the Interpretation of the NASD's Board of Governors concerning advertising generally (CCH, NASD Manual, Par. 2151) and investment company securities (CCH, NASD Manual, Par. 5252).

<sup>9/</sup> This suitability requirement is comparable in certain respects to the present NASD rule concerning member recommendations to customers. Article III, Section 2 of the NASD's Rules of Fair Practice, (CCH, NASD Manual, Par. 2152).

<sup>10/</sup> See Review of Corporate Financing Interpretation of the (NASD) Board of Governors relating to Section 1 of Article III of the Rules of Fair Practice, (CCH, NASD Manual, Par. 2151).



usual scope of the NASD's functions.<sup>11/</sup> These include requirements relating to the program's net worth and public sales (paragraph 2), amount of participant subscriptions and arrangements for installment payments (paragraph 4), assessments (paragraph 5), liquidation of program interests (paragraph 7), rights of participants (paragraph 9), conflicts of interest (paragraph 10), sponsor's compensation (paragraph 13) and periodic reports (paragraph 14).<sup>12/</sup>

The effect of these provisions would be that NASD members would be prevented from underwriting or participating in the distribution of the securities of tax sheltered programs unless such programs (e.g. the issuer and their managers) met the standards and requirements of the proposed rules. To this extent the issuer would be indirectly regulated by the NASD under federally granted powers. Since several of these regulatory standards would appear to go to the merits of tax shelter securities and to the propriety of various policies and practices of the managements of such issuers, they are substantially similar in impact to the "blue-sky" fairness statutes of a number of states. These aspects of the NASD's contemplated regulatory program give rise to a number of important policy issues:

i. The "blue-sky" impact may be in contrast with the underlying philosophy of the federal scheme of regulation of the public distribution by issuers of securities reflected in the Securities Act of 1933, which is basically one of full and fair disclosure. The thrust of the 1933 Act in this regard is "to assure ample and reliable data for decision making by investors and the financial community, as distinguished from the Federal Government assuming the more paternalistic role of passing on the merits of securities."<sup>13/</sup> Thus, there is a policy question, on which comments would be appreciated, as to whether

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<sup>11/</sup> The Commission must also consider the NASD's rule proposals in light of its regulatory responsibilities respecting those nonmember broker-dealers who qualify under Section 15(b)(8) of the Exchange Act as "SECO" firms. In this regard, the Commission generally would consider proposing rules comparable to the NASD's in order to maintain the comparability between NASD and SECO firms from a regulatory viewpoint.

<sup>12/</sup> It should be noted that several of these sections also include some provisions, such as participant suitability or disclosure standards, where the NASD has had an interest in the past.

<sup>13/</sup> Securities and Exchange Commission, Report of the Special Study of the Securities Markets, H.R. Doc. 95, 88th Cong., 1st Sess., pt. 1 (1962) at p. 591; See also Section 23 of the Securities Act of 1933, 15 U.S.C. § 77w.

the NASD, in the exercise of its broad authority under the Exchange Act over the conduct of its members,<sup>14</sup> would be engaging in a type of issuer-oriented regulation inconsistent with the intent of the 1933 Act. If so, the further question arises whether the Exchange Act affords adequate legislative sanction for such regulation.

ii. The NASD estimates that its members distribute about three-quarters of all registered tax sheltered programs and in about one-half of these, an NASD member or an affiliate is the sponsor. In view of the NASD membership's involvement in the issuer-management phases of the investment products it sells to investors, its issuer-oriented proposals may be appropriate to that extent. Thus, if it is determined that the NASD should not, as a general proposition, pursue its rule proposals insofar as they relate to issuer-quality and management practices, then, in the alternative, it may be deemed appropriate for the NASD to enact the latter rules limiting their applicability to member affiliated issuers. Public comment on the practicality of this approach is invited.

iii. It has been contended by some that if additional regulation of issuers of tax sheltered programs along the lines described in the preceding two paragraphs (i and ii) is necessary, it should be achieved through comprehensive federal regulation rather than NASD rulemaking. The argument here seems to be predicated on concern whether it would be appropriate to give self-regulatory organization composed of businessmen the authority and responsibility to effectively bar access to the capital markets for specific categories of investment "products." Since it is possible that federal regulation with respect to tax sheltered programs in the areas highlighted by the NASD proposal may be in order ultimately, there is a question as to whether the necessary authority and responsibility to administer such regulation, to the degree required, should reside solely in governmental hands rather than in the hands of distributors of competitive products. Comments on this question are invited.

iv. Considerations of the nature discussed in paragraphs i, ii and iii above bear on the question of the appropriate allocation of regulatory responsibility, in this instance as between the Commission and the NASD. Interested persons are therefore invited to comment on the NASD's tax shelter proposals from the viewpoint of how this responsibility and authority, with respect to each of the problem areas they would deal with, should be apportioned.

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<sup>14</sup> Section 15A(b)(8) of the Exchange Act provides, in pertinent part:

"An applicant association shall not be registered as a national securities association unless it appears to the Commission that . . . the rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market."

## 2. Improved Disclosures

It should be noted that the Commission has been considering under its present powers possible additional measures in the tax shelter area, including stepped up enforcement of present rules and the need for additional rules to improve prospectus disclosures.<sup>15</sup> Among the recommendations included in the Report to the Commission of the Real Estate Advisory Committee (October 1972) were suggestions that the Commission augment its efforts to ensure that full and proper disclosure is provided in prospectuses under the Securities Act of 1933 relating to real estate tax shelter offerings and to consider promulgating additional disclosure rules which would more adequately treat the individual characteristics of these tax sheltered programs.<sup>16</sup> The Commission intends to pursue this course.

## 3. Need for Development of a Legislative Program

The information gathered by the Commission through its surveillance programs and the cooperative efforts of the state authorities and the NASD indicates that additional regulation of tax shelters in the general areas included in the NASD rule proposals may well be needed. By means of such legislation the Commission could acquire full and flexible direct authority to regulate, when necessary. Many of these problems cannot readily be addressed by the Commission under its present statutory powers. Legislation also may be desirable to help resolve some or all of the legal and policy questions regarding the proper scope of NASD authority considered above. The Commission's views with respect to the formulation of a legislative program will hinge in large part on the conclusions it reaches following consideration of the public comments it receives in response to this release. Accordingly, the Commission also would welcome views of all interested persons on the need for and the appropriate structure and content of such a program.

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<sup>15</sup> With regard to recent Commission action in the disclosure area, we note that on February 2, 1973 (Release No. 33-5362 and Release No. 34-9984) the Commission announced plans to take the first steps toward integrating projections of sales and earnings of issuers into the disclosure system. The Commission also indicated, among other things, that it recognizes that any rules it may adopt in this area will have to accommodate the different time periods which may be used to formulate projections of tax sheltered programs.

<sup>16</sup> For example, in its report, the Advisory Committee recommended that a prospectus offering real estate securities should contain, among other things:

"(a) a clear exposition of the real and potential conflicts of interest that may be involved in the sale of the securities, the use of the proceeds, and the management of the properties purchased. This section should include a summary of each type of transaction in which an affiliate may engage with the registrant, and the manner of resolving the conflicts."

"(b) a clear statement of the duties that the general partner owes to the limited partners . . . along with an explanation of the various ways of enforcing the duties."

4. Partial Regulation by the NASD

Commentators also are invited to consider the advisability of the NASD proceeding to implement rules covering one or more of the "traditional" areas discussed above (at p. 7) without going forward, pending possible legislative action, in the other, less traditional areas. The Commission is now inclined to the view that the implementation of the NASD proposals which do not raise the legal and policy issues previously noted should proceed, subject to Commission and NASD consideration of the responses to this release, pending development of a legislative program.

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The Commission desires to receive comments from all interested persons and requests that such comments be directed as much as possible to the issues discussed heretofore. While comments with regard to the specifics of the NASD rule proposals are also welcome, the Commission is particularly interested in receiving the views concerning the basic policy questions referred to above as to the proper regulatory approach to tax sheltered programs.

Interested persons are requested to submit their views, any data or other comments or information, in writing with two copies, on the foregoing issues prior to August 15, 1973 to the Office of the Secretary, Securities and Exchange Commission, 500 North Capitol Street, N. W., Washington, D. C. 20549. All communications should refer to File No. 4-168.

By the Commission.

Ronald F. Hunt  
Secretary