NOTICE TO MEMBERS: 78-8
Notices to members should be retained for future reference.

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

March 2, 1978

TO: All NASD Members and Interested Persons

RE: Amendments to the By-Laws Concerning Procedures for Access to the NASDAQ System by Non-NASDAQ Market Makers and Volume Reporting by Members in NASDAQ Securities

The Board of Governors of the Association has proposed amendments to the By-Laws of the Association and is publishing them at this time to enable all interested persons an opportunity to submit comments. This proposal involves amendments to Article III, Section 2 and Article XVI, Section 3 of the By-Laws and Schedule D under Article XVI of the By-Laws.

Under the provisions of Article XVI, Section 3 of the By-Laws, the Board of Governors has the power to adopt, alter, amend, supplement, or modify the provisions of Schedule D without recourse to the membership for approval. Amendments to Article III and Article XVI of the By-Laws require a vote by the membership which will be conducted at a future date.

After the expiration of the comment period, the Board will again review these proposals and give due consideration to the comments received. If at that time the Board approves the proposals, or revised versions thereof, the amendments requiring membership approval will be submitted to the membership for a vote, and the amendments to Schedule D will be submitted to the Securities and Exchange Commission for approval.

Background and Explanation of the Proposed Amendments to Require Volume Reporting by Members in NASDAQ Securities

NASDAQ market makers are required to report, through the NASDAQ System, their daily volume in those securities in which they are registered market makers. Volume in NASDAQ securities which does not involve registered market makers is presently not required to be reported, however, the Board of Governors believes that volume reports as to block-size transactions is meaningful information for investors which should be incorporated into the NASDAQ volume data released for publication.

The amendments to Article III, Section 2 and Article XVI, Section 3 of the By-Laws would give the Board of Governors specific authority to require members to report information related to NASDAQ securities.

The proposed amendment to Schedule D would require all members who are not registered market makers to telephone, Telex or TWX, their purchases and sales of block-size to the NASDAQ Department in New York City. The volume would be entered into the System and the data would be included in the individual security statistics, the aggregate NASDAQ statistics and the NASDAQ regulatory reports.

Members would report only that volume involved in principal or agency transactions of block-size executed with others who, at the time of execution of the transaction, were not registered market makers in the NASDAQ security. A block is defined as a transaction involving 10,000 shares or more executed at a price of $1 or more. In the case of a convertible debenture, a block would be $100,000 face amount, or more.

For each transaction that meets or exceeds the definition of block-size a firm would report the following information:

1. Security name and NASDAQ symbol;
2. Number of shares;
3. Whether the transaction was a purchase or sale;
4. Whether the transaction was executed as principal, agent or dual agent; and
5. The name of the contra-broker/dealer or if the contra-side is a retail amount, the symbol, "RA".

Members would be required to report their block purchases and sales by 4:30 p.m. Eastern Time in order to have the data entered into the System prior to the 4:45 p.m. Eastern Time volume cutoff deadline.

Background and Explanation of the Proposed Amendments Regarding Procedures for Access to the NASDAQ System by Non-NASDAQ Market Makers

In order to bring additional depth and liquidity to the NASDAQ market, the Board of Governors believes it is desirable to permit non-NASDAQ market makers to have access to NASDAQ Level 3 service through NASDAQ market makers. The Board's objective is to place NASDAQ market making capability within the reach of any NASD member who makes a market in a NASDAQ security but does not find it economical to contract for a NASDAQ Level 3 terminal. At this time, service to such members will be offered for a limited period of one year, during which time the program will be closely monitored in order to develop information sufficient for the Board to determine whether the proposed service should be continued as a permanent addition to Schedule D.

The following points are the essential elements of the proposed service:

- The service would be available to "access market makers" that is, a member of the Association who does not subscribe to Level 3 NASDAQ service but is or intends to be a market maker in a security for which quotations are displayed on the NASDAQ System. The access market maker would display his quotations in the NASDAQ System through an "entering subscriber" defined as a registered NASDAQ market maker who has entered into an arrangement with an access market maker to enter quotations on behalf of such access market maker.

- The entering subscriber will assume responsibility for the transaction.

- All transactions will be executed with the entering subscriber.

- A special symbol disclosing that an access arrangement exists will accompany the entering subscriber's quotation. The identity of the access market maker must be made available upon request.

- Access market makers and entering subscribers will be limited to one access arrangement in each security.

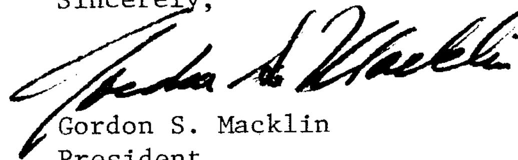
- <u>BOTH</u> the entering subscriber and the access market maker will be subject to the jurisdiction of, and be responsible for, compliance with Schedule D. Each access arrangement will be required to be registered with and approved by the NASD.

- Access market makers will be subject to an access fee, payable to the NASD, of $100 per month for the first security and $75 per month for each additional security when an approved access arrangement exists.

In addition, the Board proposes a technical amendment to Article XVI, Section 3, of the By-Laws to reflect the purchase of the NASDAQ System by the Association.

Comments on these proposals should be in writing and addressed to Christopher R. Franke, Secretary, NASD, 1735 K Street, N.W., Washington, D.C. 20006, and should be received by March 31, 1978. All comments will be available for inspection. Questions concerning this notice should be addressed to Richard Peters, (202) 833-7213.

Sincerely,



Gordon S. Macklin
President

Attachment:
Text of Amendments

TEXT OF PROPOSED AMENDMENTS

(New material is underlined, material to be deleted is indicated by striking out)

Article III, Section 2 of the By-Laws is proposed to be amended as follows:

(a) Each member shall promptly furnish all information or reports requested by the Board of Governors in connection with the determination of the amount of admission fees, dues, assessments or other charges payable by members during any given fiscal year.

(b) Each member shall report promptly such information in connection with securities for which quotations are displayed on the NASDAQ System as the Board of Governors deems appropriate.

* * * *

The first paragraph of Article XVI, Section 3 of the By-Laws is proposed to be amended as follows:

Taking into account relevant matters including the type of business done, securities traded, and service rendered, the Board of Governors may publish operating rules for the automated quotations systems, establish reasonable qualifications and classifications for registered market makers and other subscribers, provide standards for authorized securities, require members to report promptly such information with respect to authorized securities as the Board of Governors deems appropriate and specify and publish the charges to be collected from subscribers ~~by the operator of automated quotations systems~~. Services shall be provided to members on a nondiscriminatory basis and at reasonable and uniform rates designed to encourage maximum utilization by all members, with due allowance for the geographic remoteness of members or their branch offices receiving service outside of the 48 contiguous states.

* * * *

Section C.3.(c) of Part I of Schedule D Under Article XVI of the By-Laws is proposed to be amended by adding thereto a new subparagraph (iii) as follows:

(c) Reports

(iii) Reports of All Members

(1) Each member shall report to the NASDAQ Department in New York City by 4:30 p.m. Eastern Time, each business day, its transactions of block-size in NASDAQ securities

for which such member is not registered with the NASDAQ System as a market maker and which are executed with persons other than registered NASDAQ market makers in that security.

(2) "Block-size" shall mean 10,000 shares or more executed at a price of $1 or more in the case of equity securities and $100,000 face amount or more in the case of convertible debentures.

(3) The report of each transaction shall include the following information:

a. Security name and NASDAQ symbol;

b. Number of shares;

c. Whether the transaction was a purchase or sale;

d. Whether the transaction was executed as principal, agent or dual agent; and

e. The name of the contra-broker/dealer or if the contra-side is a retail account, the symbol, "RA".

* * * *

A new Part XII of Schedule D Under Article XVI of the By-Laws is proposed to be inserted as follows:

XII

PROCEDURES FOR ACCESS TO THE NASDAQ SYSTEM BY NON-NASDAQ MARKET MAKERS

These procedures permit a registered NASDAQ market maker, upon approval by the Corporation, to enter quotations into the NASDAQ System on behalf of another market maker who does not subscribe to Level 3 NASDAQ service.

A. Definitions

1. An "access market maker" is a member of the Association who does not subscribe to Level 3 NASDAQ service, but is or intends to be a market maker in a security for which quotations are displayed on the NASDAQ System.

2. An "entering subscriber" is a registered NASDAQ market maker who has entered into an arrangement with an access market maker to enter quotations in the NASDAQ System on behalf of such access market maker.

B. The entering subscriber may enter quotations in the NASDAQ System on behalf of an access market maker only upon submission and approval by the Association of the following:

1. A fully executed copy of the access arrangement agreement which shall contain all agreements and conditions concerning the access arrangement.

2. An application for registration as an access market maker for each security.

C. Access market makers and entering subscribers shall be limited to one access arrangement in each security.

D. Quotations displayed by the entering subscriber on behalf of the access market maker shall be accompanied by the entering subscriber's market maker identifier and a special symbol designating that an access arrangement exists. The identity of the access market maker must be made available by the entering subscriber upon request.

E. All transactions resulting from the display of quotations in the NASDAQ System by the entering subscriber shall be executed by the entering subscriber and he shall be responsible for the transaction. Both the entering subscriber and the access market maker shall be subject to and be responsible for compliance with the provisions of Schedule D.

F. Access market makers shall pay to the Corporation an access fee of $100 per month for the first security and $75 per month for each additional security which is subject to an approved access arrangement.

NOTICES TO MEMBERS: 78-9
Notices to Members should be retained for future reference.

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

March 8, 1978

TO: All NASD Members and Municipal Securities Dealers
Attention: All Operations Personnel

RE: Holiday Trade Date - Settlement Date Schedule

Securities markets and the NASDAQ System will be closed on Good Friday, March 24, 1978. "Regular-Way" transactions made on the business days immediately preceding that day will be subject to the following schedule.

Trade Date-Settlement Dates For "Regular-Way" Transactions

Trade Date	Settlement Date	*Regulation T Date
March 16	23	28
17	27	29
20	28	30
21	29	31
22	30	April 3
23	31	4
24	Good Friday	--
27	April 3	5

The above settlement dates should be used by brokers, dealers and municipal securities dealers for purposes of clearing and settling transactions pursuant to the Association's Uniform Practice Code and Municipal Securities Rulemaking Board Rule G-12 on uniform practice. Questions concerning the application of these settlement dates to a particular situation should be directed to the Uniform Practice Department of the NASD (212) 422-8841.

*Pursuant to Section 4(c)(2) of Regulation T of the Federal Reserve Board, a broker-dealer must promptly cancel or otherwise liquidate a customer purchase transaction in a cash account if full payment is not received within seven days of the date of purchase. The date upon which members must take such action for the trade dates indicated is shown in the column entitled "Regulation T Date."

NOTICE TO MEMBERS: 78-10
Notices to Members Should be Retained for Future Reference.

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

March 8, 1978

MEMORANDUM

TO: All NASD Members

RE: Interpretation Relating to the Writing of Exchange-Traded Call Options

On December 20, 1977, the Securities and Exchange Commission, in Release No. 33-5890, authorized its Division of Corporation Finance (the "Division") to issue a letter modifying its previous position regarding the sale of exchange-traded calls against "restricted" securities subject to either Rules 144 or 145(d) of the Securities Act of 1933. As you are aware, Rule 144 places restrictions on the transfer of securities acquired directly or indirectly from an issuer, rather than in a public offering. Rule 145(d) permits resales of securities acquired in business combinations so long as they are in compliance with Rule 144.

Paragraph (f) of Rule 144 specifically requires that restricted securities be sold in brokers' transactions and that the person selling the securities not solicit orders to buy or make payment in connection with the sale to anyone other than the broker executing the order to sell. The interpretation previously rendered by the Division under paragraph (f) effectively prohibited the sale of a listed call option where, in the event of exercise of such an option, securities subject to Rule 144 or 145(d) would be delivered. The interpretation explained that the sale of a listed option, in such an instance, constituted the solicitation of orders to buy the security by the seller of the option. As noted, paragraph (f) of Rule 144 prohibits the seller from soliciting orders to buy restricted securities.

Upon further consideration of the facts, the Division now states that the writing of exchange-traded call options should not be deemed a solicitation of orders to purchase since the mechanics of selling a call option on a national securities exchange is similar to those involved in the sale of any other exchange-traded security. In this connection, the Division warns that the interpretation relates solely to the writing of

exchange-traded call options and that, as such, the change in its position relates only to paragraph (f) of Rule 144. This effectively means that all other provisions of Rule 144 must still be satisfied in order for restricted securities to be used to effect delivery at the time the call option is exercised.

Attached for your information is the full text of SEC Release No. 33-5890. Should you have any questions concerning this notice or the attached release, please contact either John J. Cox at (202) 833-7320 or Kevin P. McEvoy at (202) 833-4878.

Sincerely,

Frank J. Wilson
Senior Vice President
Regulatory Policy and
General Counsel

Attachment

SECURITIES ACT OF 1933

SECURITIES ACT OF 1933
Release No. 5890/December 20, 1977

INTERPRETATION RELATING TO THE WRITING OF EXCHANGE-TRADED CALL OPTIONS

The Securities and Exchange Commission today announced that it had authorized the Division of Corporation Finance to issue a letter modifying its previous position regarding the delivery of underlying securities subject to Rules 144 or 145(d) under the Securities Act of 1933 in connection with the writing of exchange-traded call options. As the Commission has previously announced, it is currently engaged in an extensive study of the regulatory questions associated with trading in standardized options. The results of that study may affect the future position of the Division of Corporation Finance with respect to the matters discussed below.

Background

Subject to its provisions, Rule 144 (17 CFR 230.144) under the Securities Act of 1933 (the "Act") (15 U.S.C. 77a et seq.) permits resales of securities owned by affiliates[1] of the issuer and by persons who have acquired restricted securities[2] of the issuer without such persons being deemed to be engaged in a distribution and thus be considered underwriters as defined in Section 2(11) of the Act. Similarly, paragraph (d) of Rule 145 (17 CFR 230.145) under the Act permits resales of securities acquired in business combinations that are subject to that rule to be made by certain persons,[3] who might otherwise be considered underwriters or deemed to be engaged in a distribution, provided such resales are made in accordance with certain provisions of Rule 144,[4] including paragraph (f). Rule 144(f) requires that the securities be sold in "brokers' transactions" (as defined in paragraph (g) of Rule 144) and that the person selling the securities not solicit orders to buy such securities or make any payment in connection with their sale to any person other than the broker who executes the order to sell the securities.

The Division's interpretative letter set forth below relates to the proposed writing of exchange-traded call options on securities subject to the resale provisions of Rule 145(d) and subsequent sale of the underlying securities by delivering them in satisfaction of any exercise notices received on the options. The Division has previously expressed the view[5] that the writing of call options involves the solicitation of orders to buy the underlying securities and, therefore, does not comply with the provisions of Rule 144(f). Upon reconsideration, because the mechanics of selling call options over national exchanges are similar to those involved in the sale on an exchange of other exchanged-traded securities, the Division's view is that the writing of exchange-traded call options should not be deemed under Rule 144(f) as a solicitation for the purchase of the underlying securities. This view, which is applicable solely to the provisions of Rule 144 and Rule

[1]Rule 144(a)(1) defines "affiliate" of an issuer as a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer.

[2]Rule 144(a)(3) defines "restricted securities" as securities acquired directly or indirectly from the issuer thereof, or from an affiliate of such issuer, in a transaction or chain of transactions not involving any public offering or from the issuer in a transaction in reliance on Rule 240 under the Act or which were issued by an issuer in a transaction in reliance on Rule 240 and were acquired in a transaction or chain of transactions not involving any public offering.

[3]Rule 145(c) provides that any party to any transaction subject to Rule 145, other than the issuer, or any person who is an affiliate of such party at the time any such transaction is submitted for vote or consent, who publicly offers or sells securities of the issuer acquired in connection with any such transaction, shall be deemed to be engaged in a distribution and therefore to be an underwriter thereof within the meaning of Section 2(11) of the Act.

[4]The applicable provisions of Rule 144 are paragraphs (c) (Current Public Information), (e) (Limitation of Amount of Securities Sold), (f) (Manner of Sale), and (g) (Brokers' Transactions).

[5]See **Columbia University** letter (pub. avail. February 27, 1976); **Burroughs Corporation** letter (pub. avail. August 9, 1976).

145(d), relates only to the writing of exchange-traded options and does not extend to the writing or sale of options under any other circumstances.

While the matter dealt with in the letter relates to the writing of exchange-traded call options on underlying securities subject to Rule 145(d), the Division's view on solicitation is applicable as well to the writing of exchange-traded options on securities subject to Rule 144. The Commission emphasizes, however, that the Division's views relate only to the manner of sale provision of Rule 144(f) and do not affect the other provisions of that rule. Accordingly, for sales made under Rules 144 and 145(d) through the writing of exchange-traded call options, all of the conditions applicable to those rules must be satisfied both at the time of the writing of the options and the time that the underlying securities are delivered pursuant to exercise notices on the options. With respect to sales made under Rule 144, the notice on Form 144 required by paragraph (h) of that rule would be required to be filed with the Commission and the principal national securities exchange on which the underlying securities are listed at the time the call option is written, and subsequently amended, in the event the option is exercised, at the time of the delivery of such securities.[6]

The Commission reminds affiliates engaging in transactions in exchange-traded options[7] of the provisions of Section 16 under the Securities Exchange Act of 1934 (the "Exchange Act") (15 U.S.C. 78a et seq.). The reporting obligations of Section 16(a) and Rule 16a-6 (17 CFR 240.16a-6) thereunder would require such persons to report the writing, purchase or sale of put and call options covering equity securities of the issuer at the time of the transaction, and subsequently report the exercise, cancellation or expiration of the options.[8]

In a related matter, the Commission has recently permitted shareholders to offer and sell securities covered by an effective shelf registration statement[9] through the writing of exchange-traded call options on such securities and the delivery of those securities upon the exercise of the options. In such circumstances, the Commission believed that the requirements of Section 5 of the Act would be satisfied where: (1) a registration statement is in effect, having a prospectus meeting the requirements of Section 10 of the Act, both at the time the options are written and the underlying securities delivered; (2) copies of such prospectus are delivered, pursuant to Rule 153 (17 CFR 230.153) under the Act, to the exchanges on which the options are written prior to the time the options are written and underlying securities delivered; and (3) such prospectus describes the intended plan of distribution.[10] As indicated, the position taken by the Division relates solely to the question of what is a solicitation for purposes of Rules 144 and 145(d). Any persons considering such trans-

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[6]Rule 144(h) requires the Form 144 to be filed "concurrently with the placing with a broker of an order to execute a sale." Since the Division deems the writing of the option to be an offer to sell, its view is that the Form must be filed at that time.

[7]Many of the national exchanges currently prohibit their members from accepting orders for the writing of call options from affiliates of the issuer of the underlying securities.

[8]The Commission expresses no view as to the impact of the other provisions of Section 16 to transactions made in such options. Subject to its provisions, Section 16(b) provides that the issuer is entitled to any profit made by a ten percent beneficial owner, officer or director of the issuer from any combination of purchases and sales of its equity securities within a six-month period. In addition, under Section 16(c), such persons are prohibited from selling any equity security of the issuer if such security is not owned by them.

[9]A shelf registration statement refers to a registration statement used in connection with a deferred or extended offering. For a description of the types of offerings where such registration is permitted or required, see Securities Act Release No. 4936, as amended, (December 9, 1968), (33 Fed. Reg. 18617), Paragraph 4.

[10]Under Section 5, it is required that a registration statement be filed with the Commission prior to an offer to sell a security and that a registration statement be in effect, with a prospectus meeting the requirements of Section 10 of the Act, prior to the sale of a security. In the Division's view, the writing of a call option should be considered as an offer to sell the underlying securities, and the delivery of the underlying securities upon the exercise of the option should be considered a sale of those securities. Section 5 would require, therefore, the filing of a registration statement prior to the writing of a call option on the underlying securities being registered and an effective registration statement with a statutory prospectus at the time of the delivery of the underlying securities. Since the terms and conditions of options trading provide that the option is subject to exercise immediately after it is written, as a practical matter in order to avoid violations of Section 5, it would be necessary to have a registration statement in effect and a statutory prospectus delivered to the exchange at the time the call option is written.

actions should first carefully consider the provisions of Rule 10b-6 (17 CFR 240.10b-6) under the Exchange Act.[11]

As indicated in the Division's letter set forth below, additional restrictions on the writing of options on securities whose sale is subject to the registration requirements of the Act or Rules 144 and 145(d) may be imposed by the national securities exchanges.

The Commission authorized the Division of Corporate Finance to issue the following letter:

"Dear Mr. X:

"In your letter dated August 13, 1976, you request that this Division reconsider the position expressed in its letter of July 9, 1976, in response to your letter of May 13, 1976, concerning the proposed writing by your client, Mr. Y, of exchange-traded call options on all or a portion of his shares of the common stock of __________ __________ (the 'Company'), as more fully described below.

"You state that Mr. Y acquired all of his 8,580 shares of the Company's common stock on January 23, 1976, pursuant to a merger of Z Corporation into a wholly-owned subsidiary of the Company. In connection with the above-described merger, you indicate that the Company filed a registration statement on Form S-14 under the Securities Act of 1933 (the 'Act') covering shares issued pursuant to the merger, including the 8,580 shares issued to Mr. Y (the 'Y shares'). You further indicate that Mr. Y formerly served as a director of Z Corporation. Accordingly, you represent that sales of the Y shares are required to be effected in accordance with the provisions of Rule 145(d) under the Act. You further state that Mr. Y is not an officer, director or ten percent shareholder of the Company.

"You indicate that Mr. Y proposes to write exchange-traded call options on the Company's common stock (which options are listed and traded on the American Stock Exchange ('Amex') and the Chicago Board Options Exchange ('CBOE')) in unsolicited brokerage transactions. In the event that an exercise notice is subsequently assigned against his option account, you state that Mr. Y proposes to satisfy his obligations thereunder by delivering the requisite number of the Y shares of the Company's common stock, provided, of course, that such shares can lawfully be sold at that time.

"In your letter of May 13, 1976, you state that, in your opinion, sales by Mr. Y of the Y shares in response to an exercise notice would comply with the provisions of Rule 145(d) under the Act. In our letter of July 9, 1976, we stated that this Division was unable to concur with your opinion because the proposed writing of call options for the Company's stock and the subsequent sale of the Y shares to exercising holders of the options would involve the solicitation of orders to buy the common stock of the Company and, accordingly, would not be in compliance with the requirement of paragraph (f) of Rule 144 that the Y shares be sold in 'broker's transactions', as defined in that rule.

"Pursuant to your request for reconsideration, and after further evaluation of the facts and representations contained in your previous letters, the Commission has directed this Division to inform you that sales of the Y shares by your client in response to the receipt of an excercise notice from a holder of a call option for the Company's stock, in the manner described above, would not involve the solicitation of an order to purchase those shares and, therefore, would not be in violation of Rule 144(f). Accordingly, this Division withdraws the position with respect to Rule 144 previously taken in its letter of July 9, 1976. We wish to emphasize, however, that the foregoing position is based upon your representation that all of the conditions of Rule 145(d) (pursuant to which the Y shares are required to be sold in accordance with certain enumerated provisions of Rule 144) shall be satisfied at the time the call options are written and the Y shares sold in the manner described above.

"Notwithstanding the views expressed herein with respect to Rule 145(d) under the Act, the Division of Market Regulation has requested that we inform you that the rules of certain exchanges may impose restrictions on the delivery of underlying securities in satisfaction of option exercise notices. Specifically, your attention is directed to Amex Option Rule 928, which provides, **inter alia**, that members and member organizations may not accept shares of an underlying security 'which may not be sold by the holder thereof except upon registration thereof pursuant to the provisions of the Securities Act of 1933 or pursuant to SEC rules promulgated under the Securities Act of 1933. . . for the purpose of satisfying an exercise notice assigned against an option contract.

[11] Rule 10-6 prohibits, subject to certain specifically enumerated exceptions, underwriters and prospective underwriters, issuers, selling shareholders and broker-dealers who are participating, directly or indirectly, in a distribution of securities to bid for or purchase any securities which are the subject of the distribution or any securities of the same class and series or any right to purchase such securities until after such persons have completed their respective participations in the distribution.

"The Division of Market Regulation has further requested that we direct your attention to certain additional exchange rules as well as various rules of the Federal Reserve Board ('FRB') which may have general application to the proposed transactions including, but not limited to, Amex Rule 462, Amex Options Rules 928 and 940, CBOE Rule 12.1 **et seq**., and FRB Rules promulgated pursuant to Section 7(a) of the Securities Exchange Act of 1934 (12 CFR 220 et seq.). Responsibility for ensuring that the proposed sale of the Y shares are effected in compliance with the foregoing rules and any other applicable rules must, of course, rest with your client."

By the Commission.

George A. Fitzsimmons
Secretary

NOTICE TO MEMBERS: 78-11

Notices to Members Should be Retained for Future Reference.

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

March 8, 1978

MEMORANDUM

TO: All NASD Members

RE: SEC Rule 15c3-1, Extension of Temporary Amendments Concerning Municipal Securities

On February 28, 1978, the Securities and Exchange Commission, in Release No. 34-14513, approved the extension of two temporary amendments to the uniform net capital rule concerning municipal securities. This action by the Commission:

- extends until August 1, 1978, the current net capital treatment of good faith deposits and syndicate or joint account receivables arising in connection with municipal underwriting (i.e., allowable asset treatment for up to 90 calendar days after settlement date of the underwriting with the issuer); and,

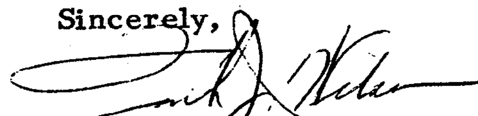
- extends to August 1, 1978, the temporary amendment excluding municipal securities from undue concentration haircuts.

The text of these amendments appears in the attached copy of the Commission's release. It is expected that these changes will appear in the next monthly supplement to the NASD Manual.

* * *

Should you have any questions concerning this notice or the attached release, please contact either John J. Cox at (202) 833-7320 or Kevin P. McEvoy at (202) 833-4878.

Sincerely,



Frank J. Wilson
Senior Vice President
Regulatory Policy and
General Counsel

Attachment

SECURITIES EXCHANGE ACT OF 1934

[Release No. 34-14513]

UNIFORM NET CAPITAL RULE

AGENCY: Securities and Exchange Commission

ACTION: Extension of Temporary Rule Amendments

SUMMARY: This release extends until August 1, 1978 temporary provisions of the rule relating to the, (i) inclusion in net capital of certain good faith deposits and syndicate or joint account receivables arising in connection with municipal securities underwritings; and (ii) undue concentration deductions, "haircuts," on positions in municipal securities. This action is necessary since the temporary amendments noted above will otherwise expire on March 1, 1978. The extension provides the Commission with additional time to formulate permanent amendments pertaining to municipal securities with regard to the treatment of certain receivables and undue concentration deductions.

C O P Y

EFFECTIVE DATE: March 1, 1978

C O P Y

FOR FURTHER INFORMATION CONTACT: Nelson S. Kibler, Assistant Director, Division of Market Regulation, Securities and Exchange Commission, Washington, D. C. 20549 (202) 755-1390.

SUPPLEMENTARY INFORMATION: In Securities Exchange Act Release No. 13806, July 28, 1977; 42 Fed. Reg. 147, August 1, 1977, the Commission extended until March 1, 1978, the temporary provisions of Rule 15c3-1 (17 CFR 240.15c3-1) under the Securities Exchange Act of 1934 dealing with the items summarized above. The Commission took such action to afford itself an opportunity to correlate the comments and statistical data it had received from interested members of the public prior to proposing permanent amendments to the rule. The Commission is in the process of formulating such permanent amendments. In the interim, the Commission has determined that it is appropriate to extend until August 1, 1978, the temporary amendments relating to the treatment of certain receivables and undue concentration.

The Commission finds, pursuant to 5 USC § 553(b)(3)(B), that further notice and public procedure respecting these amendments is impracticable and unnecessary to the public interest. The Commission finds further that these amendments relieve regulatory restrictions within the meaning of 5 USC § 553(d)(1) and may therefore become effective less than thirty days from their publication.

Introduction

As originally written, Rule 15c3-1 (c)(2)(iv)(C) required the deduction from net worth of good faith deposits arising in connection with an underwriting and outstanding longer than eleven business days. In addition, profits derived from participation in an underwriting syndicate were treated as "unsecured receivables" which pursuant to Rule 15c3-1(c)(2)(iv)(E), were deducted from net worth. In Securities Exchange Act Release No. 11854, the Commission adopted temporary amendments to Rule 15c3-1(c)(2)(iv)(C) permitting the inclusion in net worth, for ninety (90) days after settlement of the underwriting with the issuer, good faith deposits and receivables arising from participation in municipal securities underwritings. This release extends until August 1, 1978, those temporary amendments.

Rule 15c3-1(c)(2)(vi)(M) in general provides that a deduction from net worth equal to half the appropriate haircut shall be taken against long or short positions in the securities of an issuer of a single class or series, the market value of which positions exceed ten percent of tentative net capital. A similar provision, Rule 15c3-1(f)(3)(iii), applies to computations under the alternative net capital requirement. In Release No. 11854, the Commission exempted positions in municipal securities from the undue concentration provisions of Rule 15c3-1. This release continues that exemption until August 1, 1978.

C O P Y

C O P Y

Statutory Basis and Competitive Consideration and Effective Date

Pursuant to the Securities Exchange Act of 1934, and particularly Sections 15(c)(3) and 23(a) thereof, 15 USC § 78o(c)(3), w(a), the Commission amends Section 240.15c3-1 of Chapter II of Title 17 of the Code of Federal Regulations in the manner set forth below, effective March 1, 1978. The Commission finds that any burden imposed upon competition by the amendments is necessary and appropriate in furtherance of the purposes of the Act, and particularly to implement the Commission's mandate under Section 15(c)(3) thereof, 15 USC § 78o(c)(3), to establish minimum financial responsibility standards for all brokers and dealers.

Text of Amendments to Section 240.15c3-1 is as follows:

§ 240.15c3-1 Net capital requirements for brokers or dealers.

* * * * *

(c) * * *
(2) * * *
(iv) * * *

(C) Interest receivable, floor brokerage receivable, commissions receivable from other brokers or dealers (other than syndicate profits which shall be treated as required in subparagraph (c)(2)(iv)(E) of this section), mutual fund concessions receivable and management fees receivable from registered investment companies, all of which receivables are outstanding longer than thirty (30) days from the date they arise; dividends receivable outstanding longer than thirty (30) days from the payable date; good faith deposits arising in connection with an underwriting, outstanding longer than eleven (11) business days from the settlement of the underwriting with the issuer; and, until August 1, 1978, receivables due from participation in municipal securities underwriting syndicates and municipal securities joint underwriting accounts which are outstanding longer than ninety (90) days from settlement of the underwriting with the issuer and good faith deposits arising in connection with an underwriting of municipal securities, outstanding longer than ninety (90) days from settlement of the underwriting with the issuer;

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C O P Y

In Section 240.15c3-1, the last sentence of paragraphs (c)(2)(vi)(M) and (f)(3)(iii) is amended to read as follows:

Provided further, that until August 1, 1978, this provision shall not apply to municipal securities.

C O P Y

* * * * *

By the Commission.

George A. Fitzsimmons
Secretary

February 28, 1978

NOTICE TO MEMBERS: 78-12
Notices to Members should be retained for future reference.

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

March 10, 1978

IMPORTANT

OFFICERS: PARTNERS: PROPRIETORS

TO: Members of the National Association of Securities Dealers, Inc. and Interested Persons

RE: Comment Period on Proposed Appendix F to Proposed Article III, Section 35 of the Rules of Fair Practice

COMMENT PERIOD CLOSES ON: April 10, 1978

Enclosed herewith is proposed Appendix F to proposed Article III, Section 35 of the Association's Rules of Fair Practice concerning the distribution and/or sponsorship of publicly offered direct participation programs by member firms and/or their affiliates. Article III, Section 35 was approved by the membership by Mail Vote in Notice to Members: 77-3 dated January 21, 1977. The proposed Rule has subsequently been filed with the Securities and Exchange Commission under Rule 19b-4 of the Securities Exchange Act of 1934 and is presently pending Commission action.

The proposed Appendix F (which contains the substantive provisions of proposed Article III, Section 35) was previously explained in detail and submitted to the membership for comment on May 9, 1972, and was resubmitted for further comment on July 13, 1973 (Notice to Members 73-50) and again on January 21, 1977 (Notice to Members 77-3). The drafting of the proposed Appendix was conducted in coordination with

the various State Blue Sky Authorities in order to insure maximum uniformity with state securities laws. It is intended that uniformity of any amendments to the rule will be maintained by a program of coordination with Blue Sky authorities.

Following this comment period proposed Appendix F will be reviewed by the Board, taking into consideration the comments received and modifications to the extent deemed appropriate will be made. Thereafter, it is contemplated that Appendix F will be adopted, pursuant to powers given to the Board by proposed Article III, Section 35(c). It is anticipated that that proposed rule will have been approved by the Securities and Exchange Commission prior to the time final action is called for by the Board. The proposed Appendix F will then be filed for approval with the Securities and Exchange Commission under Rule 19b-4 of the Securities Exchange Act of 1934 prior to its enactment.

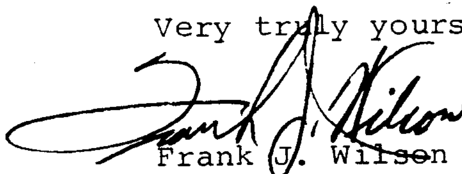
The proposed new Appendix F is important and merits your immediate attention. This is the last opportunity for the membership to comment on the substantive regulations to be applied under proposed Article III, Section 35 prior to their filing with the SEC under Rule 19b-4 of the Securities Exchange Act of 1934.

All comments should be directed to Christopher R. Franke, Secretary, National Association of Securities Dealers, Inc., 1735 K Street, N.W., Washington, D.C. 20006. All communications will be considered available for public inspection. Any questions regarding this Notice may be directed to George Warner or Harry Tutwiler of the Association staff at (202)-833-7240.

The Board of Governors believes the substantive regulations of Appendix F are necessary and appropriate and recommends that members carefully reflect on them and respond promptly with any objections, modifications, or additions that they wish to be considered.

A section by section explanation of the provisions follows.

Very truly yours,



Frank J. Wilson
Senior Vice President
Regulatory Policy and
General Counsel

Section by Section Explanation

Article III, Section 35

Appendix F

Appendix F contains the substantive rules with respect to direct participation programs which the Board would be authorized to adopt by the provisions of proposed Section 35 of the Rules of Fair Practice.

The various sections of proposed Appendix F contain little modification from the January 21, 1977 release (Notice to Members: 77-3), with the exception of new Sections 1, 2 and 8 and the substantial modification of Section 10(b) regarding sponsor's compensation in oil and gas direct participation programs. Former Sections 1 through 5 and 6 through 9 in Notice to Members: 77-3 have been redesignated Sections 3 through 7 and 9 through 12, respectively.

Section 1

This section establishes the filing requirement for all direct participation programs offered to the public by members of the Association. This requirement is cross referenced to the primary filing requirement contained in Article III, Section 1 of the Rules of Fair Practice - Interpretation of the Board of Governors - Review of Corporate Financing.

Section 2

This section states that where there is an irreconcilable conflict with the requirements of state or federal regulatory authorities, the regulations of those authorities shall prevail. In order to allow a maximum of creativity and innovative freedom to those members engaged in this evolving industry, a variance provision has also been added to this section. This provision would allow the interpretation and waiver of provisions of the rule in the case of new or unusual circumstances, where such does not violate the spirit or intent of the rule. Such variances might be granted by the Committee on Direct Participation Programs with the consent of the Board of Governors. Such a procedure is essential if the dual objectives of effective regulation in a context of maximum operational freedom are to be achieved.

Section 3 -- Definitions

Section 1 of proposed Appendix F contains a series

of definitions of words used throughout the Appendix. These terms were discussed in previous notices and are self-explanatory.

Section 4

This section would disallow a member or a person associated with a member from underwriting or participating in the distribution of a public offering of a direct participation program in which a member or an affiliate of a member is a sponsor if the program permits or does not prohibit certain conduct, or if it contains certain terms or conditions, or if certain other terms or conditions are not included within its provisions. Section 4 would thus prevent members from distributing units of direct participation programs unless a variety of terms and conditions are first satisfied by the program and/or the member-sponsor or its affiliate.

Subsection (a) would require that a member-sponsor or its affiliate have three years experience in the industry represented by the program, or in services to be performed for the program. It would not require the expertise called for to be "in-house" if it were readily available to the sponsor within its corporate complex, under contract or otherwise. This recognizes a practical situation in which some companies find themselves, i.e., a sponsor-member subsidiary may not have the industry expertise "in-house" but such is available to it within the company's corporate complex and is, in fact, drawn upon in managing the program in question. This procedure is followed by a number of companies. It also recognizes the situation where the sponsor of a program will contract for such expertise. An example of this would be a cattle operation where an experienced ranch manager would provide the day-to-day management function under contract with the sponsor. The provision is considered important since the Board does not believe it to be in the public interest if a person unskilled in the industry represented by a direct participation program is the sponsor of the program unless the expertise is readily available to it.

Subsection (b) would require that the member-sponsor of a program or its affiliate have a fair market net worth at least equal to the greater of $50,000 or the lesser of $1,000,000 or 5% of the total capital contributions made by the holders of the program participations issued by all programs of which such persons are a sponsor organized within the twelve-month period immediately preceding the offering date of the program plus 5% of the gross amount of the current offering. Certain exceptions from the term "sponsor" are also contained in

this section, i.e., members of the immediate family of, or persons associated with, the sponsor except to the extent that such persons are guarantors of obligations entered into by the sponsor in its capacity as sponsor of the program in question. In addition to having expertise in the industry represented by the program, the Board also believes a sponsor should have the financial capability to carry out its duties as a sponsor and that the requirement of this paragraph will afford a measure of protection to the public in that respect.

Subsection (c) would require that all funds received be transmitted in accordance with Rule 15c2-4(b) of the Securities Exchange Act of 1934, as amended, by being placed in an account specifically designed for that purpose until the minimum is reached.

Subsection (d) requires that if the minimum is not reached the entire amount deposited by participants, including sales commissions, be returned to them.

Subsection (e) would restrict oil and gas programs (defined at Section 1(y)) to a minimum size of no less than $500,000. It is believed that no unspecified oil and gas program can effectively undertake exploration and development operations without funds of at least $500,000. Even this amount is considered a bare minimum and experience has shown that most programs are necessarily much larger. Drilling of a specified exploratory or development prospect or acquisition of a specified exploratory or development prospect or acquisition of a specified producing property would be allowed below that minimum so long as the program was registered or exempt under applicable federal or state law. No minimum amounts would be established at this time in connection with other programs, including real estate programs, because of the differences in objectives of use of proceeds. In this connection, a real estate program could logically be, for instance, $100,000, if the purpose of the program being sold is to purchase a single building. Such a program could be workable and viable because of the extensive use of leveraging in connection with these programs. The Board does not believe such is the case in connection with unspecified oil and gas programs. Hence, a minimum size of $500,000 would be applicable to them.

Pursuant to Subsection (f) however, other programs would be required to state in their prospectuses a minimum amount which would have to be raised before the program could be activated and that such amount must be sufficient, after funding all organization and offering expenses, and giving due consideration to the fixed obligations of the program, to effect the objectives of the

program without changing the nature of the investment called for by the general terms of the program. This provision is designed to prevent a situation which would find only a small amount of the proposed offering being sold with most of the proceeds being absorbed by organization and offering expenses. Where this occurs, it would be impossible for the program to implement its original purposes, hence the nature of the participants' investment would have been changed.

Subsection (g)(1) would prohibit the distribution of units by members if the program did not meet the requirements of the Internal Revenue Code enabling participants to obtain tax benefits as described in the prospectus and if such could not be demonstrated by a favorable tax ruling or a favorable opinion from independent tax counsel with respect to such requirements. Subsection (e)(2) would permit distribution of units without a favorable ruling or opinion as long as there is a right of withdrawal and a return of investment in the event the tax ruling or opinion does not indicate that participants will obtain the tax benefit described. All funds received would be required to be escrowed until such time as a ruling or opinion is received and returned in full, including sales commissions, to the participants in the program in the event an unfavorable ruling or opinion is received. Without this provision, investors could not be certain they would realize the tax benefits which may be an important reason for investing.

Subsection (h) would restrict a participant's minimum subscription commitment in an oil and gas program to $5,000, unless a higher amount is required by state or local law. Additional increments in smaller amounts over and above that minimum amount would not be prohibited. Thus, the minimum unit size would not necessarily have to be $5,000 though the minimum commitment by an individual participant would have to be $5,000 or more. This provision is consistent with the minimum commitment requirements established by many states and a majority of the oil and gas programs. The provision for minimum commitments is presently restricted to oil and gas programs.

Subsection (i) would require full payment of subscription commitments for oil and gas programs within a twelve-month period if such payment period does not otherwise violate federal credit regulations. No such twelve-month period would be imposed with respect to other programs. A maximum twelve-month payment period is accepted practice in the oil and gas program industry and is important to it because of tax considerations.

In connection with deferred payments, however, it should be noted that the Federal Reserve Board has issued an interpretation of Section 7(a) of its Regulation T, 12 C.F.R. 220.7(a), which states that a broker/dealer would be guilty or arranging credit on terms more favorable than he could himself grant to his customers if he sold units on a periodic payment basis. This interpretation effectively prohibits broker/dealers from selling programs calling for periodic payments, at least where a binding contractual obligation to make the subsequent payments exists. In addition, the SEC has interpreted that Section 11(d)(1) of the Securities Exchange Act of 1934, which was enacted by Congress to prevent the extension of credit on offerings by broker/dealers, is also applicable. It should be noted, however, that the SEC's new Rule 3(a)12-5 under the Securities Exchange Act of 1934 offers some relief for condominium securities offerings.

Subsection (j) would prohibit the use of deferred payment plans in an unspecified property program. Since there is no description of the anticipated cash needs of the program, any type of a deferred payment plan would not appear to be in the interests of the public.

Subsection (k) would prevent charging a participant interest or a comparable charge for purchasing units on an installment basis except where the program requires immediate funding of the installment proceeds through borrowing with its incidental interest expense.

Subsection (e) through (s) relate to assessments on a participant's interest in a program. Assessments have been defined in Section 1(e).

Subsection (e) would require certain minimum information to be supplied to a program participant as a part of any assessment call.

Subsection (m) would prevent sales commissions from being charged on assessments and (n) would require that the maximum amounts of additional assessments prescribed by the program be fully disclosed in the prospectus together with a statement of whether they are mandatory or optional. Only by so requiring would the participant be able to know at the outset the total potential amount of his commitment. He would thus avoid the possibility of assessments which he could not meet. The provisions of this paragraph are further enhanced by the provisions of Subsection (r) which would limit the amount of a mandatory assessment to no more than 25% of the original amount of a participant's interest.

It is customary in connection with most direct participation programs to impose certain penalties upon participants for failure to meet an assessment. The Association believes such is not improper because, if a participant does not fully live up to the provisions of his commitment, the other program holders and the program itself are injured in an amount proportionate to his failure to perform. Penalties or liquidated damages of some kind are, therefore, not only necessary but in the opinion of the Association entirely proper. They should, however, as provided in Subsection (s), be disclosed in the prospectus, be fair and reasonable and not contain a forfeiture or a significant dilution of a participant's interest in the program for which he has already paid. The Association also believes any penalties to be imposed should not unduly benefit the sponsor but, rather, if there are to be penalties, the other participants or individuals meeting the unfulfilled commitments should receive the benefit thereof. Subsection (s)(3), therefore provides that penalties must accrue to the benefit of the program. Subsections (s)(4) and (5) integrate specific penalty provisions for voluntary and mandatory assessments respectively that are followed by Blue-Sky authorities.

Subsection (t) would prohibit the forfeiture of a participant's right to participate in a future optional development well as a penalty for failure to meet an assessment if this intended procedure is not disclosed in the prospectus. The Association does not believe this penalty is inappropriate if fully disclosed because the participant would not have invested in the future development well since he did not meet the assessment. There is no reason, therefore, why he should not forfeit his right to participate as long as disclosure of this intended procedure is properly made.

Subsection (u) would require that when reinvestment of a program's distributable cash flow into a subsequent program is provided for, such must be at the option of the investor who shall be provided, prior to the time he exercises his option, complete information as to the amount of money to which he is then entitled as well as a copy of the prospectus of the subsequent program in which reinvestment is contemplated. The decision is made by each participant and not one left to the sole discretion of the sponsor.

Subsections (u), (w) and (v) relate to the liquidation of participants' interests in the program. Subsection (v) would prohibit a sponsor or an affiliate of a sponsor from selling his interest in a program without making an offer comparable in all respects simultaneously to all other participants and giving them a reasonable period of

time in which to sell their interests. The purpose of this provision is to prevent a sponsor from extricating himself from his investment in a program in preference to the participants. Notwithstanding that a sponsor is not required to purchase interests in a program, the fact that he has done so undoubtedly creates a greater degree of assurance in the minds of participants that he will perform properly his obligations as a sponsor. A sale by him of his units could destroy that confidence. In addition to not being in the public interest, such action could possibly be inconsistent with his fiduciary obligation to the participants to act at all times in their best interests.

Subsection (w)(1) would prohibit the purchase by a program of any interests of any other program and the repurchase by a program of its own participants' interests in a manner or in an amount which is not in the best interests of the program. A customer in making his investment decision as to a given program has elected to place his trust in the possibility of success of that program and in the management ability of the sponsor. If that program invests in another, his investment has then, without any informed judgment on his part, been transferred, in part at least, to the new program.

Subsection (w)(2), relating to repurchase by a program of its own participants' interests, would prevent a situation from developing whereby so many participants chose to liquidate that an insufficient amount of funds would remain for the program to continue viable operations. This provision would, therefore, require that some limitation be written into each prospectus which is reasonable in nature. The Association does not at this time wish to prescribe the extent of such limitations other than that they be reasonable.

Subsection (x) would require that cash liquidation values be computed on the basis of an appraisal of property made within the preceding twelve-month period by a qualified independent appraiser pursuant to a formula or in accordance with terms spelled out in the prospectus. If there has been a material change in value between the time of the appraisal and the contemplated liquidation, a new appraisal would be required to be made prior to any liquidation.

Subsection (y) would require that if any person contemplates transacting business with the program in an amount aggregating more than twenty percent (20%) of the total dollar value of the participants' interests, such would have to be disclosed in the prospectus. The Board is not suggesting that such a business relationship is

detrimental to the program. However, it does feel that the knowledge of this relationship is of importance to the investing public.

Subsection (z) would require that all details with respect to all of the provisions of Subsections (a) through (x) of Section 2 be fully disclosed in the prospectus. This is in keeping with the Board's desire to not only impose a system of regulation in connection with direct participation programs but to also insure that even though the program fully complies, participants be placed on notice of all details in respect thereto so they can properly make their investment decisions.

Section 5 -- Rights of Participants

Unless there are conflicts with the laws of the state where the program is organized, this section would prevent a member, or person associated therewith, from underwriting or distributing units of a direct participation program of which a member or an affiliate of a member is sponsor which does not contain a series of provisions relating to the rights of participants. Thus, Subsection (a) would prohibit participation in the distribution where the program did not permit its participants the right by a majority vote to remove the sponsor. Subsection 6 would require that a majority of the outstanding units be allowed to amend the partnership or other agreement organizing the program entity, to dissolve the partnership or other legal entity formed to carry out the purposes of the program and/ or to approve or disapprove the sale of all or substantially all of the assets of the program. Several other rights would also be accorded to participants by Subsections (c) through (f) of this section. Generally, these provisions would prevent situations from occurring whereby significant and material provisions of a program could be changed or other action taken at the discretion of the sponsor to the possible detriment of participants. Thus they would insure ample notification (60 days) of termination of a sponsor's contract by it or the participants (Subsection (c)(1)); require the sponsor to cause a vote to be taken on any of the above listed four rights after being requested in writing to do so by at least 10% of the outstanding program interests (Subsection (c)(2)); prevent restrictions on the assignment of a participant's program interests but such would not prevent requiring approval by the sponsor prior to such a transfer (Subsection (d)); grant to all participants upon written demand the right for any proper purpose to have a list of names and addresses of, and interests held by, all participants (Subsection (e)); and require a notice by the sponsor to all participants of any material amendment

to the program proposed by him and affirmative vote of not less than a majority of the outstanding number of program interests for approval if more than 10% of the participants object to the program (Subsection (f)).

The Association recognizes that as a matter of law the possibility exists in the case of limited partnerships that if the limited partners have and exercise authority to the extent that they are conducting the day-to-day operations of the partnership, limited partners could possibly be construed as general partners and lose their limited liability notwithstanding their designation as limited partners. The laws of the states vary in several respects as to the scope of activity on the part of a limited partner which could cause such a change in his status. It is not the Association's intent by the provisions of Section 5 to cause that result. The "rights of limited partners" provisions are, therefore, preceded with the lanaguage: "Unless such conflicts with any federal law or law of the state pursuant to which the program is organized." If the law would cause loss of limited partnership status under any one of the provisions, the program would not be required to contain that provision.

Section 6 -- Conflicts of Interest

Initially, it should be noted that the Board recognizes and accepts as fact that it is not possible to eliminate all conflicts of interest in direct participation programs. It also believes that such is not necessary because all conflicts of interest are not bad if properly regulated and that some may be necessary to the success of a program and are in the best interests of the program's participants. The Board believes, therefore, that conflicts should be divided into those which are considered permissible subject to regulation and those which are considered impermissible. The impermissible conflicts should be eliminated and controls should be placed on the others. Section 4 is promulgated with these ideas in mind.

Generally speaking, one area of conflict which exists in many direct participation programs, and which is not necessarily detrimental to the program if properly regulated, is the situation of the sponsor or an affiliate of the sponsor dealing with the program. In some cases the sponsor or its affiliates will sell property, services or supplies to the program. The Association does not believe such conduct should be eliminated but it does believe that stringent controls should be imposed. Thus, the various provisions of Subsection (a) of Section 6 would place controls on these situations with regard to all programs in

which a member or an affiliate of a member acts as a sponsor. In some cases, specific situations relate to specific types of programs, i.e., oil and gas or real estate, and where such is the case the pertinent provision so indicates.

Paragraphs (1) and (2) of Subsection (a) relate to situations involving the sale of property by a sponsor or an affiliate of a sponsor which has been owned, optioned or acquired by them either prior to or subsequent to the formation of the program. In the case of property obtained by a sponsor or its affiliate, except for a limited exception made for oil and gas programs, Paragraph (1) would impose the requirement that the property to be acquired by the program must be transferred at the lesser of cost or fair market value as determined by a qualified independent appraiser. A provision for an exception to these standards is included which allows the transfer of such property at a price greater than cost if all the details of the transaction, including the profit to the sponsor or its affiliates, are fully disclosed to the program participants and to subsequent program subscribers, the acquisition is at no more than fair market value, and the sponsor or its affiliate has owned the property for at least two years or there has been a material change in the value of the property.

Paragraph (2) of Subsection (a) deals with the acquisition by an oil and gas program of non-producing acreage owned by the sponsor or an affiliate of the sponsor. It provides that such acquisition shall be at cost unless the sponsor or its affiliate has reason to believe that the cost is materially different than fair market value. In that case the acquisition may be at a price determined by an independent appraiser as long as the details of the transaction are fully disclosed.

Paragraph (e) of Subsection (a) deals with the reverse situation. The purchase by a sponsor or an affiliate of the sponsor of property owned by an oil and gas program shall be at fair market value determined by an appraiser unless the sponsor or its affiliate has grounds to believe that the cost is materially higher than fair market value. In that case the purchase shall be at a price not less than cost. This paragraph contains the only exception to the prohibition in Section 6(b)(6) against a sponsor's or its affiliate's purchase of property from a program.

Paragraph (4) of Subsection (a) relates to the sale of services, supplies, equipment, furnishings or other property to the program by the sponsor or an

affiliate of the sponsor. The Board recognizes that conflicts of interest exist in such situations and that the possibility of overreaching is present. At the same time, however, it believes that in many cases such sales by a sponsor and its affiliates are beneficial to the program and its participants. Because the possibility of overreaching does exist, proper guidelines must be established to reduce that possibility. Paragraph (4) would, therefore, require, in order for a member to participate in the distribution of units of a program which permits such activity, that the fees and prices charged be no higher than those customarily charged for similar services in the same or a comparable geographical location by persons who are dealing at arms'-length and have no affiliation with the recipient. A further provision states that if there exists no basis for comparing fees or if the sponsor or its affiliates are not engaged in an ongoing business of providing such services, the services shall be provided at no more than cost.

In addition to the requirements stated above concerning self-dealing by a sponsor or an affiliate of the sponsor with a program, additional protections to the investor are required by Section 11 dealing with periodic reporting to participants. Subsection (d) thereof would require that the total amount of expenditures made by a program in connection with the sale to it of services, supplies, equipment, furnishings or other property by the sponsor or its affiliates be fully disclosed in the annual audited financial statements required by Subsection (b) of Section 11. The same requirement is made as to any person with whom the program transacts business in a material amount. Also, where a sponsor or its affiliates have sold services, supplies, equipment, furnishings or other property to previous programs sponsored by them, the full details with respect to this activity must be made available in the prospectus of the current program (Section 11(d)). The potential participant is, therefore, able to take these activities into consideration prior to making his investment decision.

Paragraph (5) of Subsection (a) prevents the retention by the sponsor or an affiliate of the sponsor of an oil and gas program of any rights of any kind in property which he has transferred to the program unless the sponsor or its affiliate is required by the terms of the program to participate in the development of the property on a cost basis proportionate to his retained interest in the property. Those rights created by virtue of its status as sponsor of the program are excepted

from this prohibition so long as those rights are fully disclosed in the prospectus. This latter provision relates to sponsors' compensation which is covered in Section 10. The purpose of this paragraph is to prevent a sponsor or its affiliate from benefiting at the expense of the program carrying on the development by retaining rights in a property. By requiring the sponsor and its affiliates to participate with the program in the development of the property on a cost basis proportionate to their retained interest, the possibility of it benefiting at the expense of the program is decreased.

Paragraph (6) of Subsection (a) relates solely to real estate programs and requires that in cases where the sponsor or an affiliate of the sponsor is to provide development or construction services for the program, the program shall require that such be done on a firm contract basis at a price not to exceed the appraised value of the property when completed, including the total cost of the real property as determined by a qualified independent real estate appraiser at the time of the commitment for such service. It provides further that if any developing or contracting is to be supplied by the sponsor or its affiliates after the formation of the program it must be done in accordance with the provisions set forth in Subsection (a)(4) relating to the rendition by a sponsor or its affiliates of services, supplies or equipment to the program.

Section 6(b) -- Impermissible Conflicts of Interest

As noted above, the Board believes several situations exist which constitute impermissible conflicts of interest and should not be allowed in connection with any direct participation programs of which a member or an affiliate of a member is a sponsor. One of these, relating to retention of rights in adjacent or surrounding acreage, has been discussed above.

Subsection (b)(1) related to real estate programs and would prohibit the sponsor or an affiliate of the sponsor from being a principal or prime tenant on property owned by the program. This provision would tend to minimize the potential detriment to participants in a situation where a sponsor and/or its affiliates would be dealing with the program on a non-arms'-length basis. There is no real reason why a sponsor or its affiliates should not be permitted to be a tenant of program property but they would have great leverage to cause it to operate less than optimally to their benefit if they were the only or principal tenant. Subsection (b)(1) excludes from its proscriptions a fully guaranteed lease back

arrangement (defined in Section 1(q)) where the terms of such are fair and reasonable and no more favorable to the sponsor or its affiliates than those offered to other persons. A "principal or prime tenant" has been defined in Section 1(ii).

Subsection (b)(2) would prevent the rendition by the sponsor or an affiliate of the sponsor of professional services to the program, such as legal services or auditing services, or the payment of fees in that connection. The purpose of this provision is to insure that a program has the benefit of independent legal opinions, auditing, and other professional services. This would not prevent the payment to the sponsor or its affiliates for services which are offered in connection with the day-to-day management of the program, such as day-to-day legal, accounting and recordkeeping services, leasing agreements, settlement arrangements and property management, among others.

Subsection (b)(3) would prevent the sale or exchange of any property between programs with the same sponsor. An exception would be made, however, to allow such sales and exchanges in the case of oil and gas programs where the sales and exchanges are of non-producing exploratory acreage, are at cost or, if there is reason to believe there has been a material change in value, at fair market value as determined by a qualified independent appraiser, and are between programs whose compensation arrangements with the common sponsor are substantially comparable. This paragraph would also allow transactions among oil programs by which property is transferred from one to another in exchange for the transferee's obligations to conduct drilling activities on the property transferred or to joint ventures among such oil programs, provided that the compensation arrangement of the manager and each affiliated person in each such oil program is the same, is reasonably calculated to be the same, and is in the best interest of the program. This paragraph would prevent one program from benefiting at the expense of another program. Unless such a prohibition were imposed, the possibility would exist for the transfer of property on a preferential basis depending upon, for instance, the interests of the sponsor in the respective programs or other considerations. The overall intent of the paragraph is to prevent improper self-dealing.

The provision contained in Subsection (b)(4) of Section 6, relating to impermissible conflicts of interest, prohibits the retention by the sponsor or an affiliate of the sponsor of any interests in adjacent acreage (as defined

in Section 1(b)) to property transferred to an oil and gas program or, in the case of all other programs, in property in the general area of the property so transferred. The purpose of this prohibition is to prevent a sponsor or its affiliates from capitalizing on a program's expenditures on the property in question. This possibility is more acute in the case of oil and gas programs. In such cases, a sponsor or its affiliates, retaining surrounding properties to that transferred to the program, could cause the program to expend its funds for drilling operations on the transferred property. If oil or gas were discovered, a reasonable possibility would exist that the discovery would extend to their own surrounding property. This conflict is especially acute since the sponsor would have available the geological reports and could specify where the program's drilling operations should take place. They could then tap into the reservoir with a high probability of profit. The cost of exploration in such a case would have been borne by the program for the benefit of the sponsor and its affiliates. Such is considered to be an impermissible conflict of interest and inconsistent with the sponsor's fiduciary duty to the participants.

An exemption would be granted in the case of real estate programs to the prohibition of retaining an interest in surrounding property as long as such is fully disclosed in the prospectus including a disclosure of any potential benefits to the sponsor or an affiliate of the sponsor or any conflicts of interest which could result from any type of service or supplies rendered by them to the surrounding properties. This exclusionary provision recognizes an accepted, and not improper, course of doing business in the real estate industry. When a real estate program expends funds in connection with the development of a property it assuredly adds value to it, i.e., it constructs a building, as distinguished from expenditures by an oil and gas program which do not necessarily add value to the property. Indeed, expenditures could lead to the discovery that the oil property is a worthless prospect. The provisions also recognize the fact that oil and gas is a depletable asset and to the extent a sponsor draws oil or gas from a reservoir discovered by the program, it assists in the depletion of the asset to the detriment of the program and its participants. This does not occur in the case of real estate programs since there is no depletable asset from which the sponsor can draw to the detriment of the participants. Further, notwithstanding the fact that the sponsor's surrounding property would increase in value because of expenditures by the program, more often than not, the sponsor or his transferee would himself, sooner or later, develop that property thus

adding to the overall value of the property in the neighborhood including property owned by the program.

Subsection (b)(5) would prevent the sale to the program by a sponsor or an affiliate of the sponsor of an unspecified property program of any services including development and construction contracting on any property owned by it unless the property is specifically designated and detailed information concerning the services to be rendered is disclosed in the prospectus. An unspecified property program has been defined in Section 1(bbb).

Subsection (b)(6) of Section 6 would prevent the sale to the sponsor or an affiliate of the sponsor by the program of any property except as provided in Subsection (a)(3).

Subsection (b)(7) would prevent the direct or indirect payment of a commission or fee to a sponsor or an affiliate of the sponsor in connection with the reinvestment of the proceeds of the resale, exchange, or refinancing of program property except when the aggregate of initial acquisition fees and the reinvestment fee are within the limits of Section 10(a)(1).

Subsection (b)(8) would prevent a sponsor or an affiliate of the sponsor from having an exclusive right to sell or exclusive employment to sell property for the program.

Subsection (b)(9) would prohibit the program from making loans to the sponsor or an affiliate of the sponsor.

Subsection (c) of Section 6 is a general provision relating to all other conflicts of interest not specifically provided for in Section 6 and states that all such conflicts shall be considered impermissible and members shall not be permitted to distribute units of programs containing them where a member or an affiliate of a member is a sponsor unless justified taking into consideration standards of fairness and reasonableness to participants. Thus, if a program of which a member or an affiliate of a member is a sponsor contains any conflict not specifically covered by this Appendix F, it would be considered impermissible and prior to distribution by a member it would be mandatory that justification for the fairness and reasonableness of the conflict be affirmatively demonstrated to the Association. Such justification would include not only the basis for functioning in the given manner but would also include a demonstration of the measures which are proposed to be taken for the purpose of protecting the interests of participants in view of the conflict. It seems, in evaluating

conflicts of interest the predominate consideration in the specific provisions discussed above is that all conflicts are not improper as long as proper controls are imposed for the protection of participants.

Section 7 -- Suitability

The suitability of a direct participation program for a particular customer is an extremely important matter to be considered by members. Usually, because of the tax consequences inherent in such programs, they are a suitable investment only for persons of substantial financial resources who are in an income tax bracket appropriate to enable them to obtain the tax benefit described in the prospectus. Higher than normal suitability standards would be imposed by the Association under Subsection (b) of this section in connection with investment in oil and gas programs which are not formed to acquire producing properties.

However, while the Association believes that suitability standards for investment in certain direct participation programs should be higher than those for investment in general securities, it does not believe they should be so rigid that exceptions could not be made in appropriate circumstances or that discretion to make a suitability determination should be taken completely from the member. Thus a provision is included in Subsection (c) to permit deviations from the provisions of Subsections (a) or (b) if such can be justified. However, certain additional record-keeping must be maintained with respect to this prerogative.

Subsection (a) of Section 7 would prohibit a member from participating in the distribution of a direct participation program unless standards of suitability have been established by the program for its participants which are fully disclosed in the prospectus and are not inconsistent with the provisions of Subsection (b) of this section.

Subsection (b)(1) of Section 7 would require that a member, in recommending the purchase of a direct participation program, whether it be an initial distribution or a subsequent sale, inform his customer of all pertinent facts relating to the liquidity and marketability of the program, the tax aspects of the program during the term of the investment and the tax consequences upon dissolution of the program. This would add a measure of protection for participants who may not be aware of these factors or who may not have the sophistication to determine investment consequences on their own. Mere notification to customers of these factors, however, would not relieve a member from the responsibility of being assured that the other requirements of Subsection (b) are satisfied and that the investment is suitable to that particular customer.

In addition to informing the customer of the stated pertinent facts, a member, pursuant to Subsection (b)(2), would have to be assured on the basis of information obtained, that the customer, after giving effect to all of his direct participation investments, is reasonably anticipates to be in a federal tax bracket (defined at Section 1(aaa)) appropriate to enable him to obtain the tax benefit described in the prospectus. Pursuant to Subsection (b)(3) the investor must have a fair market net worth sufficient to sustain the risk inherent in the program including loss of investment and loss of liquidity. The investor's commitment to all direct participation programs must bear a reasonable relationship to his net worth. Subsection (b)(4) would require a member, in addition to the above, to have reasonable grounds for believing that the purchase of the program is suitable for each customer on the basis of information furnished by that customer concerning his investment objectives, financial situation and needs, and any other information known by the member. Subsection (b)(5) would require that the member maintain in its files the basis for the determination of suitability with regard to each customer.

Thus, under the proposals a member would have a strict obligation to not only inform each of his customers of the tax consequences of the investment as well as the liquidity and marketability of the program, but also to be assured on the basis of information received from the customer that his tax bracket and net worth indicate the investment to be suitable. The member thereafter would be required to maintain in its files a statement containing the basis for and the reasons upon which the determination was made.

As stated, exception procedures are contained in Subsection (c). The procedures would impose the burden of justifying a determination of suitability which departs from the provisions of Subsections (a) and (b) upon the member who makes that determination and would require that the member document in writing the basis for his departure from the provisions and retain such documentation in its files. Thus, whether a determination of suitability is made pursuant to the provisions of Subsections (a) and (b) or pursuant to a departure therefrom, a record of suitability bases would be required to be kept in the member's files in connection with all participants.

Subsection (d) would require a member soliciting or recommending the resale, transfer or other disposition of an outstanding direct participation program interest to inform the seller of any evaluations which were made by the program sponsor and of the tax consequences of the transaction.

Subsection (e) would prohibit the sale of a direct participation program interest without first receiving specific authority from the customer to execute that transaction.

Section 8

Although this section is entirely new to Appendix F, it consists of modified portions of Notice to Members 75-33, dated April 25, 1975, and previously considered by the membership, concerning a Proposed Statement of Policy of the Board of Governors Concerning Due Diligence Requirements For Public Offerings of Securities. The main provisions of that proposal have been withdrawn by the Association. However, in view of the overwhelmingly favorable comments received regarding the need for investigative measures in the offering of direct participation programs, the provisions which apply to offerings of these programs have been partially preserved and restated here. In the case of direct participation programs, the Association believes, in view of the nature of the offerings, that investigation of the issuer's activity should be intensive. The lack of traditional underwriting methods used in the distribution of these securities and the need for highly technical knowledge in the specific area of program enterprise require these additional measures. This section as reconstructed makes NASD member firms responsible for conducting a reasonable evaluation of the accuracy and adequacy of disclosure in any direct participation program offering in which they participate.

Section 9 -- Organization and Offering Expenses

This section is designed to assist in insuring that expenses incurred in connection with organizing and offering a program are fair and reasonable. Thus Subsection (a)(2) would place a limitation on organization and offering expenses to be paid directly by any member-sponsored program of fifteen percent (15%) of the dollar amount of the cash receipts of the offering. It should be noted that "Organization and Offering Expenses" has been defined in Section 1(bb) to include all sales commissions paid to broker/dealers in connection with the distribution and all other expenses incurred in connection with preparing a direct participation program for registration. Further, the fifteen percent (15%) relates to the total dollar amount of the cash receipts of the offering as distinguished from the total stated amount of the proposed offering. Thus, if an offering were for $1,000,000, the maximum permissible organization and offering expenses would not necessarily be $150,000 if all the units of the program were not sold. If, for instance, units representing only $500,000 were sold, total organization and offering expenses paid by the program could not exceed $75,000. Should a substantial portion of a proposed offering not be sold and if limitations such as these were not imposed, it would be possible for organization and offering expenses to absorb a significant portion of the invested funds. Such would obviously be detrimental to investors.

Subsection (a)(3) would restrict sales commissions paid to members to a standard of fairness and reasonableness taking into consideration the size of the program being offered. In this connection, it should be noted that the Association has reviewed many offerings of all types of programs and has ascertained that certain norms have developed in the various industries offering direct participation programs. It should be expected that these norms would be considered by the Association in its determination of whether the sales commissions and other offering expenses in a given direct participation program are fair and reasonable. Presently, a maximum underwriting compensation of 10.0% of the gross dollar amount of units sold is being applied in all direct participation programs. In an integrated program, i.e., one where the sponsor or its affiliate also acts as the distributor, a lower compensation would be expected except where specifically justified. Included in the maximum suggested figure of compensation would be all items of compensation to distributors such as expenses of underwriter's counsel, advertising, wholesaling, retailing, investor relations fees, due diligence expense reimbursements, and all other items of value.

Subsection (a)(4) would prohibit the direct or indirect payment or awarding of commissions or other compensation to any person engaged by a potential investor for investment advice as an inducement to such person to advise the purchaser of interests in a particular program, unless such person is a registered broker/dealer or other person properly licensed for selling program interests. Subsection (a)(4) is reflective of other rules of the Association and is designed to prevent the granting of sales commissions to accountants, legal counsel or investment advisors who may be giving advice to the investor but who are not properly registered under the appropriate securities laws.

Subsection (a)(5) would prohibit members or persons associated with members from receiving compensation in forms other than cash if of an indeterminate nature for services of any kind rendered in connection with the distribution of units of a direct participation program. Items such as, but not necessarily limited to, a percentage of the program management fee, a profit sharing arrangement, brokerage commissions, overriding royalty interests, a net profits interest, a percentage of revenues, a reversionary interest, a working interest, or other similar incentive items are included in the prohibition.

Subsection (b) of Section 9 prescribes the various types of compensation to underwriters or dealers, deemed to be in connection with the offering, which will be taken into

consideration in calculating the amount of sales commissions to determine compliance with the provisions of Subsection (a)(3).

Subsection (c) of Section 9 prohibits a member or person associated with a member from receiving in connection with an offering any warrants, options, stock or partnership interests in a sponsor or an affiliate of a sponsor. What is in connection with an offering shall be determined on the basis of factors such as, but not necessarily limited to, the timing of the transaction, the consideration rendered, the investment risk and the role of the member or person associated with the member in the organization, management and direction of the enterprise in which the sponsor is involved. The guidelines set forth in the Interpretation of the Board of Governors With Respect to Review of Corporate Financing shall govern so far as applicable for purposes of determining the factors utilized in computing compensation derived from securities received prior to the filing of an offering with the Association.

Subsection (d) of Section 9 is directed at an area of compensation to members in which the Association has noticed much abuse. It has been found that sales incentive compensation has been awarded to members and their salespersons in the form of free vacation trips and merchandise but that these incentive compensation arrangements have not been disclosed to the Association as part of the compensation package. Not only will the use of such items when undisclosed violate the compensation arrangements under Subsections (a)(4) and (5) and Subsection (b) of this section but such nondisclosure may violate the disclosure laws under the federal and state securities laws. This paragraph prohibits the allowance of any sales incentive items by a sponsor or an affiliate of a sponsor or a program to a member or person associated with a member such as, but not necessarily limited to, travel bonuses, prizes and awards in an amount in excess of $25. The payment of any incentive compensation must be disclosed and the dollar amount of the incentive items shall be taken into consideration in computing the amount of sales commissions to determine compliance with the provisions of Subsection (a)(3).

Section 10 -- Sponsor's Compensation

This section addresses itself to various sponsor's compensation arrangements which are believed to be improper in any direct participation program and also to specific arrangements in the oil and gas and real estate areas.

Subsection (a) of Section 10 is composed of several paragraphs dealing with specific situations which apply to

all direct participation programs. Its provisions are applicable only to public programs of which a member or an affiliate of a member is the sponsor. Subsection (a)(1) provides generally that compensation to a sponsor or an affiliate of a sponsor must be fair and reasonable taking into consideration all relevant factors. The following paragraphs would require complete disclosure in the prospectus of all compensation to the sponsor and affiliates, whether direct or indirect, and a summary of compensation arrangements to appear in one section so entitled with a clear reference to other parts of the prospectus where more detail can be found (Subsection (a)(2)); prohibit payment of compensation directly or indirectly to a sponsor in connection with the dissolution of a program unless such payment is consistent with the sharing arrangement and is fully disclosed in the prospectus (Subsection (a)(3)); require that any interest and fees earned on funds held for the sole account of the program be payable only to it and not to the sponsor or any other person (Subsection (a)(4)); and prohibit rebates, give-ups, or reciprocal business arrangements in the conduct of the sponsor's duties (Subsection (a)(5)).

Subsection (b) of Section 10 establishes more specifically certain acceptable standards of compensation with regard to oil and gas programs. Subsection (c) does likewise with regard to real estate programs. Subsections (b) through (e) are applicable only to programs of which a member or an affiliate of a member is a sponsor.

Subsection (b) sets forth permissible levels of sponsor's compensation in oil and gas drilling programs and production programs. These provisions are essentially uniform with those which were adopted by the North American Securities Administrators Association on September 22, 1976. While these provisions represent a substantial departure from previous proposals filed under this rule, they clearly adhere much more closely to the current organization and structure of arrangements in public oil and gas programs.

Subsections (b)(1) through (b)(6) indicate permissible spreads between cost and revenue participation and related arrangements for programs in which the general partner contributes to operating capital. Subsection (b)(7) indicates the permissible participation of program sponsors in revenues on a subordinated basis where they contribute nothing to the program's operating capital. Subsections (b)(8) through (b)(10) indicate permissible levels of participation in the revenues of production programs depending on the role of the sponsor in management of operations. Subsection (b)(11) indicates the manner in which and extent to which expenses may be allocated to and paid by an oil and gas program.

Subsection (c) of Section 10 relates to sponsor's compensation in real estate programs and, as stated, these provisions are in addition to those specified in Subsection a. as being applicable to all programs. These provisions adhere closely to the Statement of Policy adopted by the Midwest Securities Commissioners Association of February 28, 1973 and subsequently amended February 26, 1974 and July 22, 1975. Subsection (c)(1) would prohibit the payment of an "acquisition fee" any greater than the lesser of a. the customary real estate commission charged by others rendering similar services in the same area, or b. 18 percent of the gross proceeds of the offering provided the total purchase price, including all commissions paid by both the seller and the program, do not exceed fair market value. Subsection (c)(2) would provide that payment of a real estate brokerage commission or similar fee to the sponsor or an affiliate of the sponsor on the resale of property by the program may not exceed 50% of the standard real estate commission and require that such must be subordinated to a return of 100% of the participant's capital contribution plus a 6% per annum cumulative return thereon; Subsection (c)(3) would prohibit the payment of more than one standard real estate or other commission or fee of a similar nature for the sale of any program property in any transaction in which the sponsor or an affiliate of the sponsor is a participating broker.

Subsection (c)(4) would prohibit the payment of any real estate acquisition fees, brokerage fees or other commissions except for services actually rendered by a sponsor or an affiliate of the sponsor that is licensed as a real estate broker or agent and that is engaged in the ongoing business of offering similar services to others. Subsection (c)(5) would prohibit leasing fees or similar types of compensation from being paid to a sponsor or an affiliate of a sponsor on property leased to them. Subsection (c)(6) would require that no more than one mortgage placement fee be paid on any property owned by a program with the proviso that fees received for securing both a construction loan and a permanent mortgage on a property shall be deemed to be one fee. Subsection (c)(7) would require that, where the sponsor or an affiliate of the sponsor is to manage the property of a program, the property management fees to be paid be for services actually rendered and be at a rate based on a percentage of the cash received during the period of operation of the program and no higher than those fees which would customarily be charged for similar services in the same geographical area on similar property by property management as an ongoing business activity.

Subsection (c)(8) would impose limitations on the fees to be paid to a sponsor or an affiliate of a sponsor

for the administration of a program. These provisions are limited to those programs which invest in raw land and in government subsidized housing.

Subsection (c)(9) would allow the sponsor or an affiliate of the sponsor two alternatives of receiving promotional compensation in the form of a sharing arrangement. The first would be on the basis of a 25 percent sharing arrangement fully subordinated after payment to investors of an amount at least equal to 100 percent of their capital contributions. The second would allow the sponsor or its affiliate to receive an interest equal to 10 percent of the cash available for distribution, unsubordinated, and a 15 percent sharing arrangement subordinated until after a return to investors of an amount at least equal to 100 percent of their capital contributions plus an amount equal to 6 percent of the capital contributions per annum on a cumulative basis.

Subsection (d) of Section 10 would provide for flexibility in programs of which a member or an affiliate of a member is a sponsor for levels and methods of compensation other than those listed but would require that justification for alternative arrangements be demonstrated by the persons proposing them. This provision would require, however, that such levels or methods be comparable or equitably equivalent to those listed, that they should be fair and reasonable taking into consideration all relevant factors and that they should not include levels or methods of compensation prohibited by those paragraphs. The purpose of the exception provision is to provide a flexibility to businessmen. It is recognized that new methods of compensation may develop in the future and that alternative arrangements must be consistent in total effect with the methods and levels of compensation which have been specified in Section 10.

Subsection (e) would specify that income received by a sponsor or an affiliate of a sponsor as a result of an interest held as a participant in a program will not be included in computing sponsor's compensation for purposes of Section 10.

Section 11 -- Periodic Reports

Section 11 would prohibit a member from distributing units of a direct participation program of which a member or an affiliate of a member is a sponsor unless certain periodic reports are required by the terms of the program to be sent to participants. These reports generally are divided into quarterly and annual reports.

Subsection (a) of Section 11 contains provisions requiring quarterly operations reports to be sent by oil and gas programs on the one hand and all other programs on the other hand. This provision is necessitated because of differences in the nature of the operations of oil and gas programs for those of other types of programs. Thus, in the case of an oil and gas program, a quarterly report covering the period prior to the commencement of drilling operations would not be meaningful. It is required, therefore, that the report be sent quarterly to all participants during the drilling phase of operations disclosing in reasonable detail the progress of drilling operations, the amount of production, if any, receipt and disbursement of revenue and any other relevant information. In the case of all other programs the quarterly reports are required for each quarterly period after the activation of the program and similar information must be disclosed. The purpose of these reports is to enable an investor to follow the progress of operations as well as the success or failure of his program's undertakings.

Subsection (b) would require that participants receive audited financial statements and tax information within 75 days after the close of each fiscal year in order to allow the participant sufficient time in which to file his tax return.

Subsection (c) relates only to an oil and gas program and would require the sponsor to send to each participant within 90 days after the end of the second year of the program, and at least annually thereafter, a report of projected cash flow by years from proven reserves as determined by an appraisal made by a qualified independent petroleum engineer. It is unlikely that such a report would be meaningful prior to the end of the second year of operations, hence the reason for that period.

Subsection (d) would require that the details of arrangements between a sponsor or an affiliate of a sponsor and any person with which the sponsor transacts a large amount of business be set forth in periodic reports. Subsection (d) would also require that the gross receipts received by the persons delineated in this Subsection from prior programs be also disclosed in the prospectus of the current program. This enables the potential participant in the current program to evaluate previous expenditures to such persons prior to making his investment decision.

<u>Section 12 -- Sales Literature</u>

The increase in interest in direct participation programs has resulted in a corresponding increase in the flow

of brochures, pamphlets and other forms of sales literature used as supplements to prospectuses. The Association has developed what it considers to be basic requirements for sales literature which are related to the specific features and unique characteristics of direct participation programs.

Subsection (a) under "General Requirements" deletes the previous filing requirement in conformance with the provisions of proposed Section 37 of Article III of the Rules of Fair Practice forwarded to the membership for comment under Notice to Members 77-34 and shortly to be submitted to it for vote.

Subsection (b) under "General Requirement" sets forth the general requirements of accuracy and clarity of sales literature on which the provisions of this section are based.

Subsection (c) under "General Requirements" specifies that the standards of this section are applicable to both oral and written statements which would not conform to the standards outlined.

Subsections (d)(1) through (8) under "Required Content" set forth certain factors which must be explained in the sales literature, including the general nature of the program, suitability factors, sales and management charges, assessments, liquidity limitations, the tax aspects of the program and the sponsor's expertise in order that the sales literature not be considered materially misleading. These paragraphs also contain a statement regarding the necessity of a prospectus accompanying or preceding sales literature. If a sales kit or other integrated grouping of sales material is used collectively, the data required by these paragraphs would be permitted to be contained in only one or more pieces except that the requirement covering delivery of a prospectus would be required to be in each piece of the integrated grouping of materials. The grouping in the aggregate, however, must contain all of the required data.

Subsections (e)(1) through (11) under "Prohibited Content" set forth specific prohibitions with respect to the content of sales literature and prescribe that sales literature containing such data shall be considered materially misleading.

Paragraph (1) thereof generally prohibits projections or forecasts of future returns from an investment in a program. Specific exceptions are provided for oil and gas and reasl estate programs when illustrations or tables are limited in format and content to the standards set forth.

Paragraph (2) prohibits forecasts and projections of capital appreciation and assurances of safety or protection against loss.

Paragraph (3) prohibits any discussion of appreciation or profit potential unless balanced with a clear statement of the potential risks of investment in a direct participation program.

Paragraph (4) prohibits undocumented claims of management expertise and is self-explanatory.

Paragraphs (5) and (6) prohibit misleading references to approval or endorsement of regulatory organizations including the Association.

Paragraph (7) would prohibit any statistical statement, table, graph, chart or illustration unless the source of data is disclosed.

Paragraph (8) would prohibit any statement of potential tax benefits unless accompanied by disclosure of the basis for such statement, such as the opinion of independent tax counsel or an Internal Revenue Service ruling.

Paragraph (9) would prohibit any type of stated or implied comparison of the structure or performance of an investment in a direct participation program with that of an investment in another non-affiliated program or of any other investment or industry.

Paragraph (10) would prohibit references to or statement of the financial condition of any affiliate of a management or sponsoring organization which does not have a direct financial responsibility for the program.

Paragraph (11) would prohibit any projection of the results of an exchange of program interests for other securities as well as illustrations of actual exchanges which have no direct relationship to the program being offered. The last sentence of the paragraph clarifies that its purpose is not to prohibit the presentation of factual data regarding completed exchanges of prior programs in accordance with the provisions of the paragraphs concerning oil and gas and real estate programs, respectively.

Subsection (f) under "Oil and Gas Programs" is limited in scope to illustrations and performance data on oil and gas programs and would be applicable to oil and gas program sales literature in addition to the paragraphs

discussed above. Subsection (f)(1) is concerned with the format and content of hypothetical illustrations while Subsection (f)(2) is related to historical presentations of the results of previously offered programs.

The basic intent of Paragraph (1)a. is to standardize the format and terminology used in illustrating the major tax advantages of an oil and gas program.

Subparagraph a.1. would require the illustrations of the effects of intangible drilling costs deductions be based on an assumed investment of $10,000 regardless of the minimum investment requirements of the program. In addition to the $10,000 illustration, however, illustrations based upon the total value of the program or the minimum subscription commitment would be permitted. Subparagraphs a.2. through 2.8. set forth the specific content, terminology and sequence which would be required in such an illustration. Subparagraph a.7. sets forth certain minimum disclosures and explanatory statement which would also be required to be included in such an illustration. Schedule I, entitled "Hypothetical Illustration of Tax Treatment of a $10,000 Investment in an Oil and Gas Program," is attached to Appendix F to assist members in preparing illustrations which conform to the requirements.

Paragraph (1)b. would set forth the requirements of content, terminology and sequence for all illustrations of the effects of the depletion allowances and/or depreciation on the taxability of income as well as the minimum disclosures and explanatory statements which would also be required to be included in such an illustration. It also requires that such illustrations be uniformly based on $1.00 of gross income since it is considered unnecessary to use higher figures to illustrate depletion and the use of higher figures may carry implications of future income results. Schedule II, entitled "Hypothetical Illustration of the Tax Treatment of Cash Flow in an Oil and Gas Program on a per $1.00 Basis," is attached to Appendix F to assist members in preparing illustrations conforming to the provisions.

Paragraph (1)c. would require that illustrations of both the intangible drilling costs deduction and the depletion allowance be used if either illustration is used. While there is no requirement that illustrations be used, this provision would prohibit the selective use of an illustration reflecting only one of these major tax features.

Subsection (f)(2) has as its primary goal the development of standardized illustrations of the results of

previously offered programs. While there would be no requirement that such illustrations be used, this section sets forth what would be the minimum required content of any illustration which is used.

Paragraph (2)a.1. would require that all programs offered within the previous ten years be reflected. This provision would thus prohibit the illustration or analysis of selected programs which may show the most favorable results. This paragraph would also permit the use of programs offered more than ten years prior to the date of the analysis as long as the results of all earlier programs are included.

Paragraph (2)a.2. would require that results be reflected both in terms of cash liquidation value and distributable cash flow if the program has a liquidation provision. Neither would be required but if one is used both must be.

Paragraph (2)a.3. would require that figures used in such illustrations be updated annually based on appraisals of reserves made by a qualified independent petroleum engineer.

Paragraph (2)a.4. would require that distributable cash flow estimates be based only on proven, producing properties and cash liquidation values, as of the date of the illustration, calculated in accordance with a formula or in accordance with terms contained in the prospectus.

Paragraph (2)a.5. would require that all illustrations be based on an assumed investment of $10,000, including actual assessments which must be prorated in such a manner as to reflect that $10,000 is the total investment. This provision would in certain circumstances also permit higher or lower investment illustrations but only as a supplement to the $10,000 illustration. A statement would also have to be made on the $10,000 illustration in connection with a program with a minimum investment requirement in excess of this amount that that figure has been used for clarity of illustration only and that an investment below the program's minimum is not possible.

Paragraph (2)a.6. would require that the illustration be updated annually based on the independent appraisals discussed above. It would permit more frequent updating, using figures based on reserve estimates of "in-house" engineers, so long as their update is based on the annual appraisal by a qualified independent petroleum engineer.

Paragraph (2)a.7. requires a caveat legend regarding the nature of the analysis.

The remaining provisions of Subsection (f)(2) specify the content, terminology and sequence of the items which would be required in the illustration. Schedule III, entitled "Analysis of XYZ Exploration Co., Inc. Programs' Return to Participants in 50% Federal Tax Bracket as of ________________," is attached to Appendix F to assist members in preparing illustrations conforming to the provisions of Subsection (f)(2).

Subsections (g) and (h) under "Real Estate Programs" are limited in scope to illustrations and performance data on real estate programs and are supplemental to Subsections (a) through (e) of this Section 12. Subsection (g) is concerned with hypothetical illustrations of potential benefits while Subsection (h) is related to historical presentations of the results of previously offered programs.

Subsection (g)(2) prohibits the use of projections in the prospectus or sales literature of unspecified property programs.

Subsections (g)(3) and (g)(4) allow use of projections meeting certain minimum information requirements for specified property programs and unimproved land programs, respectively. The tables and charts in these subsections are largely self-explanatory.

Finally, Subsection (h) would require that any track record analysis contain the results of all programs offered in the last five years, be factually accurate and comply with federal or state regulations under which the program has been qualified.

These subsections follow almost verbatim the rules for Track Records and Projections adopted by the Commissioner of Corporations of the State of California (Rule 250.140.117.3(k) and Rule 260.140.117.4).

It is intended that all sales literature in connection with real estate programs will conform to the general provisions of Subsection (g)(1) as well as the specific provisions of Subsections (G)(2) through (g)(4), Subsection (h), and the requirements of the Securities and Exchange Commission and/or the regulations of the state or states under which the program is qualified.