



SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

May 6, 1974

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

RECEIVED

Dear Senator Sparkman:

This is with reference to the letter sent to you on July 2, 1973 by former Commissioner Hugh F. Owens, concerning the Commission's publication for comments (Release No. 34-10260) of the proposal of the National Association of Securities Dealers, Inc. to amend its Rules of Fair Practice to provide for the regulation of distributions of tax shelter programs. Former Commissioner Owens indicated that, after review of the comments received in response to the release, we would apprise you of our conclusions. The Division of Market Regulation has today sent a letter to the Association suggesting that the Commission would welcome the submission by the Association for consideration by the Commission of definitive rules dealing with organization and offering expenses, suitability and content of advertising and sales literature - the traditional areas of regulation by the Association. The letter goes on to indicate that the Commission does not believe, at this time, that the Association should attempt to provide a regulatory structure which impacts directly on issuers, sponsors and others which are not members of the Association, but that much of the thought behind those rules included in the Association's proposal relating to the operation, structure and management of tax shelter programs could still prove useful to members of the Association as general guidelines in the area of suitability.

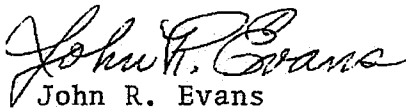
In the absence of the Chairman I am enclosing, for your information, a copy of the letter sent to the Association.

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Because of existing and potential abuses in connection with tax shelter programs, the Commission has directed its staff to formulate various proposals, including new rules or guidelines applicable to all packagers and promoters of tax shelter programs, enlarged enforcement programs and suggestions for additional legislation, for its consideration and to continue to collect information with respect to abuses involving tax shelter programs so that the Commission will be in a position to determine how best to provide proper regulation. The staff has also been directed to cooperate with the staff of the Association in the suggested implementation of the proposal of the Association.

I have also sent similar letters to Senator Harrison A. Williams and Representatives Harley O. Staggers and John E. Moss.

Sincerely,

A handwritten signature in cursive script that reads "John R. Evans".

John R. Evans  
Commissioner

Enclosure



SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

DIVISION OF  
MARKET REGULATION

May 6, 1974

Gordon S. Macklin, President  
National Association of Securities  
Dealers, Inc.  
1735 K Street, N. W.  
Washington, D. C. 20006

Dear Mr. Macklin:

This is in reference to the proposal of the Association to amend its Rules of Fair Practice so that a member or a person associated with a member may not underwrite, participate in the distribution to the public of or sponsor a tax shelter program the provisions of which are inconsistent with standards of fairness and reasonableness adopted by the Board of Governors. The Board would be authorized to prescribe such standards with respect to underwriters' compensation, suitability for investment, content of advertising and sales literature (which would be required to be filed with the Association) and the operation, structure and management of tax shelter programs. The proposal includes the standards to be prescribed initially by the Board.

While recognizing that there was wide support for more precise and effective regulation concerning tax shelter programs, the Commission, in Securities Exchange Act of 1934 Release No. 10260 (July 2, 1973), requested comments on the proposal directed to (1) whether the Association, in the exercise of its broad authority under the Securities Exchange Act of 1934, would be engaging in issuer-oriented regulation inconsistent with the intent of the Securities Act of 1933, (2) whether the Association's proposal should be limited in its application to member affiliated issuers and (3) whether the regulation of issuers of tax shelter programs should be achieved through a comprehensive federal regulatory program rather than rule making by the Association. In order to assist the Commission in obtaining comments, the Association on July 13, 1973, sent a letter to all members bringing to their attention the release referred to above, summarizing those same policy questions and printing the full text of the proposal. The Commission received a substantial number

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of comments, which have been carefully reviewed, and has concluded that it would welcome the prompt submission by the Association for consideration by the Commission of definitive rules dealing with organization and offering expenses (e.g., underwriters' compensation), suitability and content of advertising and sales literature - the traditional areas of regulation by the Association.

With respect to those rules included in the proposal relating to the operation, structure and management of tax shelter programs, the Commission does not believe, at this time, that the Association should attempt to provide a regulatory structure which impacts, as do those rules, directly on issuers, sponsors and others which are not members of the Association. The Commission, nevertheless believes that much of the thought behind those rules included in the proposal relating to the operation, structure and management of tax shelter programs could still prove useful to members of the Association as general guidelines in the area of suitability. Both the existing rules of the Association and the proposal recognize implicitly that suitability is a concept that involves a judgment by the member which matches both an investment profile of the customer and the characteristics of the security being recommended. The existing rules already require that, in recommending a particular security, members must have reasonable grounds for believing that the recommendation is suitable for a particular customer upon the basis of facts disclosed by that customer as to his other security holdings and as to his financial situation and needs. The proposal would, among other things, require that, in connection with tax shelter programs, standards of suitability be established for participants and disclosed in the prospectus. The member would also be required to inform the customer of all pertinent facts relating to the program and be assured that his customer will be in an appropriate tax bracket and has a fair market net worth sufficient to sustain the inherent risk. It may be possible for the Association to develop general guidelines as to suitability based on the rules included in the proposal relating to the operation, structure and management of tax shelter programs. With such general guidelines members will indeed have better tools with which to fulfill current obligations to ensure that suitable investments are recommended to customers.

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Viewing what is now the issuer-oriented part of the proposal from a revised perspective based on the suitability concept will no doubt lead to some restructuring of the proposal. For example, the proposal requires a sponsor to have four years' experience and net worth equal to the greater of (1) \$50,000 or (2) \$1,000,000 or 5% of the capitalization of all programs organized within the preceding year by the sponsor, whichever is less. At a minimum the proposal reflects recognition on the part of the Association that the risk of investing in a particular tax shelter program is substantially increased if the sponsor lacks that basic experience or does not have the specified minimum in net worth. A suitability approach would mean that compliance by a sponsor with the particular standards of the proposal would not be obligatory before a tax shelter program operated by it could be a suitable investment for any possible customer. Where, however, the sponsor of a program falls short of appropriate guidelines, a member should recognize that the number of its customers to whom that program may properly be recommended will necessarily be reduced. While suitability guidelines would not absolutely preclude a member from deciding (and, if necessary, subsequently demonstrating) that offsetting factors made a program sufficiently attractive to justify recommending it to selected customers, a member so deciding will obviously wish to document that the selected customers had, for example, an ability to comprehend fully the extra risk involved and greater capital or income than the average customer to whom it recommended tax shelter programs generally. It would, of course, be inappropriate to select customers on a basis that failed to match the investment profile of the customer and the characteristics of the program.

The foregoing is by way of example; where other factors in the structure of a particular tax shelter program, such as rights of participants, conflicts of interests, sponsor's compensation or obligation to provide periodic reports, reflect departures from generally accepted norms, it seems reasonable and indeed advisable for a member to apply a similar analysis of increased risk and to conclude, where appropriate, that there would be a consequent lack of suitability for many of its customers. In that connection, the Association may fairly expect that it will, with experience be able to speak with greater authority in outlining generally accepted norms and in adding to the specificity of its guidelines.

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The greater part of the offerings of tax shelter programs, by dollar volume, appears to be sold in transactions characterized by the participants as not involving a public offering, and the Commission urges the Association to emphasize that a member's obligation with respect to suitability exists in connection with every recommendation for the purchase of a security, not merely those made in connection with offerings that are classified as public by the Association.

The Commission recognizes that its suggestion for general guidelines as to suitability, in lieu of the proposal's prohibitions of participation in specific types of public distributions, means that the Association will have a somewhat more difficult task in supervising compliance by its members. At this juncture, however, it is not necessary to conclude that the Association and state securities commissions need bear the entire regulatory burden. Because of existing and potential abuses in connection with tax shelter programs, the Commission has directed its staff to continue to collect information with respect to abuses involving tax shelter programs and to formulate various proposals, including new rules or guidelines applicable to all packagers and promoters of tax shelter programs, enlarged enforcement programs and suggestions for additional legislation, for the consideration of the Commission so that it will be in a position to determine how best to provide proper regulation. The Association has already been most helpful in the collection of information and the Commission hopes to continue to have the benefit of its assistance. The staff has been directed to cooperate with the staff of the Association in the suggested implementation of the proposal of the Association. The Commission trusts that the Association will share with the staff of the Commission the experience the Association gains in operating under the proposal and assist in evaluating whether changes in its implementation can increase its effectiveness.

On behalf of the Commission I want to express appreciation for the work of the Association, its special committees and staff to date in dealing with problems involving tax shelter programs. Their work and that of various state officials and other interested persons who are concerned with the problems of tax shelter programs has been

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extremely valuable to the Commission. The Commission hopes that the suggestions in this letter will provide a means for the Association to implement the fruits of that work immediately and effectively so that we can make rapid progress toward improving protection of investors who buy tax shelter programs.

Sincerely,

Lee A. Pickard  
Director