NOTICE TO MEMBERS: 77-1
Notices to Members should be retained for future reference.

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

January 14, 1977

TO: All NASD Members

FROM: Quarterly Check List of Notices to Members (Fourth Quarter, 1976)

Topically indexed below are the Notices to Members which were issued during the fourth quarter of 1976.

The "Reference" column on the right gives the numbers of Notices to Members which were issued on the corresponding topic, during the first three quarters of 1976.

Topic	Serial No. and Summary Description	Date	Reference
Check List of Notices	76-34 Quarterly Check List (Third Quarter, 1976)	10/11/76	76-2 76-16 76-23
Lost Securities	76-39, various Arizona securities no longer missing	11/10/76	None
Municipal Securities Transactions	76-40, Board of Governors Interpretation re Section 25 of Rules of Fair Practice	12/8/76	None
Receivers & Trustees, Appointments of	76-32, SIPC Trustee for Institutional Securities of Colorado, Inc.	10/6/76	76-6, 76-7, 76-9, 76-11
	76-36, Temporary Receiver for E.J. Albanese & Co., Inc.	11/3/76	
	76-38, SIPC Trustee for E.J. Albanese & Co., Inc.	11/9/76	
	76-42, SIPC Trustee for Stilwell, Coker & Company, Inc.	12/20/76	
Settlement Dates	76-33, Columbus Day	10/4/76	76-5, 76-14, 76-20, 76-22, 76-28
	76-35, Veterans Day & Election Day	10/18/76	
	76-37, Thanksgiving Day	11/8/76	
	76-41, Holiday Schedule	12/10/76	

Topic	Serial No. and Summary Description	Date	Reference
Termination Notice, Uniform, for Securities Industry Personnel	76-43, Form U-5 effective January 1, 1977	12/17/76	None

Members should note that only one copy of each Notice to Members is mailed to every main office of every member. Copies are not mailed to branch offices or to additional personnel in the main office other than the Executive Representative. Therefore, we suggest that all members retain the original copy of each Notice to Members in a separate file in their main office, and that copies needed for internal or branch office distribution be duplicated from the original Notice.

If your main office file is missing any of the above notices, please write to the Office Services Administrator at the NASD Executive Office. Requests for copies should be accompanied by a self-addressed label.

NOTICE TO MEMBERS: 77-2
Notices to Members should be retained for future reference.

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

January 14, 1976

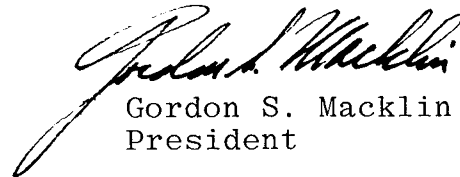
TO: ALL NASD MEMBERS

RE: 1977 Schedule of Holidays

Listed below is the NASD 1977 Schedule of Holidays.

February 21, Monday	Washington's Birthday
April 8, Friday	Good Friday
May 30, Monday	Memorial Day
July 4, Monday	Independence Day
September 5, Monday	Labor Day
November 24, Thursday	Thanksgiving Day
December 26, Monday	Christmas

Sincerely,



Gordon S. Macklin
President

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

MAIL VOTE

IMPORTANT

OFFICERS: PARTNERS: PROPRIETORS

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

DATE: January 21, 1977

RE: Mail Vote on Proposed Article III, Section 35 of the Rules of Fair Practice and Appendix F to Proposed Article III, Section 35

LAST VOTING DATE IS: February 21, 1977

Enclosed herewith is proposed new Section 35 and related Appendix F of the Association's Rules of Fair Practice concerning the distribution and/or sponsorship of publicly offered direct participation programs (formerly referred to as Tax Sheltered Programs) by member firms and/or their affiliates. This new rule must be approved by the membership and filed with the Securities and Exchange Commission for approval pursuant to Section 19(b) of the Securities Exchange Act prior to becoming effective.

The proposed new rule and Appendix F (which contains the substantive provisions of the new regulation) were previously explained in detail and submitted to the membership for comment on May 9, 1972 and resubmitted for further comment on July 13, 1973 (Notice to Members 73-50). The drafting of the proposed new rule 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. This is evidenced by some recent amendments to state laws and changes within the industry practices which are presently

under consideration. It can be expected that any subsequent amendments to Appendix F to the rule will be circulated to the membership for comment. In addition, the proposed new rule was informally submitted to and reviewed by the Securities and Exchange Commission and was the subject of Securities Exchange Act Release No. 10260 dated July 2, 1973, requesting public comment regarding certain policy questions which it raised. On the basis of comments received in response to the release, the Securities and Exchange Commission advised the Association by letter dated May 6, 1974 that certain changes in the structure and impact of the proposed new rule seemed appropriate. Since that time, the appropriate committee of the Association met on several occasions and made recommendations which were presented to and accepted by the Board of Governors of the Association. This latest action by the Board resulted in substantial changes from the original proposals which reflect input received from comment letters as well as from comments by the SEC staff in more recent meetings.

Section by Section Explanation

Article III, Section 35

Initially it should be noted that the term "tax sheltered program" originally used in the proposed rule to describe securities to which the rule would be applicable has been changed to "direct participation program." This new term, which is defined in Section 35(d)(2), more appropriately reflects the type of securities which the rule was originally intended to reach. The term "tax sheltered program" is also not reflective of the growing number of programs which are intended to be included within the scope of the rule but which are not primarily tax shelter oriented. In addition, the definition has been broadened to make specific inclusions and exclusions of certain types of programs.

Proposed Section 35 will be a new Rule of Fair Practice of the Association. Subsection (a) thereof would prohibit members or persons associated with a member from underwriting or participating in the distribution of units of a direct participation program, or from sponsoring such a program, if its provisions are inconsistent with the rules, regulations and procedures prescribing standards of fairness and reasonableness adopted by the Board of Governors of the Association.

Subsection (b) would delegate to the Board the authority to adopt for the protection of investors and the public interest, among other purposes, such rules, regulations and procedures. Areas in which the Board would be authorized to establish rules are delineated in Subsection (b) and with the exception of Subsection (b)(2) thereof have not changed

materially from the original release. Subsection (b)(2) has materially changed in that the authority granted to the Board under this provision would now only apply to offerings in which a member, a person associated therewith, or an affiliate thereof is to act as sponsor of a program. The definition of an affiliate of a member is set forth under Subsection (d)(1) of the rule. Originally the proposed rule gave authority to the Board to establish rules for the terms and conditions concerning operations, structure and management over all publicly sponsored programs in which members of the Association participate as distributors. Thus, unaffiliated nonmember sponsors would indirectly have fallen within the scope of the regulation. The Board believes that the revised provisions comply with the request of the Association to avoid providing a regulatory structure which in effect imposes regulation on issuers, sponsors and others who are not members of the Association or are not affiliated or associated with members. In light of this Appendix F, Sections 2 through 4, 7 and 8 as proposed would now only be applicable to members and their affiliated organizations when acting as sponsors of programs. The remaining sections, Sections 5, 6 and 9, are essentially unchanged as to the extent of the Association's authority since these are traditional areas in which the Association has exercised regulatory authority. This is also consistent with suggestions made by the Commission in its May 6, 1974 letter.

Subsection (b)(3) authorizes the establishment of appropriate suitability standards in connection with such programs. Subsection (b)(4) authorizes the establishment of standards concerning the content and filing with the Association of advertising and supplemental sales literature used in connection with the sale of programs, and Subsection (b)(5) authorizes the definition of words commonly used in connection with the distribution of direct participation programs. The only definitions which the Board is proposing at this time are those contained in Section 1 of Appendix F. Those definitions are only of words which are otherwise contained in the Appendix and an overall glossary of terms has not yet been promulgated.

Subsection (c) specifies that the rules, regulations and procedures developed by the Board in accordance with the authority granted by Subsection (b) shall be incorporated into Appendix F to be attached to and made part of the Rules of Fair Practice. Subsection (c) also delegates to the Board the authority to adopt, alter, amend, supplement or modify the provisions of Appendix F without first submitting such for approval by the membership as would otherwise be required by the provisions of Article VII of the Association's By-Laws. Necessary to the effectiveness of such, however, would be filing with

and approval by the Securities and Exchange Commission. Prior to such filing, or final approval by the Board of Governors, however, proposed changes would be submitted to the membership and other interested parties for comment.

Appendix F

Appendix F would contain 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 July 13, 1973 release (No. 73-50), with the exception of the major modifications made in the applicability provisions of Sections 2 through 4, 7 and 8 referred to above. Those modifications would make the provisions thereof applicable only to direct participation programs sponsored by members or their affiliates. Also, Section 9(g) was added to Appendix F so as to permit the use, as sales literature, of projections which conform to certain specific standards. The remaining sections are fundamentally unchanged and apply to all publicly offered direct participation programs distributed by members.

Section 1 -- Definitions

Section 1 of proposed Appendix F contains a series of definitions of words used throughout the Appendix. These terms are self-explanatory; thus no explanation is necessary except for the following.

The definitions of affiliate and sponsor have been altered in proposed Section 35 and Appendix F pursuant to comments and suggestions received on the original proposals. The new definition of affiliate specifies the types of relationships between a member and a sponsor that will activate the issuer-oriented sections (i.e., Sections 2-4, 7 and 8) of Appendix F. The definition of sponsor has been altered to make it complementary to the new definition of affiliate and is defined in terms of the management functions of the sponsor. Three new definitions have been added to those contained in the release of July 13, 1973, namely: the definitions of development fee, equity interest, and sales memoranda, all of which are self-explanatory.

Section 2

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 2 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 thus 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. Subsection (a) would not require the expertise called for to be "in-house," however, 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 restrict oil and gas programs (defined at Section 1(x)) 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 (d)(1), 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. The Board does not believe this is proper and thus it would require, pursuant to Subsection (d)(2), that all funds received be escrowed in an account specifically designated for that purpose until the minimum is reached, and in Subsection (d)(3), that if the minimum is not reached the entire amount deposited by participants, including sales commissions, be returned to them. These latter provisions would also apply to the minimum requirement for an oil and gas program.

Subsection (e)(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 (f) 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 (g) 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 of 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 (h) 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 (i) would prevent charging a participant interest or any other comparable charge for purchasing units on an installment basis. It is believed that such would be manifestly unfair because the installment privilege is allowed by the program itself consistent with its normal operations and because subscription revenue is not currently needed. The public investor should not, therefore, be charged a fee for meeting the payments. This provision would apply to all direct participation programs.

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

Subsection (j) would prevent sales commissions from being charged on assessments and (k) 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 (n) 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 (o), 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 (o)(3), therefore provides that penalties must accrue to the benefit of the program.

Subsection (q) 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 (r) 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 (s), (t) and (u) relate to the liquidation of participants' interests in the program. Subsection (s) 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 (t)(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 (t)(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 (u) 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 (v) 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 (w) would require that all details with respect to all of the provisions of Subsections (a) through (v) 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 3 -- 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, 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 the program. Several other rights would also be accorded to participants by Subsections (b) through (e) 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 (b)(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 (b)(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 (c)); 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 (d)); 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 (e)).

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 3 to cause that result. The "rights of limited partners" provisions are, therefore, preceded with the language: "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 4 -- 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 4 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 (3) 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 4(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 8 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 8. 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 8(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 7. 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 4(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) relates 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(p)) 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(hh).

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 obligation 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, or is reasonably calculated to be the same. 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 4, 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).

Another provision relating to unspecified property programs appears in Section 7(a)(9) of Appendix F governing management fees for unspecified property programs which requires that those fees be drawn only from the operating income of the program's property investments.

Subsection (b)(6) of Section 4 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.

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 4 is a general provision relating to all other conflicts of interest not specifically provided for in Section 4 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. Thus, in evaluating these conflicts of interest what is predominate 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.

<u>Section 5 -- Suitability</u>

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 recordkeeping must be maintained with respect to this prerogative.

Subsection (a) of Section 5 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 5 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 of 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 anticipated 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 6 -- 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(aa) 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. 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 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 6 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 6 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 6 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 7 -- 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 7 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 subsections 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)); 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 (a)(5)); 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 (a)(6)); 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 (a)(7)); 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 (a)(8)); require that the management fee for an unspecified property program be drawn from the operating income of the program's property investments (Subsection (a)(9)); and prohibit rebates, give-ups, or reciprocal business arrangements in the conduct of the sponsor's duties (Subsection (a)(10)).

Subsection (b) of Section 7 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) and (c) are applicable only to programs of which a member or an affiliate of a member is a sponsor.

Subsection (b)(1) would prevent the sponsor or an affiliate of the sponsor from receiving an overriding royalty interest or any other interest free from the burden of operating expenses of the program unless otherwise specifically permitted.

The broad proscription on overriding royalty interests contained in Subsection (b)(1) is qualified by Subsection (b)(2). That Subsection (b)(2) would permit a variety

of arrangements involving such interests, including working interests, to a sponsor and its affiliates. In each case, however, limitations are imposed and outside parameters of permissibility are detailed.

Subsection (b)(3) would prohibit general and administrative expenses paid to the sponsor or an affiliate of the sponsor unless they are chargeable to the program at cost on a fully audited basis, they are not in an amount which exceeds 10% of the proceeds of the offering in the first year of operation and, in each subsequent year, they are not unfair and unreasonable or in excess of the first year's general and administrative expenses.

Subsection (c) of Section 7 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. Subsection (c)(1) 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)(2) 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)(3) 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)(4) 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 divided between those programs which provide for a fixed fee arrangement and those which do not. The provisions relating to fixed fee situations parallel existing industry practice and would require that in such situations the fee must be restricted to an amount not in excess of one-half of one percent of the gross assets of the program or two and one-half percent of the equity of the program per annum, whichever is less (Subsection (c)(4)a.). In other than fixed fee situations, a standard of fairness and reasonableness would be established. Thus, in such cases where the general and administrative costs are to be charged directly to the program, Subsection (c)(4)b. would provide that the fee must be limited to an amount which is consistent with that normally charged for the administration of a similar type program and that in no event may those charges be other than fair and reasonable taking into consideration all relevant circumstances.

Subsection (c)(5) 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.

The general purpose of Subsections (c)(1) through (c)(5) is to prohibit the sponsor and affiliates of the sponsor from being enriched at the expense of the program. Potential abuses in each of these areas have been seen by the Association. Thus the requirements of these paragraphs are considered important.

Subsection (d) of Section 7 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 in Subsections (a), (b), and (c) 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 in Subsections (a), (b) and (c), 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 7.

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 7.

<u>Section 8 -- Periodic Reports</u>

Section 8 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 8 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 from 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 details 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.

Section 9 -- Sales Literature

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 basic requirements for sales literature which are related to the specific features and unique characteristics of direct participation programs.

Subsection (a) under "General Requirements" places upon the member the responsibility of filing sales literature with the Association prior to its use.

Subsection (b) under "General Requirements" 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 real 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 statements 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 that 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 statements 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, <u>including</u> actual assessments which must be prorated in such a manner as to reflect that $10,000 is the <u>total</u> 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 9. 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 ten years, be factually accurate and comply with federal or state regulations under which the program has been qualified.

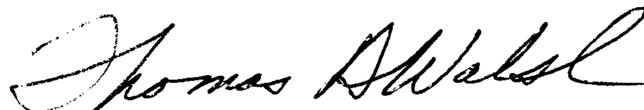
These subsections follow almost verbatim The Rules for Track Records and Projections adopted by the Commission of Corporations of the State of California (Rule 250.140.117.3(k) and Rule 260.140.117.4).

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 under which the program is qualified.

The proposed new Rule of Fair Practice is important and merits your immediate attention. Please mark the ballot according to your convictions and return it in the enclosed stamped envelope to "The Corporation Trust Company." Ballots must be postmarked no later than February 21, 1977.

The Board of Governors believes the Rule of Fair Practice is necessary and appropriate and recommends that members vote their approval.

Very truly yours,



Thomas D. Walsh
Secretary