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STRUCTURING LIMITED PARTNERSHIP OFFERINGS— RECENT DEVELOPMENTS

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I. INTRODUCTION

Public and private offerings of interests in limited partnerships have become as much a part of the securities business as stock or debt offerings. The structure of partnership offerings has been based primarily on a combined application of the rules governing stock offerings, the SEC's Industry Guides (particularly real estate and oil and gas), the rules of the National Association of Securities Dealers (particularly Appendix F), the North American Securities Administrators Association's guidelines for registration of real estate and oil and gas programs, and a substantial reliance on existing practice in the industry. The unique problems posed by partnership offerings, however, have resulted in an increased interest in, and development of, certain areas of regulation. Significant recent developments have taken place in the integration of private offerings, offering practices in all-or-none offerings, and deferred or installment payments for subscriptions. Other areas of particular interest in the partnership area, such as the so-called "section 4(1-1/2) exemption"[1] and the need for broker-dealer registration of associated persons of the issuer, have been the subject of substantial discussion elsewhere that need not be repeated here.[2]

II. LIMITED PARTNERSHIP INTEGRATION

The doctrine of integration, simply stated, stems from the premise that the registration and disclosure provisions should not be circumvented by dividing an offering into its component parts. Although each part of the offering viewed separately may be exempt, considered as a whole the offering does not qualify for the exemption.

The doctrine of integration historically has been applied to offerings by corporate issuers. In recent years the doctrine has been extended to separate offerings by a single limited partnership or to separate offerings by related

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1. *See The Section "4(1-1/2)" Phenomenon: Private Resales of "Restricted Securities,"* 34 BUS. LAW. 1961 (1979).

2. *See* Persons Deemed Not To Be Brokers, Exchange Act Release No. 34-22172 [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,792 (June 27, 1985).

limited partnerships, which often feature a common general partner. This extension is inevitable given the popularity of the limited partnership as a financing vehicle and the peculiar structural characteristics of the limited partnership.

Considerable confusion has arisen in the extension of the integration doctrine to the limited partnership offering. This confusion is caused by several factors, some inherent in the integration doctrine and some peculiar to limited partnerships. This article discusses the confusion surrounding the integration doctrine and suggests some guidelines for applying the integration doctrine in the context of the limited partnership offering.

A. *History of the Integration Doctrine*

The Securities and Exchange Commission (the "Commission") first dealt with what now is known as the integration doctrine in 1933 in Securities Act Release 97[3] when the Commission adopted rule 152 that now reads:

> Transactions by an issuer not involving a public offering in section 4(2) shall be deemed to apply to transactions not involving any public offering at the time of said transactions although subsequent thereto the issuer decides to make a public offering and/or files a registration statement.[4]

Subsequently, the Commission sought to establish more objective tests of integration, first in its 1938 decision in *Unity Gold Corporation*,[5] and thereafter in two releases: Securities Act Release No. 4434[6] and Securities Act Release No. 4552,[7] relating to section 3(a)(11) and section 4(2) offerings, respectively. These releases applied the following five criteria for determining whether or not integration applied:

(a) are the offerings part of a single plan of financing;

(b) do the offerings involve the issuance of the same class of security;

(c) are the offerings made at or about the same time;

(d) is the same type of consideration to be received; and

(e) are the offerings made for the same general purpose.[8]

The Commission also has issued a number of rulings using objective standards to interpret the various exemptions under the Securities Act of

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3. 1 Fed. Sec. L. Rep. (CCH) ¶¶ 1021, 1027 (Dec. 28, 1933).
4. 17 C.F.R. § 230.152 (1986).
5. 3 S.E.C. 618 (1938).
6. 1 Fed. Sec. L. Rep. (CCH) ¶ 2270 (Dec. 6, 1961).
7. 1 Fed. Sec. L. Rep. (CCH) ¶ 2270 (Nov. 6, 1961).
8. *Id.* ¶ 2781.

1933. For example, under the exemption in Regulation D the determination of the exemption's availability is based largely upon objective criteria including a six-month offering safe harbor from integration. Nevertheless, the five criteria set forth in Securities Act Release No. 4552[9] remain the basic position of the Commission.

Because of confusion in staff letters interpreting integration,[10] the Federal Securities Committee of the Section of Corporation, Banking and Business Law of the American Bar Association formed a task force in 1984 to study the integration issue. Its report was published in the *Business Lawyer* in January 1986.[11] The Task Force recommended that rule 152 be rescinded and replaced by a new rule 152 that would create safe harbors from the application of integration in the following situations:

> 1. The offerings are made by different issuers. Securities are deemed to be offered by different entities if (a) the offering entities are separate legal entities with separate books and records and the funds received by each entity are not commingled, (b) each entity upon the offering and the receipt of the offering proceeds had an independent opportunity to meet its primary investment objectives, and (c) no material portion of the offering proceeds shall have been invested in projects in which an affiliate shall have invested a material amount of its gross offering proceeds.
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> 2. The offerings are separated by at least six months.
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> 3. The offerings involve different classes of securities and immediately prior to the second offering the issuer does not have a negative net worth and is not a development stage company. All securities shall be deemed to fall into one of the following classes:
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> (a) Common Stock shall include only equity securities with ordinary voting rights and customary dividend rights.
>
> (b) Preferred Stock shall include all equity securities with a preferential right to dividends and any distribution of net assets.
>
> (c) Non-Secured Debt shall include all unsecured and non-guaranteed debt.
>
> (d) Secured Debt shall include all non-subordinated indebtedness secured by a bona fide mortgage or security interest or assets.

9. *Id.*

10. *See* Clover Financial Corp., [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,091 (April 5, 1979) (announcing that SEC staff would no longer issue no-action letters involving integration doctrine because of confusion in existing staff letters interpreting integration).

11. *See Integration of Securities Offerings: Report of the Task Force on Integration,* 41 BUS. LAW. 595 (1986) [hereinafter cited as *Report of ABA Task Force on Integration*].

(e) Hybrid Securities include all securities which do not fall within the above categories.

Convertible securities and stock warrants or options are deemed to include the security into which they are convertible or exercisable.

4. The offerings are effected for different purposes. For this purpose all offerings are deemed to have been undertaken for one or more of the following purposes: (a) to raise capital; (b) to extinguish indebtedness through an exchange of securities; (c) to secure human resources; or (d) to acquire business operations or assets; and in determining whether an offering is for the purpose of acquiring assets or for raising capital, the offering shall be deemed to be for any purpose for which more than 25% of the proceeds of the offering are intended to be used or are used.

5. The offering satisfies section 3(a)(10) or, if effected by an issuer whose securities are registered under section 12 of the Securities Exchange Act of 1934 and which has filed all reports required by section 13 of such Act during the preceding 12 months, satisfies the requirements of section 3(a)(9).

No offering of securities shall be integrated with:

1. An offering registered under the Securities Act of 1933; or
2. An offering of securities made outside the United States to persons who are not residents of the United States where steps are taken to prevent such securities flowing back into the United States.[12]

The Report of the Task Force has had little effect on Commission positions on integration, and the five factor test remains its primary criteria in responding to integration questions. The only direct response to the Task Force Report was the resumption of publishing no action letters on integration questions.[13]

B. Limited Partnership Offerings

Traditional integration tests for corporate issuers generally have been applied to limited partnership offerings. However, both the SEC and the Bar have recognized that there are determinants of integration peculiar to the limited partnership. An early recognition of this difference is noted in the SEC staff's response in *National Association of Home Builders.*[14] The staff stated that separate offerings to limited groups would not be integrated solely because of the presence of a common general pattern if the projects were financed by separate mortgages on separate sites or, if successive

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12. *See id.* at 631-41 (recommending new safe harbors from application of integration).

13. *See* 17 Sec. Reg. & L. Rep. (BNA) 403 (1985) (SEC staff announcing at symposium held in March 1985 that staff would resume issuing no-action letters on integration questions).

14. (avail. Mar. 23, 1972) (SEC no-action letter).

portions of a project were involved, the portions were financially independent.

This separateness test also has been used in oil and gas offerings; projects are not integrated when drilling is on geographically separate projects or acreage, the purchase of an interest in one partnership would not entitle the purchaser to any right or interest in the prior project, and offers in one partnership would not start until drilling had commenced on the prior project.[15]

Subsequently in 1982, in response to what it perceived to be confused and conflicting precedent, the ABA Subcommittee on Partnerships, Trusts and Unincorporated Associations issued a position paper entitled "Integration of Partnership Offerings: A Proposal for Identifying a Discrete Offering."[16] The Subcommittee proposed a safe harbor for limited partnership offerings if all of the following conditions are met:

> 1. *Separate Entity:* The partnership shall be a separate legal entity with separate books and records, and funds received by or contributed to the partnership shall not be commingled with funds of a common sponsor or any other entity with a common sponsor.
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> 2. *Economic Independence:* The partnership shall, at the time interests therein are offered and sold, have an independent opportunity to meet its primary investment objectives, i.e., the economic results of its investments shall not be substantially dependent upon the creation, continued existence or economic results of the investments of another entity previously, simultaneously or subsequently formed with a common sponsor.
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> 3. *Application of Proceeds:* [N]o material portion of the gross offering proceeds of the partnership shall be invested in properties in which another entity with a common sponsor shall invest, or shall have invested (and continue to hold invested), a material portion of its gross offering proceeds.[17]

If the assets in which the partnership intends to invest at least fifty percent of its gross offering proceeds (as its principal business or businesses) are not specifically identified to offerees, then: (i) each other entity with a common sponsor previously formed to conduct the same general types of activities shall have invested or committed for investment the major portion of its gross offering proceeds before the commencement of the offering of the partnership interests; and (ii) no simultaneous or subsequent offering of interests in another entity with a common sponsor organized for the same general types of activities shall be commenced before the partnership has

15. Martin Exploration Co., SEC No-Action Letter, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,794 (Sept. 7, 1976); Churchill and Hoskins (avail. Oct. 25, 1978) (SEC NO-ACTION LETTER).

16. 37 BUS. LAW. 1591 (1982).

17. *Id.* at 1611.

invested or committed for investment the major portion of its gross offering proceeds, unless the assets in which such other entity intends to invest at least fifty percent of its gross offering proceeds are identified specifically to its offerees.[18]

C. *Single Issuer Versus Different Issuers*

Integration fact patterns may be divided into issuer integration and offering integration. The first category, and the most straightforward, involves integration of multiple and often contemporaneous offerings by the same issuer. A typical example would involve several contemporaneous offerings by the same issuer. In these cases, the staff in no action letters has used the traditional five tests, and particularly the general purpose test, to determine whether the offerings should be integrated.[19] These offerings, given the identity of the issuer, are more susceptible to application of the traditional five tests. Even in these situations, however, the SEC staff has not differentiated the relative weight to be given the different tests. Thus the staff has declined to integrate offerings that were not for the same general purpose even when the other tests were met.[20] Similarly the staff has held the integration doctrine to be inapplicable on facts that on their face would seem to fall within the integration tests. Thus in the case of issuers of high grade commercial paper, the staff has declined to integrate the commercial paper offered under the section 3(a)(3) exemption with promissory notes offered under the section 4(2) exemption.[21]

Offerings by different but related issuers involve distinctly different questions from multiple offerings by the same issuer. Most of these offerings arise in the context of the limited partnership. The differences in the applicability of the integration doctrine to single and multiple issuers stems from structural differences in the single issuer limited partnership offering and multiple issuer offerings. The corporate issuer customarily is formed to conduct one or more businesses over a period of time. The limited partnership, on the other hand, customarily is formed for a specific project or purpose, generally has no operating history, and has a finite and limited life. Management of the limited partnership is often separate from management of the project and often performs its duties on a part time basis. In these circumstances traditional tests of integration have tended to be irrelevant. For example, consider the applicability of the five factors to simultaneous offerings of limited partnership interests by separate limited partnerships with a common general partner. Under the five factors the two offerings

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18. *Id.*

19. Delorean Motor Co. (avail. Sept. 15, 1977) (SEC no-action letter).

20. Wellington Fund, Inc. (avail. Sept. 22, 1976) (SEC no-action letter).

21. *See Report of ABA Task Force on Integration, supra* note 11, at 619-20 (citing *e.g.*, First & Merchant Corp. (avail. July 27, 1978) (SEC no-action letter); Pittsburg Nat'l Corp. (avail. Aug. 15, 1977) (SEC no-action letter); Alabama Bancorporation (avail. July 8, 1977) (SEC no-action letter); Security Pac. Corp. (avail. Oct. 14, 1976) (SEC no-action letter)).

would be considered integrated since they were made (i) at the same time, (ii) for the same consideration (cash), (iii) for the same general purpose and (iv) as part of a single plan of financing (to benefit the sponsor). Whether the offerings involve the issuance of the same class of securities would appear to depend on whether the limited partnership interests had similar rights and claims on assets.

Perhaps because of the difficulty in applying the traditional tests to limited partnership offerings, the SEC staff has tended to give weight to those factors tending to support economic dependence of the separate limited partnerships. Applying these criteria, it has been easier for the staff to find separate projects, and therefore discrete transactions, if real estate, horses, or shopping center booths rather than oil and gas properties were involved.[22]

D. *Underlying Rationale*

The rationale for integration must at bottom be a concern that the disclosure obligations not be circumvented by separating a unitary offering into its component parts. Without disclosure concerns there would appear little need for invoking the doctrine. Disclosure traditionally has been associated with offerings of securities. If the offering was subject to registration, the mandatory disclosure requirements would be activated and any prescribed disclosures would be made in the statutory registration statement with respect to the issuer's business and its management. In recent years two significant developments have occurred that have reduced the importance of offering-oriented disclosure: selective or differential disclosure, and ongoing post-offering disclosure. Differential disclosure has resulted in differing degrees of disclosure depending on the quality and seasoning of the issuer and the amount and type of securities offered.[23] Ongoing disclosure requirements broadly attach to all companies in which there is a significant public interest. In a related development, the Commission has required in Regulation D of the Securities Act of 1933 that the offering documents contain disclosure modeled on the several registration forms.[24] These developments on the one hand have reduced the importance of the statutory prospectus as the unique basis of disclosure and, on the other hand, have emphasized that the type and extent of disclosure varies depending on such factors as the quality of the issuer and the type of offering.

At the same time as the Commission has departed from unitary disclosure, there has been a heightened concern with anti-fraud disclosure. To the extent that disclosure has become more differentiated and pervasive, anti-fraud disclosure has tended to receive greater emphasis by the courts. The

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22. *See Integration of Partnership Offerings: A Proposal for Identifying a Discrete Offering, supra* note 16, at 1605-06.

23. For example, Forms S-1, S-2 and S-3 tailor the requisite disclosure to the quality of the issuer and the length of time it has been subject to the filing requirements. Form S-16 is for oil and gas offerings, and Form S-11 is for real estate offerings.

24. 17 C.F.R. § 230.502 (1986).

recent holding in *SEC v. Murphy*[25] illustrates this point. In *Murphy,* interests in approximately thirty separate limited partnerships with different general partners were sold to purchase cable television systems formed by the promoter.[26] The limited partnerships were separate legal entities and in most instances the general partners were not related to the promoter, Murphy.[27] Approximately $7.5 million was raised from more than 400 investors over a two-year period.[28] Murphy was enjoined from violating the registration and anti-fraud provisions of the Federal securities laws.[29] The court held that because the purpose of the registration provisions was to protect investors and because financial information about the promoter was material to the investment decision, the promoter was considered the issuer of the partnership interests for purposes of determining the availability of the private offering exemption.[30] When the offerings were integrated, the private offering exemption was destroyed. The court stated:

> [W]e note that our holding today does not mean that anyone who has information material to an investment decision is transformed into an issuer. We hold only that when a person organizes or sponsors the organization of limited partnerships and is primarily responsible for the success or failure of the venture for which the partnership is formed, he will be considered an issuer for purposes of determining the availability of the private offering exemption.[31]

Murphy involved clear anti-fraud violations, including commingling of partnership funds. The interrelation of the integration and the anti-fraud issues is not considered in the opinion. It is not by accident, however, that Murphy and other cases[32] which sweepingly expand the integration doctrine arise in an anti-fraud context.

E. Observations

The broad generic tests of integration that arose in the early years of the Federal securities acts are no longer adequate for present day integration concerns. They have not proven adequate for the traditional corporate offering and are certainly not responsive to the unique structural characteristics of the limited partnership. The increasingly sophisticated and far reaching disclosure scheme has rendered these tests inadequate if not obsolete. As the disclosure in a Regulation D private placement memorandum more

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25. 626 F.2d 633 (9th Cir. 1980).
26. *Id.* at 637.
27. *Id.*
28. *Id.*
29. *Id.* at 659.
30. *Id.* at 643-44.
31. *Id.* at 644 (footnote omitted).
32. *See* SEC v. Holschuh, 694 F.2d 130 (7th Cir. 1982) (involving sham operation in which money raised by partnership was siphoned off by defendant and his business associates for their own uses).

closely approaches prospectus disclosure, the need for integration would appear to turn on different determinants. We submit that there should be separate determinants for integration of the limited partnership in view of its unique structural characteristics and the determinants should be responsive to limited partnerships' characteristics. Tests that are directed to the economic realities of limited partnerships,[33] rather than the traditional purpose-oriented tests, are consistent with this objective. The tests suggested by the ABA Subcommittee on Partnerships, Trusts and Unincorporated Association[34] represent a realistic response to these concerns.

III. All or None Offerings under Rule 10b-9[35]

Rule 10b-9 and its companion rule 15c2-4 were adopted to prohibit offerings from being made on an "all or none" basis or some other contingency unless all securities required to meet the contingency were in fact sold before the offering's designated termination date. In recent years, a partly unwritten body of interpretation developed regarding what constitutes a "bona fide" purchase of securities for purposes of rules 10b-9 and 15c2-4, what advance disclosure may be required regarding purchases by general partners or broker-dealers, and even what constitutes an all or none offering. In two recent interpretive letters,[36] the SEC staff not only provided more specific interpretations, but in effect promulgated what are highly specific regulations for certain selling practices.

A. History—Rule 10b-9 and Rule 15c2-4

Most partnership offerings, such as real estate and oil and gas offerings, need a certain minimum level of subscriptions to undertake operations (to purchase the property or to purchase prospects and drill wells), and, consequently, normally are made on an all-or-none or part-or-none ("minimum-maximum") basis. In an all-or-none offering, all of the securities must be sold within the specified offering period or, if that condition is not met, all subscriptions must be returned to the investors. In a part-or-none, or minimum-maximum offering, a designated minimum amount of the securities must be sold within a specified time, or the issuer must return all subscriptions to investors. If the minimum number of securities is sold within the designated period, the subscriptions received may be accepted, the issuer usually

33. For example, whether projects are covered by a common mortgage, the sharing of project amenities, the interdependence of operating results, cross-collateralization of mortgages, and common or generic advertising and sales efforts for one or more projects.

34. *See supra* notes 16-18 and accompanying text (discussing tests suggested by ABA Subcommittee on Partnerships, Trusts and Unincorporated Associations).

35. This section expands on and updates this subject, which was previously addressed in two articles by Mr. Robbins. *See* Robbins, *All-or-None Offerings,* 19 Rev. Sec. Reg. 59 (1986); Robbins, *All-or-None Offerings: An Update,* 19 Rev. Sec. Reg. 180 (1986).

36. *See* Timothy M. Horner, Esq. (Oct. 16, 1985) (SEC interpretive letter); American Bar Association (Apr. 29, 1986) (SEC interpretive letter).

will commence operations, and the issuer may continue selling for the duration of the offering period.[37]

The natural pressures to close offerings led some issuers in the early days of partnership offerings to construct offerings that, although apparently all-or-none or part-or-none, in fact could be closed without sales of all the securities if commitments, or indications of interest, for all the securities had been obtained. This frequently meant that the issuers were ultimately capitalized with far less than the anticipated proceeds of the offering. The SEC responded in 1962 with the adoption of rules 15c2-4 and 10b-9.

Rule 15c2-4 makes it a "fraudulent, deceptive or manipulative act or practice" for purposes of section 15(c)(2) of the Securities Exchange Act of 1934 (the '34 Act) for a broker, dealer or municipal securities dealer to participate in an offering made on an "all or none" basis or on the basis of some other contingency, unless all funds received from investors are transmitted promptly[38] to a bank that has agreed in writing to hold all such funds in escrow until the designated contingency has either been fulfilled or has failed.[39] Rule 10b-9, adopted under section 10(b) of the '34 Act, specifies

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37. A variant is the "step" offering, in which the issuer may accept subscriptions only at the minimum and in designated "steps" up to the maximum offering. This may be used, for instance, for a partnership that will purchase expensive equipment such as drilling rigs, and which requires a designated increment of subscriptions to purchase each additional piece of equipment. *See* Falcon 80-2/Tierra 80-2, SEC Reg. No. 2-68966 (1980).

38. The practical application of the "prompt transmittal" provision of Rule 15c2-4 was subject to a number of questions, which were generally resolved in the SEC staff's interpretive letter to Linda A. Wertheimer, Chairman, Subcommittee on Partnerships, Trusts and Unincorporated Associations, Federal Regulation of Securities Committee, American Bar Association. *See* Linda A. Wertheimer (Oct. 16, 1984) (SEC interpretive letter); NASD Notice to Members 84-64 (November 26, 1984). *See also* Bergmann, *Contingency Offerings: Escrow Accounts and Related Issues,* Broker-Dealer Compliance—A Compliance Conference for the Financial Services Industry (September 27, 1985) [hereinafter cited as *Contingency Offerings*]; Bergmann, *Some Compliance Considerations in Underwritings,* Critical Current Legislative and Regulatory Issues Affecting Publicly Traded and Private Limited Partnerships (ABA Section of Corporation, Banking and Business Law, 1986 Annual Meeting) (July 15, 1986) [hereinafter cited as *Compliance Considerations in Underwritings*].

39. Rule 15c2-4 provides in full as follows:

> It shall constitute a "fraudulent, deceptive, or manipulative act or practice" as used in section 15(c)(2) of the Act, for any broker, dealer or municipal securities dealer participating in any distribution of securities, other than a firm commitment underwriting, to accept any part of the sale price of any security being distributed unless:
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> (a) The money or other consideration received is promptly transmitted to the persons entitled thereto; or
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> (b) If the distribution is being made on an "all-or-none" basis, or on any other basis which contemplates that payment is not to be made to the person on whose behalf the distribution is being made until some further event or contingency occurs, (1) the money or other consideration received is promptly deposited in a separate bank account, as agent or trustee for the persons who have the beneficial interests therein, until the appropriate event or contingency has occurred, and then the funds are promptly transmitted or returned to the persons

that it is a "manipulative or deceptive device or contrivance" to represent:

(1) that a security is being sold on an all-or-none basis, unless the security is part of an offering made on the condition that all or a specified amount of the consideration paid will be returned to the purchasers unless (A) all of the securities are sold at a specified price within a specified time and (B) the seller receives the total amount due him by a specified date; or
(2) that a security is being sold on the basis of a contingency that a certain amount be sold, unless it is part of an offering made on the condition that all or a specified amount of the consideration paid will be returned to the purchasers unless (A) a specified number of units of the security are sold at a specified price within a specified time and (B) the total amount due to the seller is received by him by a specified date.[40]

The two rules are intended to ensure that when securities are offered pursuant to an all-or-none or designated minimum condition, investors' funds will not be at risk until the designated amount of proceeds actually

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> entitled thereto, or (2) all such funds are promptly transmitted to a bank which has agreed in writing to hold all such funds in escrow for the persons who have the beneficial interests therein and to transmit or return such funds directly to the persons entitled thereto when the appropriate event or contingency has occurred.

17 C.F.R. § 240.15c2-4 (1986).

40. Rule 10b-9 provides in full as follows:

(a) It shall constitute a "manipulative or deception [sic] device or contrivance," as used in section 10(b) of the Act, for any person, directly or indirectly, in connection with the offer or sale of any security, to make any representation:

> (1) to the effect that the security is being offered or sold on an "all-or-none" basis, unless the security is part of an offering or distribution being made on the condition that all or a specified amount of the consideration paid for such security will be promptly refunded to the purchaser unless (i) all of the securities being offered are sold at a specified price within a specified time, and (ii) the total amount due to the seller is received by him by a specified date; or
> (2) to the effect that the security is being offered or sold on any other basis whereby all or part of the consideration paid for any such security will be refunded to the purchaser if all or some of the securities are not sold, unless the security is part of an offering or distribution being made on the condition that all or a specified part of the consideration paid for such security will be promptly refunded to the purchaser unless (i) a specified number of units of the security are sold at a specified price within a specified time, and (ii) the total amount due to the seller is received by him by a specified date.

(b) This rule shall not apply to any offer or sale of securities as to which the seller has a firm commitment from underwriters or others (subject only to customary conditions precedent, including "market outs") for the purchase of all the securities being offered.

17 C.F.R. § 240.10b-9 (1986).

has been received in cash in the escrow account, and that investors' funds will be returned promptly if the designated amount has not been received by the offering's stated termination date. The SEC summarized rule 10b-9's purpose in the proposing release:

> It is the purpose of the proposed rule to prohibit any person from making any representations to the effect that the security is being offered on an "all-or-none" basis unless it is clear that the amount due to the purchaser is to be refunded to him unless all of the securities being offered are sold and the seller receives the total amount due to him in connection with the distribution.[41]

In the principal (and only substantial) interpretive release regarding rules 10b-9 and 15c2-4,[42] the Commission indicated that the rule was primarily a disclosure rule, designed to prevent the designation "all or one" from being used unless the terms of the offering require actual receipt of the full amount sought:

> [O]ne of the primary purposes of the rule was to prohibit the designation "all or none" or "part or none" from being utilized where the underwriter is required only to get persons to agree to purchase the specified minimum securities within the specified period and is not required to collect full payment for such sales within the specified period.[43]

Thus, the release states, an offering may not be considered sold unless "all the securities required to be placed are sold in bona fide transactions and are fully paid for."[44] The release goes on to indicate that "non-bona fide sales" are sales "designed to create the appearance of a successful completion

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41. Exchange Act Release No. 6864, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,855 (July 30, 1962). *See also* Exchange Act Release No. 6905 [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,869 (Oct. 3, 1962) (adopting Rule 10b-9). The release adopting rule 15c2-4 described the Commission's concern as follows:

> Sometimes the issuer on whose behalf a distribution is being made is a comparatively new company, is making the public offering to raise the capital necessary to begin or expand its activities, and the failure to receive it will substantially impair its ability to continue in business or to conduct necessary operations. In some cases the "sale" becomes final only if all the securities are sold within a specified period of time; and the arrangement contemplates that the payments made by customers will be returned to them if the distribution is not completed in the required time. The failure of the underwriter or a participating broker-dealer to transmit the funds, or to maintain them so that they will be insulated from and not be jeopardized by his unlawful activities or financial reverses, could involve a fraud either upon the person on whose behalf the distribution is being made or upon the customer to whom the payment is to be returned if the distribution is not completed.

Exchange Act Release No. 6737 [1961-1964 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76,825 (February 21, 1962).

42. Exchange Act Release No. 11532, Fed. Sec. L. Rep. (CCH) ¶ 22,730 (July 11, 1975).

43. *Id.*

44. *Id.*

of the offering, such as purchases by the issuer through nominee accounts or purchases by persons whom the issuer has agreed to guarantee against loss."[45]

The history of rule 10b-9 supports the proposition that it is a *disclosure* rule, intended to prevent misuse of the phrases "all-or-none" or "part-or-none." Lawyers practicing in the area generally have assumed that an offering would not offend rule 10b-9, regardless of its structure, if the terms of the offering were fully, fairly and prominently disclosed. The SEC's Division of Market Regulation, however, in recent years has developed a number of unpublished interpretations regarding various issues that frequently arise, and which in some cases have conflicted with custom and practice. While the Division will not make available its internal telephone advice memoranda, certain interpretations were included in the few available interpretive releases and letters and in a 1982 outline prepared by Douglas Scarff, then Director of the Division.[46] Additional information has been provided more recently in two recent staff outlines,[47] and in two recent interpretive letters, *Timothy M. Horner, Esq.*[48] and *American Bar Association.*[49] The result has been a commendable increase in the availability of guidance, but certain difficult substantive issues remain.

B. *Application—Rule 10b-9 in Practice*

1. Closings prior to minimum level of subscriptions;

As previously noted, the underlying purpose of rule 10b-9 was to prevent offerings made on an all-or-none basis from closing if the contingencies described in the offering were not met. The core decisions applying the rule all involve situations in which an issuer and broker-dealer acted to create the false appearance of an offering's successful completion, usually by arranging for orders by purchasers who either had no intention of paying or were guaranteed against any investment risk.

In *SEC v. Manor Nursing Center,*[50] for example, the issuer and selling shareholders in a public all-or-none stock offering received the proceeds of the offering even though, at the time of the closing, all of the purchasers' checks had not cleared, and the number of shares purchased did not equal the number offered. Certain of the selling shareholders then reinvested offering proceeds to buy unsold shares, and creditors of the issuer were paid

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45. *Id.*

46. Scarff, *Developments in Trading Practices,* 1 FOURTEENTH ANNUAL INSTITUTE ON SECURITIES REGULATION 435 (1982).

47. *See* Bergmann, *Contingency Offerings, supra* note 38; Bergmann, *Compliance Considerations in Underwriting, supra* note 38.

48. Timothy M. Horner, Esq. (Oct. 16, 1985) (SEC interpretive letter).

49. American Bar Association (April 29, 1986) (SEC interpretive letter).

50. 340 F. Supp. 913 (S.D.N.Y. 1971), *modified,* 458 F.2d 1082 (2d Cir. 1972).

in stock "in an effort to make it appear that the issue had been sold."[51] After the closing, checks for over half the proceeds bounced, having been submitted with no expectation of payment by persons who had been solicited by two of the selling shareholders to create the appearance of bona fide sales.[52] The checks delivered by the underwriter to the selling shareholders in turn bounced, whereupon the issuer paid out to the selling shareholders the proceeds that the issuer had received.[53] The court described the subscriptions by persons who had no intention of buying shares as "a'bootstrap operation' to give the underwriting a facade of completeness."[54] While the court failed to mention that this "monstrous fraud" violated Rule 10b-9 as well as rule 15c2-4 and a host of other provisions, it may have been avoiding excessive detail.

In the context of the *Manor Nursing Center* case and other cases of clearly fraudulent closings,[55] not surprisingly courts began to describe broadly the evils proscribed by rule 10b-9. In *A. J. White & Co. v. SEC*,[56] for example, a 1977 case involving a public part-or-none stock offering, the issuer and underwriter achieved the minimum level of "sales" by arranging loans for purchases in violation of sections 7(c) and 11(d)(1) of the '34 Act.[57] In addition to guaranteeing persons for whom the issuer and underwriter purchased shares that they would not have to put up any money, the issuer and underwriter purchased shares using borrowed funds for persons who were not even aware of the offering or who had indicated that they could not pay for any purchases.[58] The First Circuit observed that the use of sales financed by bank loans to purchasers who were guaranteed against loss was a material and misleading change in the method of distribution:

> The knowledge that the minimum amount has been sold to bona fide investors may be a very important matter to the other investors. Particularly in cases such as this, an offering of shares in a new company, one of the investors' major concerns will be whether the price they are paying for the securities is a fair market price. The inability of the underwriter to sell the specified minimum to bona fide investors may well indicate that the market judges the offering price to be too high. *Thus, to declare an offering completed through non-bona fide sales financed through bank loans, where the purported investors have not made an investment decision backed with*

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51. *Id.* at 918.
52. *Id.* at 918-19.
53. *Id.*
54. *Id.* at 924.
55. *See, e.g.*, SEC v. Coven, 581 F.2d 1020 (2d Cir. 1978), *cert. denied*, 440 U.S. 950 (1979); FAI Investment Analysts, Inc., 46 S.E.C. 1134 (1977); Roald George Gregersen, 46 S.E.C. 387 (1976).
56. 556 F.2d 619 (1st Cir.), *cert. denied*, 434 U.S. 969 (1977).
57. *Id.* at 623-24.
58. *Id.* at 621.

> *their own money, may significantly mislead the legitimate investors as to a crucial factor in their decision.*[59]

The Commission opinion under review also had emphasized the loans and guarantees against loss,[60] but it was the First Circuit's "fair market price" language that the court repeated in *SEC v. Blinder, Robinson & Co., Inc.*[61] five years later. In *Blinder, Robinson,* the issuer and underwriter of an all-or-none stock offering committed some of the proceeds in advance of the closing to obtain a bank loan to purchase additional shares and obtained funds from the escrow account before the closing of the offering.[62] The underwriter then engaged in substantial trading activity in the stock, all without an actual closing of the offering.[63] The district court, citing *A. J. White,* stated in dictum that in an all-or-none stock offering by a new company the investors are entitled to assume that the offering will succeed only if their investment judgment, in effect, is corroborated by sufficient other investors to fully subscribe the offering:

> [I]n an "all or none" offering of securities by a new company, whether all the securities have been sold to the public in bona fide transactions is of particular importance because the "all or none" contingency is the investors' principal protection. Each investor is comforted by the knowledge that unless his judgment to take the risk is shared by enough others to sell out the issue, his money will be returned.[64]

The "corroboration" theory (advanced to date only in the *A. J. White* and *Blinder, Robinson* cases), with its concept of investor "comfort," gives rule 10b-9 far more content than ever appeared in its adopting and interpretive releases and could lead to the conclusion that even when purchasers take the risk of the investment, their affiliation with the issuer (or other lack of independent judgment) may give rise to a violation. For example, when an underwriter makes purchases for discretionary accounts in an all-or-none

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59. *Id.* at 623 (emphasis added).

60. *See* A. J. White & Co., Exchange Act Release No. 12614 (July 9, 1976). In *A.J. White & Co.,* the Commission noted that

> [t]hese arrangements, which in essence constituted 100% financings, relieved the ultimate purchasers from the commitments and the obligations that a purchaser of securities normally incurs. Since the loans were quite convenient, and were considered windfalls to a number of purchasers, the purchasers did not have to make investment determinations based solely upon the investment risks and merits of the securities. Under the circumstances, the purchasers seemed to have little concern regarding personal obligations under the loans, especially in view of registrant's representations that losses would be most unlikely.

Id.

61. 542 F. Supp. 468 (D. Colo. 1982), *aff'd,* 748 F.2d 1415 (10th Cir. 1984), *cert. denied,* 105 S. Ct. 783 (1985).

62. *Id.* at 479.

63. *Id.* at 478.

64. *Id.* at 476.

offering, has the underwriter deprived other investors of their expectation that unaffiliated investors exercising their independent judgment would be purchasing all of the offered securities?[65] In a private offering of real estate limited partnership interests, would substantial purchases by the seller of the real estate "mislead" investors? Is the answer different if the officers of the sponsor who make the purchases have the right to purchase units net of commissions?[66]

The *Blinder, Robinson* "comfort" language, extending far beyond the stated purposes of rule 10b-9, should not be the basis for expanding rule 10b-9 from a "full disclosure" rule to a vague guarantee of investor assurance. Nevertheless, some reliance on the *Blinder, Robinson* reasoning has developed recently.[67] Given the vagueness of the "corroboration" or "comfort" standard, practitioners recently have had increasing difficulty defining the circumstances in which rule 10b-9 applies. The difficulties are greatest in the case of purchases or undertakings to purchase by affiliates of the issuer.

2. Purchases by the General Partner or Affiliates

a. Discretionary Purchases of Unsold Units.

The "corroboration" concept assumes that sales will be made to unaffiliated third parties exercising independent investment judgment. Many instances exist, however, in which the sponsor or affiliates may purchase unsold interests in an all-or-none offering.[68] In the case of private offerings

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65. *See* Rooney, Pace, Inc., Administrative Proceeding File No. 3-6332 (May 24, 1985), at n.24 (initial decision) (citing SEC v. Blinder, Robinson & Co., Inc., 542 F. Supp. 468 (D. Colo. 1982), *aff'd,* 748 F.2d 1415 (10th Cir. 1984), *cert. denied,* 105 S. Ct. 783 (1985)). In *Rooney, Pace, Inc.,* Administrative Law Judge Regensteiner in his initial decision raised, but did not decide, the question whether an underwriter, by purchasing for discretionary accounts in all-or-none offerings, deprives other investors of their expectations that unaffiliated investors exercising independent judgment would be purchasing all of the offered securities. *Id.*

66. *See infra* note 91 and accompanying text (discussing purchases net of commissions).

67. *See* Timothy M. Horner, Esq. (Oct. 16, 1985) (SEC interpretive letter). The staff indicated in *Timothy M. Horner, Esq.,* a recent interpretive letter under Rule 10b-9, that satisfaction of the "Specified Sales Level" in an all-or-none or part-or-none offering "indicates that the offering was priced fairly." *Id. See infra* notes 67-84 and accompanying text (discussing *Horner* interpretive letter). *See also* Bergmann, *Contingency Offerings, supra* note 38.

68. Naturally, such purchases may not be made by the issuer itself, when the effect would be to reduce the capital anticipated to be available to the issuer at the completion of the offering. Exchange Act Release No. 11532, FED. SEC. L. REP. (CCH) ¶ 22,730 (July 11, 1975). In the situation generally presented, however, purchases by affiliates of the issuer would not affect the financial condition of the issuer.

Certain disclosure requirements also will apply whenever a possibility exists that an affiliate may purchase a substantial amount of securities. At a minimum, the offering document should describe the risk that such purchases may make it more difficult for unaffiliated investors to exercise whatever voting rights are provided by the documents, and also should indicate that such purchases may create an additional conflict of interest between the sponsor and unaffiliated investors, since the sponsor may have an interest in recovering its investment earlier than unaffiliated investors. *See infra* text at p. 852 (discussing risk factors associated with purchases by general partner).

of partnership interests under Regulation D, the staff has approved such purchases by the general partner of the partnership making the offering when

(i) the issuer has disclosed the possibility that the general partner may purchase limited partnership interests in order to meet the specified minimum;

(ii) the maximum amount of the possible purchases is disclosed; and

(iii) the purchases are made for investment rather than resale.[69]

The portion of the release cited above (Question 79) applied by its terms to private offerings only, and at least the requirement that purchases be made "for investment" could be read as limited to the private offering context.[70] The staff recently indicated, however, that it considers the position taken in Question 79 to be fully applicable to public offerings,[71] and the staff has confirmed in discussions that it believes specifically that purchases by the general partner or affiliates must be made *for investment* even in a public offering.

This position, which appears to blur together the concepts of "purchasing for investment" and "taking the risk of investment," has not been articulated in a published release or interpretive letter. The relevant question appears to be not whether a purchase is made "for investment," since in a public offering no such requirement is imposed on any purchaser, but whether the purchase is "bona fide" for purposes of rule 10b-9. Neither existing releases nor case law have taken the position that a sale must be "for investment" to be bona fide; the purchaser must simply be purchasing the securities on the same terms as other investors, for the same consideration, and without any guarantees against loss. He must, under the case law, take the risk of the investment.[72] It remains unclear, however, to what extent the staff may consider purchases for resale by the sponsor or affiliates in a public offering to be inconsistent with rule 10b-9.

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69. Securities Act Release No. 6455, Fed. Sec. L. Rep. (CCH) ¶ 2380, at Question 79 (March 3, 1983) [hereinafter cited as Release No. 6455].

70. *See* Item 18(D) of Securities Act Industry Guide 5, Fed. Sec. L. Rep. (CCH) ¶ 3829, at 3347 (May 4, 1983). Item 18(D) of Securities Act Industry Guide 5 specifically contemplates resales, in a public offering, of securities purchased by the general partner or affiliates to meet the minimum in a real estate offering:

> If the General Partner or its affiliates intend to purchase interests, and such interests will be included in satisfying the minimum offering requirements, it should be disclosed whether such interests are intended to be resold, and if so, the period of time these interests will be held prior to being resold. Depending on the circumstances, such interests may be considered to be unsold allotments under Section 4(3) of the Act. (See Securities Act Release 4150.)

Id.

71. *See* Bergmann, *Contingency Offerings*, *supra* note 38.

72. *See* A. J. White & Co., Exchange Act Release No. 12614 (July 9, 1976); *supra* note 60 (quoting *A. J. White & Co.).*

b. Undertakings to Make Loans or Purchase Units

It is often desirable in a private placement, particularly when the sale of all the securities is necessary to accomplish the offering's objectives, for the sponsor to undertake the purchase of unsold units. The sponsor may undertake that it will purchase unsold units at the close of the offering, or during the offering, after the sale of a designated minimum, in an effort to provide assurance that the offering will close and to permit early admission of some investors. Under rule 10b-9, however, a commitment to purchase interests is not a bona fide purchase, and in the normal case such a commitment will not itself provide the basis for closing an all-or-none offering.[73]

It is equally clear that a general partner *may* undertake to purchase any units that remain unsold on termination of the offering, when the closing takes place at the offering's termination on the basis of actual purchases by the general partner rather than only a commitment.[74] Questions arise when the general partner desires an interim closing based on assurances that the offering will be fully sold.

As recently as 1982, the staff took a no-action position under Rule 10b-9 to permit the general partner of a limited partnership to loan funds to the partnership to meet the designated minimum level of subscriptions for an interim closing, on the conditions (i) that the possibility of the loan and the maximum amount of the loan, if made, are disclosed and (ii) that by the offering's terms, the general partner must make an irrevocable commitment, disclosed in the offering document, to purchase for investment any securities not sold to investors at the offering's expiration date.[75] This position was workable and was based soundly on the disclosure principles of Rule 10b-9. A more restrictive position was taken, however, in a 1985 seminar outline prepared by a staff member,[76] and then in a staff interpretive letter, *Timothy M. Horner, Esq.*[77]

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73. FAI Investment Analysts, Inc., 46 S.E.C. 1134, 1136 (1977).

74. Roger C. Hartman, Esq. (Urban Improvement Fund Ltd.—1975), SEC Interpretive Letter [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,396 (Oct. 3, 1975) [hereinafter cited as *Urban Improvement Fund Ltd.—1975*]. The staff indicated that since no funds would be returned to investors regardless of the number of units sold, based on the general partner's undertaking to purchase all unsold units, rule 10b-9 would not even be applicable. In the *American Bar Association* interpretive letter discussed below, the staff reiterated this position, but imposed certain requirements on the General Partner. *See infra* notes 87-92 and accompanying text (discussing *American Bar Association* interpretive letter).

75. *See* Scarff, *Developments in Trading Practices, supra* note 46, at 473. Although the outline stated that the staff had taken a "no-action" position, the position was never set out in a no action or interpretive letter. It is rarely if ever appropriate for the *broker-dealer* to loan funds to the issuer, since such loans would violate section 11(d)(1) of the Exchange Act and applicable margin regulations.

76. Bergmann, *Contingency Offerings, supra* note 38, at § I.4.d:

> On occasion, the staff has been asked whether an irrevocable commitment by the general partner or an affiliate to purchase any securities that are unsold at the offering's termination date will satisfy the offering's contingency that some or all of

c. The Horner Interpretive Letter.

In *Timothy M. Horner, Esq.*, the issuer offered two alternative offering structures for consideration. The *Horner* issuer first proposed to conduct its offering precisely in the manner described in the staff's 1982 position (Horner proposal 1): if minimum subscriptions had not been received by a specified date, the sponsor would provide a loan to the partnership in an amount equal to the aggregate sales price of all unsold units, and an interim closing would then be held at which subscriptions then in escrow would be released. The sponsor would continue to offer the securities and its loan would be repayable out of the proceeds from the sales. At the offering's termination, if any securities remained unsold, the sponsor's loan would be repaid by issuance of the unsold securities, which would be held by the sponsor for investment.

The staff concluded that *Horner* proposal 1 failed to satisfy the requirement of rule 10b-9 that "an offering may not be considered 'sold' for purposes of the representation 'all or none' unless all the securities required to be placed are sold in bona fide transactions and are fully paid for."[78] The staff articulated the position described above,[79] that "a bona fide transaction is one in which the investor purchases with investment intent (i.e., not with a view to immediate resale),"[80] then indicated that the *Horner* proposal 1 was unacceptable because it (i) would allow a closing before all of the securities had been sold and (ii) would allow a closing based on a commitment to purchase rather than an actual purchase.

The staff's first basis, that the offering would allow a closing before all of the securities had been sold, took a relatively inflexible approach to disclosure and rule 10b-9. Certainly the *Horner* proposal 1 envisioned a

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the securities be sold by a specified date. Usually, the general partner states that the purpose for the commitment is to allow tax or other benefits to accrue to the investors who would become limited partners after an interim closing is held. The staff, however, has declined to grant no-action relief under these circumstances since the contingencies of the offering have not been satisfied. Release 34-11532 *supra* makes it clear that commitments to purchase are not bona fide sales for purposes of Rule 10b-9. Investors may become subject to the risks and/or benefits of the partnership only after a closing of the offering and breaking of escrow based upon complete satisfaction of all contingencies.

An additional suggestion has been made that the general partner's commitment to purchase would be backed by a letter of credit. However, the staff does not believe that a letter of credit satisfies the requirements that the securities be fully paid for prior to closing.

77. Timothy M. Horner, Esq. (Oct. 16, 1985) (SEC interpretive letter).

78. *Id.*

79. *See supra* notes 70-71 and accompanying text (discussing requirement that purchase be made with investment intent).

80. One might assume that this statement should be limited to the private offering context in which it was made, since the sponsor otherwise would have the burden of establishing to its own satisfaction that all purchases in a public all-or-none or part-or-none offering are being made with investment intent. *But see supra* notes 70-71 and accompanying text (discussing applicability to public offerings).

closing before all of the securities had been sold, but it also provided for complete disclosure of the arrangement and the possibility that an interim closing could occur based on a sponsor loan. The staff's 1982 position approving such an arrangement on the basis of full disclosure seems more soundly based on the disclosure policies of rule 10b-9.

The staff's second basis for rejecting *Horner* proposal 1 was that the arrangement would permit a closing based on a commitment to purchase "rather than purchases with investment intent accompanied by full contemporaneous payment for those purchases."[81] In *Horner* proposal 1, however, all of the sponsor's funds would be advanced at the time of the interim closing in the form of a loan. The only transaction that the general partner promised was the conversion of the loan into an investment in partnership interests at the termination of the offering, which presumably could have occurred automatically by the terms of the loan documents without any affirmative action by the sponsor.

In *Horner,* the staff approved of an alternative arrangement (Horner proposal 2) under which the same offering would be conducted on a part or none, or minimum-maximum, basis. Investor funds would be held in escrow until the sponsor had sold the minimum level of subscriptions, at which time an interim closing could be held, and the sponsor would loan to the partnership the full purchase price of the unsold securities. The proceeds from subsequent sales would be used to repay the sponsor's loan, and at termination of the offering, the sponsor would *either* accept repayment of the loan in unsold securities or leave the loan in place.

The principal differences between the two proposals were that in *Horner* proposal 1 (a) there was no designated minimum that had to be achieved based on actual sales before the interim closing,[82] and (b) the general partner made a commitment to purchase unsold interests, rather than leaving open the possibility that not all of the securities would be sold. Which difference was determinative in the staff's view? Could a designated minimum level of subscriptions for the interim closing be combined with a commitment by the general partner to convert its loan into unsold units at the termination of the offering?[83] In telephone advice, the staff stated that it could not—such

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81. Timothy M. Horner, Esq. (Oct. 16, 1985) (SEC staff interpretive letter).

82. *See Urban Improvement Fund Ltd.—1975, supra* note 74. Under *Urban Improvement Fund Ltd.—1975,* the lack of a specified minimum should not in itself be determinative. *Id.* When the general partner pledged to purchase all unsold units at the closing, regardless of the amount sold, the staff concluded that the offering was not even covered by rule 10b-9. Is *Horner* proposal 1 that different? Although the general partner will make a loan rather than purchase unsold units, the loan must be repaid in unsold units at the termination of the offering.

Further, it was established in Securities Act Release No. 6455 that the designated minimum level of subscriptions need not be reached solely by sales to third parties. *See* Release No. 6455, *supra* note 69, at Question 79; *supra* note 69 and accompanying text (quoting Release No. 6455). The sponsor may purchase securities to reach the minimum, provided there has been adequate advance disclosure. Release No. 6455, *supra* note 69, at Question 79.

83. The *Horner* interpretive letter, in approving the second proposal, indicates only that

a commitment by the general partner would convert the offering into an all-or-none offering, instead of a part-or-none offering, and the interim closing would then violate rule 10b-9.[84]

The *Horner* approach attempted to divide offering structures cleanly into "all-or-none" or "part-or-none," yet an intermediate approach along the lines of *Horner* proposal 1 offers the greatest benefits to investors. Investors benefit from an undertaking that if the offering is closed on an interim basis with a specified minimum level of subscriptions and a loan from the general partner covering the unsold interests, at termination of the offering the general partner's loan will be converted into units. Since the funds have already been provided to the partnership, no risk of default exists, and if the general partner instead were to leave the loan in place, the accompanying interest cost would burden the partnership's operating results. If the general partner is not permitted to undertake to convert its loan to partnership interests, the investors must accept the uncertainty of not knowing whether such a loan by the general partner, of undetermined size, will remain in place during the life of the partnership.[85]

Horner was criticized by practitioners on the ground that it prohibited even fully disclosed offering structures that generally were accepted as fair and reasonable. Additionally, *Horner* required that offerings be structured in a manner that left investors uninformed about the general partner's intention to purchase unsold units on termination of the offering.[86]

d. The American Bar Association Interpretive Letter

The *Horner* letter prompted action by a Task Force of the American Bar Association Federal Regulation of Securities Committee, Subcommittee on Partnerships, Trusts and Unincorporated Associations (Task Force), which requested by letter dated April 16, 1986 that the staff reconsider certain positions taken in the *Horner* letter. The Task Force indicated that it was "concerned that the apparent positions expressed by the staff in [the *Horner* letter] . . . and in other contexts would prohibit certain offerings which are common industry practice and which the Task Force believes are in compliance with both rule 10b-9 and rule 15c2-4."[87]

> it is clear to investors that the syndication will achieve the Required Funding Level [the maximum offering], but only the Specified Minimum is required to be sold to investors who make full payment for their securities with investment intent prior to the Specified Minimum Date.

Timothy M. Horner, Esq. (Oct. 16, 1985) (SEC interpretive letter).

84. Telephone advice from Kevin Corcoran, Staff Attorney, Division of Market Regulation, Securities and Exchange Commission (October 1985).

85. Projections, where provided, would have to address at least the anticipated results assuming (1) all the securities are sold, and (2) only the minimum level of sales is achieved, and the general partner's loan for the remainder remains in effect for the life of the partnership.

86. *See* Robbins, *All-or-None Offerings*, *supra* note 35, at nn. 29-30.

87. Letter from Task Force of the American Bar Association Federal Regulation of Securities Committee, Subcommittee on Partnerships, Trusts and Unincorporated Associations to Securities and Exchange Commission Staff (Apr. 16, 1986).

The Task Force proposed, and the staff agreed, that offerings which comply with the following procedures will satisfy rules 10b-9 and 15c2-4:

A. *"Part or none" Offerings*

An offering shall not be deemed to be an "all or none" offering for purposes of rule 10b-9(a)(1) and shall be in compliance with rules 10b-9 and/or 15c2-4, provided that:

1. Where there is a specified minimum number of securities ("Specified Minimum") which must be sold by a specified date ("Specified Date"), investors' funds are held in escrow until the Specified Minimum has been sold.

2. If the Specified Minimum is sold in bona fide transactions by the Specified Date and such securities have been fully paid for with customer funds that have cleared the banking system, the funds received at the interim closing date for the offering ("Interim Closing Date") may be distributed from escrow to the issuer and the offering may continue, where the Sponsor agrees at the commencement of the offering that if a specified maximum number of securities ("Specified Maximum") has not been sold and the purchase price for such securities is not received by a specified offering termination date ("Termination Date"):

   a. On such Termination Date, the Sponsor will purchase for its own account the balance of the unsold securities required for the partnership's business operations as specified in the offering documents, and/or

   b. On the Interim Closing Date and/or Termination Date, the Sponsor will lend to the issuer all or that portion of the difference between the Specified Minimum and Specified Maximum required for the partnership's business operations as specified in the offering documents.

   c. In the case of an offering that is intended to comply with either paragraph 2(a) or (b) above, all of the following conditions must also be met:

   a. Any such commitment of the Sponsor to purchase securities or lend funds as described in the offering documents is an unconditional obligation of the Sponsor;

   b. The Sponsor can demonstrate at the time of commencement of the offering and at the Interim Closing

Date a present and continuing ability to satisfy its commitment ("continuing ability" being deemed to mean no known or reasonably foreseeable events that would make it unable to satisfy its commitment);

c. The offering materials contain full and fair disclosure of:

(i) The terms of the offering, including the extent and nature of the Sponsor's commitment and its ability to satisfy such commitment;

(ii) The risks associated with the Sponsor's commitment;

(iii) The Termination Date of the offering; and

(iv) The maximum level of potential purchases of securities or loans by the Sponsor; and

d. Any purchases by the Sponsor are for investment and not resale and the offering materials must so state.

B. *Offerings with no Stated Contingency*

Where the terms of the offering do not provide for sale of a Specified Minimum prior to a Specified Date or return of funds to investors, and the Sponsor commits at the commencement of the offering to purchase on the Termination Date any securities remaining unsold or sufficient securities to reach a certain amount specified in the terms of the offering, provided that the conditions specified in paragraphs 3(a)-(d) above are also met, the offering will not be deemed to be contingent so as to cause rules 10b-9 and 15c2-4(b) to apply.

C. *Discount Purchases*

In offerings subject to rules 10b-9 and 15c2-4, the issuer may offer to sell securities on special terms, for example offer to sell securities net of commissions or provide for volume discounts, as long as (a) such varied terms are offered uniformly to persons in a certain specified class or classes, and (b) such terms are fully disclosed in the offering materials.[88]

The staff indicated that the procedures described in part A above modify the *Horner* letter by permitting a general partner to undertake at the time of

88. *Id.*

an interim closing to purchase all units which remain unsold at the termination date of an offering. The most significant conditions are that the Specified Minimum must be sold in bona fide transactions before the Interim Closing;[89] that the sponsor unconditionally agree that it will either purchase unsold interests for investment on the offering's termination or loan the partnership all or a specified portion of the unsold interests' purchase price (either at the Interim Closing or at the Termination Date); and that the offering materials contain a full and fair disclosure of the arrangement, including the extent and nature of the sponsor's commitment, its ability to satisfy the commitment, the risks associated with its commitment, and the maximum level of potential purchases. Presumably *Horner* proposal 1, which envisioned that the General Partner could loan funds to reach the designated minimum, would still be considered a violation of rule 10b-9 under the *American Bar Association* opinion letter, even though the loan for unsold units in excess of the Specified Minimum is approved.

Disclosure of the risks associated with the general partner's commitment must depend of course on the facts of a particular offering. In many situations, the risks associated with substantial purchases of interests by the general partner will include the following:

1. As a holder of limited partnership interests, the general partner is likely to have interests which conflict with those of other limited partners. If the general partner is required to purchase a substantial number of limited partnership interests, it may have an interest in a sale or refinancing of the partnership's assets earlier than would the other investors.

2. Substantial purchases of limited partnership interests by the general partner may limit the ability of the other limited partners to exercise voting rights granted by the partnership agreement.

3. Substantial purchases of limited partnership interests by the general partner may limit the general partner's financial capacity to fulfill other financial obligations to or on behalf of the partnership.

Part B of the Task Force procedures, "Offerings with no Stated Contingency," is intended to modify *Roger C. Hartman, Esq. (Urban Improvement Fund Ltd.—1975),* in which the staff had indicated that rule 10b-9 would

89. *See id.* Paragraph 2 of part A of the Task Force procedures contains a reference to the securities having been "fully paid for with customer funds that have cleared the banking system," but this should not be read to mean that the funds must have cleared the banking system by the Specified Date. The staff previously has indicated that subscriptions received by a selling broker on the last day of an offering period may be counted if the "prompt transmittal" guidelines of NASD Notice to Members 84-64 are followed, the checks deposited in the escrow account clear the banking system, and the suitability of the investor has been determined. *See* Robbins, *All-or-None Offerings, supra* note 35, at nn. 34-37.

not apply to an offering when the general partner undertook at the commencement of the offering to purchase all unsold units upon termination of the offering, regardless of the number of units sold.[90] The staff's new position simply subjects such offerings to the same substantive and disclosure requirements described in part A(3)(a)-(d).

Part C also modifies a recent staff position that purchases by persons entitled to purchase securities net of brokerage commissions must be at the full purchase price with a rebate of the commissions after closing.[91] Such sales net of brokerage commissions, or at volume discounts, may now be made at the discounted price if (a) the varied terms are offered uniformly to persons in a certain specified class or classes, and (b) the terms are fully disclosed in the offering materials. In telephone advice provided to a representative of the ABA Task Force, the staff made it clear clear that such purchases may be counted in determining whether a designated minimum sales level has been achieved.[92]

3. Changes in Offering Terms

Rule 10b-9 has been interpreted to require a high degree of specificity in the terms of an offering. A change in a material term of an offering is in effect a termination of the offering as originally made, and requires that investors' funds be returned. The staff has taken the position that any of the following changes in the terms of an offering subject to rule 10b-9 is in effect a termination of the offering as to all previous investors and requires that all proceeds be returned to the investors:

1. Extension of the offering period.

2. Change in the offering price.

3. Change in the minimum purchase required of investors.

4. Change in the amount of proceeds necessary to release proceeds in escrow.

5. Change in the application of proceeds.[93]

The staff has permitted offerings to be extended beyond the initial offering period only if the following procedure is followed:

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90. *Urban Improvement Fund Limited—1975, supra* note 74. *See supra* notes 74, 82 (discussing *Urban Improvement Fund Ltd.—1975* interpretive letter).

91. *See* Bergmann, *Contingency Offerings, supra* note 38, at § A.4.C.

92. Telephone advice to Linda Wertheimer by Larry Bergmann, Assistant Director, Division of Market Regulation, Securities and Exchange Commission (April 1986).

93. *See* Bergmann, *Contingency Offerings, supra* note 38; Scarff, *Developments in Trading Practices, supra* note 46, at 471 (extension of offering period); Tucson Hotel Associates (March 12, 1985) (SEC staff interpretive letter regarding extension of offering); Reliance Trust Company (July 25, 1985) (SEC staff interpretive letter).

1. A reconfirmation offer must be made to all subscribers prior to the specified expiration date. The reconfirmation offer must disclose the extension and any other material information necessary to update the prospectus disclosure in order to permit subscribers to make an informed new investment decision.

2. The reconfirmation offer must be structured so that the subscriber affirmatively elects to continue his investment and those subscribers who take no affirmative action will have their subscriptions returned.

3. In order to comply with the requirement of rule 15c2-4 that funds held in escrow pending a stated event or contingency be promptly returned if the stated event or contingency does not occur, the reconfirmation offer must be made far enough in advance of the initial expiration date so that a subscriber who does not reconfirm will have his funds returned promptly after the initial expiration date.[94]

The same procedure would apply in a public or private offering. In a public offering, the offering may proceed by post-effective amendment rather than a new registration statement, although in any case except an extension of the offering period, funds must actually be returned to investors before the reconfirmation offer.[95]

4. What Sales May be Counted; "Last Day Sales"

Rule 10b-9 requires both that the specified amount of securities be "sold" within a specified time and that the total amount due to the seller be received by the seller by a specified date. When a selling broker receives subscriptions on the last day of the offering period, but not deposited in escrow on that day, may the subscriptions be counted toward the required minimum? The staff has indicated that such subscriptions may be counted,[96] so long as the "prompt transmittal" guidelines of NASD Notice to Members 84-64 are followed,[97] but this does not mean that the escrow can be released immediately.

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94. Release No. 6455, *supra* note 69, at Question 80; Scarff, *Developments in Trading Practices, supra* note 46, at 471-72. In *Contingency Offerings: Escrow Accounts and Related Matters,* Bergmann indicates that "extension of the offering period is the only situation involving a change in the terms of the offering in which the staff deems such a reconfirmation procedure to be appropriate," but provides no reason why more should be required in the case of, for example, a change in the minimum purchase required of investors. Bergmann, *Contingency Offerings, supra* note 38. The staff specifically has refused to permit the reconfirmation procedure when the sponsor proposed to reduce the level of minimum subscriptions required for closing. Tucson Hotel Assoc. (Mar. 12, 1985) (SEC interpretive letter).

95. *See* Tucson Hotel Assoc. (Mar. 12, 1985) (SEC interpretive letter).

96. Bergmann, *Contingency Offerings, supra* note 38.

97. *See supra* note 38 (discussing prompt transmittal guidelines).

All checks deposited in the escrow account must have cleared the banking system and represent immediately available funds for the securities to be "fully paid" within the meaning of Securities Exchange Act Release No. 11532.[98] Further, to the extent that the offering requires a suitability determination (or, in the case of an offering under Regulation D, an accreditation determination) by the managing broker-dealer or sponsor, subscriptions may not be counted until the investor's suitability has been determined.[99]

5. Refunds of Subscriptions

On failure of the conditions to an offering, rule 10b-9 requires that "all or a specified amount" of investors' subscriptions be promptly refunded. If less than all of an investor's subscription may be refunded, the minimum amount that will be refunded must be stated in the offering memorandum.

The risks to which subscriptions may be subject should not include the form of investment of the escrow account. Offerings made through NASD member broker-dealers are required to comply with NASD Notice to Members 84-7 (January 30, 1984) with respect to investment of escrow accounts. To the extent that an offering is not required to, and does not comply with the investment guidelines, there should be an appropriate risk factor dealing with risk of loss of the proceeds.

C. Remaining Issues

While the *American Bar Association* letter represents a substantial advance by the staff in taking a reasoned, disclosure-oriented approach to rule 10b-9, the principal remaining problem area is the need to clarify that purchases, to be bona fide for purposes of rule 10b-9, need be made "for investment" only in a private offering. In a public offering, rule 10b-9 requires only that a purchaser "take the risk of the investment," not that he purchase "for investment."[100] This clarification is essential to prevent certain references in the *Horner* interpretive letter from creating substantial uncertainty and disruption of public offerings subject to rule 10b-9.

IV. INSTALLMENT PAYMENTS IN PUBLIC AND PRIVATE OFFERINGS

A. Regulation T

Section 7(c) of the '34 Act makes it unlawful for any broker or dealer "to extend or maintain credit or arrange for the extension or maintenance

98. Fed. Sec. L. Rep. (CCH) ¶ 22,730 (July 11, 1975). *See* Chris Anderson (March 29, 1984) (SEC staff interpretive letter); *supra* note 42 (quoting Exchange Act Release No. 11532). A broker may not substitute its own funds for those of a customer whose check has been dishonored. *See* Roald George Gregersen, 46 S.E.C. 387 (1976). It is clearly contrary to rule 10b-9 to close on the basis of checks which the broker knows will not be honored. SEC v. Manor Nursing Center, 340 F. Supp. 913, 934-35 (S.D.N.Y. 1971), *modified,* 458 F.2d 1082 (2d Cir. 1972).

99. Bergmann, *Contingency Offerings, supra* note 38, at § A.4.e.

100. 17 C.F.R. § 240.10b-9 (1986). *See supra* note 40 (quoting Rule 10b-9).

of credit to or for any customer" on any security in contravention of the margin rules adopted by the Federal Reserve Board.[101] Section 220.13 of the Board's Regulation T,[102] issued by the Board pursuant to its regulatory authority under section 7(a) of the '34 Act, provides in part as follows:

> A creditor [broker or dealer] may not arrange for the extension or maintenance of credit to or for any customer by any person upon terms and conditions other than those upon which the creditor may itself extend or maintain under the provisions of this part, except that this limitation shall not apply to credit arranged for a customer which does not violate parts 207 and 221 of this chapter and results solely from:
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> (a) [investment banking services]; or
>
> (b) the sale of nonmargin securities (including securities with installment or other deferred payment provisions) *if the sale is exempted from the registration requirements of the Securities Act of 1933 under section 4(2) or section 4(6) of the Act.*[103]

Regulation T generally provides that a securities customer must pay at least 50 percent of the price of any "margin security"[104] purchased.[105] Securities that are not margin securities, including most securities issued in private offerings, may not be the subject of an extension of credit, or an arranging for the extension of credit, by a broker or dealer.[106]

A tax shelter program that provides for installment payments of the sale price of the interests purchased, but permits a customer to obtain the entire benefit of ownership before making all of the payments, has been interpreted by the Federal Reserve Board to be a prohibited "arranging for the extension of credit to purchase or carry securities" in violation of section 220.13.[107]

Neither the SEC nor the Federal Reserve Board until recently had articulated clear guidelines for determining when a provision for deferred payment, or a provision for assuming or incurring indebtedness constitutes "arranging for the extension of credit." Interpretive rulings of the Federal Reserve Board staff, however, appear to indicate that a provision for deferred payment generally will not be considered to constitute an extension of credit if (1) the deferred payment is made to purchase a "new" or separate security, (2) failure to make the deferred payment would not result in a forfeiture of

101. 15 U.S.C. § 78g(c) (1982).

102. 12 C.F.R. §§ 220.1-220.18 (1986).

103. *Id.* § 220.13 (emphasis added).

104. Margin securities generally are securities registered on a national securities exchange and certain over-the-counter securities.

105. 12 C.F.R. § 220.18 (1986).

106. 12 C.F.R. §§ 220.4(b), 220.18(f) (1986).

107. 12 C.F.R. § 220.124 (1986); FEDERAL RESERVE BOARD, SECURITIES CREDIT TRANSACTION HANDBOOK ¶ 5-470 [hereinafter cited as SCTH].

the investor's existing interest, and (3) the amount and timing of the deferred payment are truly contingent so that it may be considered a "bona fide contingent assessment."[108] These three principles overlap substantially and are emphasized separately depending on the facts of each case.[109]

B. *Application of Regulation T to Offerings under Regulation D*

Securities offerings that are exempt under section 4(2) (private placements), or section 4(6) (small business offerings) of the 1933 Act are exempt from the application of Regulation T.[110] The private placement exemption from Regulation T is available for offerings that comply with either rule 505 or rule 506 under Regulation D.[111] The Federal Reserve Board staff has refused to extend the exemption from Regulation T to offerings made pursuant to rule 504, however, on the ground that the SEC has not characterized rule 504 offerings as private offerings.[112] Consequently, a broker or dealer *may* arrange for the extension of credit, such as an installment sale or deferred payment provision, in connection with a private placement of securities under rule 505 or 506, but not an offering under rule 504.

C. *Section 11(d) of the 1934 Act*

In addition to the provisions of section 7(c) of the 1934 Act and Regulation T, section 11(d)(1) of the '34 Act prohibits a broker-dealer from

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108. *See infra* note 109 (citing interpretive rulings of Federal Reserve Board staff).

109. *See* SCTH, *supra* note 107, ¶ 5-607 (Fed. Res. Bd. Staff Op., May 31, 1972) (contingent assessment permitted in oil and gas program when payment of assessment would provide interest in wells drilled after certain date as "security separate from the assessable interest"); *id.* ¶ 5-606.17 (Fed. Res. Bd. Staff Op., Dec. 23, 1981) (when only consequence of failure to pay assessment is pro rata reduction of investor's interest to amount actually paid, there is no prohibited arranging for credit, but when failure to pay assessment also makes investor's interest nontransferable, economic penalty for nonpayment violates Regulation T); *id.* ¶ 5-560 (Fed. Res. Bd. Staff Op., Oct. 30, 1973) (when limited partnership interests are sold coupled with warrant to purchase additional interests, if "the economic penalty for non-exercise of the warrant (when weighed against the new investment required) is such that the purchaser of the first interest would not have a genuine choice as to whether or not to put up the money for the second interest," there would be prohibited extension of credit); *id.* ¶ 5-608 (Fed. Res. Bd. Staff Op., July 10, 1972 (bona fide contingent assessments permitted even though they would be legally enforceable when called); *id.* ¶ 5-607 (Fed. Res. Bd. Staff Op., May 31, 1972) (same).

110. 12 C.F.R. § 220.13 (1986). *See* SCTH, *supra* note 107, ¶ 5-606.12 (Fed. Res. Bd. Staff Op., Apr. 1, 1981) (§ 4(6)); *id.* ¶ 5-598 (Fed. Res. Bd. Staff Op., Mar. 29, 1979) (§ 4(2)); *id.* ¶ 5-595 (Fed. Res. Bd. Staff Op., Sept. 13, 1978) (§ 4(2)).

111. Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 47 Fed. Reg. 11251, 11258 n.33 (1982); SCTH, *supra* note 107, ¶ 5-606.19 (Fed. Res. Bd. Staff Op., Apr. 1, 1982) (RULE 505); *id.* ¶ 5-606.18 (Fed. Res. Bd. Staff Op., Jan. 8, 1982) (Rule 506).

112. SCTH, *supra* note 107, ¶ 5-606.2 (Fed. Res. Bd. Staff. Op., May 20, 1982). *See* Interpretive Release on Regulation D, Securities Act Release No. 6455, 48 Fed. Reg. 10045, 10054, nn. 50-51 (1983).

arranging for the extension of credit in connection with a "new issue." Section 11(d)(1) provides in pertinent part that

> [i]t shall be unlawful for a member of a national securities exchange who is both a dealer and a broker, or for any person who both as a broker and a dealer transacts a business in securities through the medium of a member or otherwise, to effect through the use of any facility of a national securities exchange or of the mails or of any means or instrumentality of interstate commerce, or otherwise in the case of a member, (1) any transaction in connection with which, directly or indirectly, he extends or maintains or arranges for the extension or maintenance of credit to or for a customer on any security (other than an exempted security) which was a part of a new issue in the distribution of which he participated as a member of a selling syndicate or group within thirty days prior to such transaction. . . .[113]

For a transaction to violate section 11(d)(1), it must be effected by one who acts *both* as a broker and a dealer, in connection with a "new issue in the distribution of which he participated as a member of the selling syndicate or group."[114] One who acts only as a broker, and not as a dealer, does not come within the prohibition.[115]

D. *Application of Section 11(d)(1) to Offerings under Regulation D*

Section 11(d)(1) does not contain an exemption for offerings exempt from the registration provisions of the 1933 Act, as does Regulation T. However, the SEC staff has taken the position that if no public market exists for the securities, and the offering does not constitute a "public distribution" (which term is not defined), it will not recommend any action under that section.[116] The Federal Reserve Board Staff has taken the position that it has no responsibility for interpretation of section 11(d)(1).[117]

The staff of the Commission's Division of Market Regulation has not provided any written advice regarding the application of section 11(d)(1) to

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113. 15 U.S.C. § 78k(d)(1) (1982).

114. *Id.*

115. *See* Saul, Ewing, Remick & Saul, SEC No-Action Letter [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,564 (Nov. 12, 1973); State of Ohio, Dept. of Commerce Division of Securities, SEC No-Action Letter [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,558 (Oct. 27, 1973).

116. *See* Saul, Ewing, Remick & Saul, SEC No-Action Letter [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,564 (Nov. 12, 1973); Great Plains Western Corp. (avail. Dec. 9, 1973) (SEC no-action letter). The staff took the following position in *Great Plains Western Corp.:*

> It is our view . . . that section 11(d)(1) does not apply to transactions which do not constitute a distribution of securities to the public. . . . The ultimate responsibility for determining whether a particular offering of securities constitutes a distribution to the public for purposes of section 11(d)(1) must rest with the issuer.

Great Plains Western Corp. (avail. Dec. 9, 1973) (SEC no-action letter).

117. SCTH, *supra* note 107, ¶ 5-606.16 (Fed. Res. Bd. Staff Op., Dec. 4, 1981); *id.* ¶ 5-606.15 (Fed. Res. Bd. Staff Op., April 17, 1981).

offerings made pursuant to Regulation D. The staff has given oral advice that it would mirror the interpretations of the Federal Reserve Board staff under Regulation T regarding the type of transactions that would constitute "arranging for the extension of credit" and also has given oral advice that offerings made pursuant to rule 505 and rule 506, but not rule 504, would be exempt from the application of section 11(d)(1).

E. Current Developments

1. The Adoption of Rule 3a12-9

On March 7, 1986, the SEC adopted rule 3a12-9[118] that grants the exemptions from sections 7(c) and 11(d)(1) of the '34 Act presently enjoyed by private offerings under rules 505 and 506 under Regulation D to publicly offered securities of certain direct participation programs, provided that certain conditions are met.[119] Consequently, broker-dealers can participate in public offerings of securities for direct participation programs that feature mandatory deferred payments provided that:

(1) The securities are registered under the 1933 Act or are sold or offered exclusively on an intrastate basis in reliance upon section 3(a)(11) of the 1933 Act;

(2) The mandatory deferred payments bear a reasonable relationship to the capital needs and program objectives described in a business development plan disclosed to investors in a registration statement filed with the Commission under the 1933 Act or, where no registration statement is required to be filed with the Commission, as part of a statement filed with the relevant state securities administrator;

(3) Not less than 50 percent of the purchase price of the direct participation program security is paid by the investor at the time of sale; and

(4) The total purchase price of the direct participation program security is due within three years in specified property programs or two years in non-specified property programs. Such pay-in periods are to be measured from the earlier of the completion

118. 17 C.F.R. § 240.3a12-9 (1986).

119. Exemption of Certain Direct Participation Program Securities, Exchange Act Release No. 34-22979, 51 Fed. Reg. 8795 (1985) [hereinafter cited as Exchange Act Release No. 34-22979].

of the offering, or one year following the effective date of the offering.[120]

In SEC Exchange Act Release No. 34-22979 (rule 3a12-9 release), the Commission defined "direct participation programs" to exclude securities listed on exchanges or quoted on NASDAQ during the pay-in period as a result of efforts by the issuer, underwriter, or other participants in the initial distribution of such securities, reasoning that such securities raise price volatility and speculation concerns that are central to the margin regulations.[121]

In the rule 3a12-9 release, the Commission placed special emphasis on the requirement that installment payments "reasonably" be related to the capital needs and business objectives of the program. The SEC made it clear that it would be necessary to coordinate payments so that they bear a reasonable relationship to substantive program events or capital needs. Consequently, programs that intend at the offering's outset to factor, or otherwise assign investor notes to raise capital for purchasing property or meeting program objectives before receipt of the deferred payments cannot rely on rule 3a12-9.[122]

Since the securities governed by rule 3a12-9 normally are sold in contingency offerings, the release contained guidelines for compliance with rule 10b-9 (requiring specificity in terms) and rule 15c2-4 (addressing the handling of investors' funds by broker-dealers) that both cover such offerings. According to the rule 3a12-9 release, rule 10b-9 would be satisfied, and the consideration[123] may be released to the issuer, only when: (1) the specified sales level is achieved; (2) with respect to the sale of each security counted towards the specified sales level, the 50% down payment is fully paid; and (3) the required documentation reflecting the installment payment obligations comports with the requirements of the offering material.[124]

Rule 3a12-9, however, does not provide the exclusive method by which deferred payments can be included in public offerings. A number of different structures have been approved by the Federal Reserve Board staff as not in

120. 17 C.F.R. § 240.3a12-9 (1986). "Business Development Plan" is defined as one which describes the program's anticipated economic development and the amounts of future capital contributions, in the form of mandatory deferred payments, to be required at specified times or upon the occurrence of certain events. *Id.* § 240.3a12-9(b)(2). "Specified Property Program" is defined as a direct participation program in which, at the date of effectiveness, more than 75 percent of the net proceeds from the sale of program securities are committed to specific purchases or expenditures. *Id.* § 240.3a12-9(b)(3).

121. Exchange Act Release No. 34-22979, *supra* note 119.

122. *Id.* According to the release, however, it will be permissible to use investor notes as collateral to secure program debt. *Id.* at 8799. The line between the permissible and the impermissible is therefore somewhat unclear. *Id.*

123. *Id.* The consideration in a "direct participation program" would be the 50 percent down payment and the documentation reflecting the contractual obligation of the investor to make mandatory installment payments. *Id.* at 8800.

124. *Id.*

conflict with Regulation T, and for those types of offering no exemption is required.[125]

Compliance with rule 15c2-4 requires that any consideration received by a broker-dealer in a rule 3a12-9 offering before the satisfaction of the contingencies be deposited promptly by the broker-dealer in a separate bank account as agent or trustee for the persons who have the beneficial interests therein, or promptly transmitted to a bank that has agreed in writing to hold all such consideration in escrow for the persons who have the beneficial interests therein. Finally, the Commission made it clear that rule 3a12-9 does not preempt state securities laws. Accordingly, those securities that qualify under rule 3a12-9 also must comply with applicable state laws.

2. Proposed NASAA Amendments

In a related development, the North American Securities Administrators Association, Inc. (NASAA)[126] has proposed amendments to its guides for registration of real estate programs that for the first time would permit in limited cases mandatory deferred payments for certain non-specified program interests in public offerings.[127] Under the proposed amendments the sponsor must satisfy an administrator that the mandatory deferred payment provisions bear "a reasonable and demonstrable relationship to the capital needs and program objectives described in the business development plan disclosed to investors."[128] In addition, 50 percent of the purchase price of the program interests would have to be paid by the investor at the time of the sale, with the remainder payable within two years of the earlier of the end of the offering or one year following the effective date of the offering, or within a shorter period specified by the state securities administrator.[129]

The proposed amendments also prescribe new requirements for mandatory deferred payments for specified programs, which would be equally applicable to non-specified programs. They include the requirements that:

> (1) at least 50 percent of the purchase price of the program interests be paid by the investor at the time of sale, with the rest to be paid within three years of the earlier of the completion of the offering, or one year following the effective date of the offering;
>
> (2) selling commissions for program interests sold on a mandatory deferred payment basis be paid only on a pro rata basis as cash payments are made by participants;

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125. *See supra* note 109 (discussing alternative forms of deferred payments).

126. NASAA is a voluntary organization comprised of state securities regulatory agencies, which issues guidelines that are adopted by many states. *See* NASAA Rep. (CCH) ¶¶ 1-6, at 11-15 (1986).

127. *See id.* 3609, at 2041 (NASAA Statement of Policy re: mandatory deferred payments in public real estate offering programs).

128. *Id.*

129. *Id.*

(3) responses to defaults be designed to protect the capital requirements of the program and the best interests of the non-defaulting participants;

(4) any security interest taken by the program in the participant's program interests be in proportion to the ratio as the unpaid face value of the promissory notes given by the participant bears to the total face value of such notes;

(5) non-defaulting participants (other than the sponsor) be given the right of first refusal to purchase program interests recovered as a result of a default in payments, unless mandatory deferred payments are guaranteed by the sponsor or by a surety bond or other arrangement; and

(6) notification be given by the sponsor to an assignee or transferee of program interests purchased through a deferred payment program of the material terms of the mandatory deferred payment obligation.[130]

The NASAA guidelines serve as guides for use by state securities officials in reviewing registration statements and have no further substantive effect. Certain requirements, such as NASAA guideline (3) (requiring that responses to defaults be designed to protect the interests of non-defaulting participants and the capital requirements of the program), will have substantive content only in the context of accumulated decisions of state securities officials on individual programs. In practice, the interpretation of the guidelines from state to state generally has been uneven, and it remains to be seen what types of offering structures generally will be approved.

130. *Id.* at 2039-40.