APPLICABILITY OF THE INVESTMENT COMPANY ACT OF 1940 TO REAL ESTATE SYNDICATIONS

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This paper will consider the application of the Investment Company Act of 1940 [the 1940 Act][1] to real estate syndications in three problem areas: first, the "start up" problem; second, the second-tier partnership problem; and third, the overall regulatory problem. Each of these areas was considered recently by the Real Estate Advisory Committee to the Securities and Exchange Commission.[2] In addition, the policies of the staff of the Securities and Exchange Commission [SEC] regarding these problem areas have been spelled out to some extent in no-action letters, public releases and exemptive orders granted upon formal applications for exemption from the 1940 Act. For the most part, however, the staff's policies have been articulated in informal conferences with registrants and prospective registrants, and accordingly have not become readily available to the public. Each of the three problem areas will be discussed, highlighting the staff position and the potential stumbling blocks presented by each.

I. THE "START UP" PROBLEM

A. *The Statutory Basis*

The "start up" problem can be illustrated by reference to *S.E.C. v. Fifth Avenue Coach Lines, Inc.*,[3] a case arising in a slightly different context. Until early 1962, Fifth Avenue operated one of the nation's largest privately owned municipal transit systems. However, in March of that year, the City of New York acquired all of Fifth Avenue's operating assets through condemnation proceedings. After considerable litigation with the city, the corporation received an initial condemnation award of eleven and one-half million dollars. Fifth Avenue then embarked upon an aggressive and active investment program, purchasing the stock of several operating companies and making several tender offers for the stock of another. The program resulted in Fifth Avenue placing more than eight million dollars in

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[1] 15 U.S.C. §§ 80a-1 - 80a-52 (1971)

[2] SEC, REPORT OF THE REAL ESTATE ADVISORY COMMISSION, (1972) [hereinafter cited as the "R.E.A.C. REPORT"].

[3] 435 F.2d 510 (2d Cir. 1970).

stocks or time deposits and, through trading and further investment, reducing available cash to $843,000.[4] The SEC contended that Fifth Avenue became an investment company within the meaning of § 3(a)(1) of the 1940 Act[5] at the time it first received the condemnation proceeds.[6] Fifth Avenue, on the other hand, argued that it was not an investment company because it had endeavored from the time it received the proceeds of the condemnation award, to gain operating control of companies in order to become a conglomerate.[7] The Court of Appeals for the Second Circuit rejected this latter contention. It did not find that the Fifth Avenue became an investment company immediately upon receipt of the award as contended by the SEC. It did, however, accept the district court's finding that "Fifth has been markedly unsuccessful in carrying out . . . [its] policy"[8] and held that the corporation became an investment company shortly after initial receipt of the proceeds. The lesson of *Fifth Avenue* is simple: whenever a company invests a substantial portion of its total assets in securities, without also carrying on substantial operating activities, the question of its classification as an investment company is likely to arise.

The term "start up" period refers to the interval between the completion of a public offering of interests in a limited real estate partnership and its full investment of the proceeds and substantial involvement in its real estate business activities. It is during this hiatus, which is common to most real estate syndications, that the so-called "start up" problem may arise. Because it is contrary to the interest of the partnership for these uncommitted proceeds to be sterile during the start up period, they are frequently invested temporarily in instruments defined as securities in the 1940 Act.[9] It is these temporary investments which, according to the SEC staff,

[4] *Id.* at 514.
[5] 15 U.S.C. § 80a-3(a)(1) (1971).
[6] 435 F.2d at 516.
[7] *Id.* at 515.
[8] *Id.* at 516.
[9] 15 U.S.C. § 80a-2(a)(36) (1970).

The definition of security is as follows:

"Security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral trust agreement, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

raise a question as to the status of the partnership under § 3(a)(3) of the 1940 Act.[10] In essence, § 3(a)(3) defines an investment company as a company which is engaged in the business of investing in securities and which owns investment securities having a value exceeding forty percent of the value of the company's total assets. Government securities and cash items are excluded in making the calculation.[11] The SEC staff tends to de-emphasize the first part of the definition, which states that the company must be engaged "in the business"[12] of investing in securities. It generally takes the position that any issuer which holds investment securities (exclusive of Government securities and cash items) representing in excess of forty percent of the value of its total assets automatically falls within § 3(a)(3).[13] Therefore, a limited partnership which, during the start up period, invests a substantial portion of the proceeds of its public offering in investment securities may technically fall within the § 3(a)(3) definition and thus be subject to the registration and other provisions of the 1940 Act.

It may seem, at first blush, that the start up problem can be avoided simply by investing the proceeds of the public offering during the start up period in Government securities or in cash items, since these investments are excepted by § 3(a)(3) from the forty percent test. Moreover, rule 6-03 of Regulation S-X, which prescribes accounting rules for investment companies, includes as "cash items" time deposits, call loans, and funds subject to withdrawal within one year.[14] Thus, the court in *S.E.C. v. Fifth Avenue Coach Lines, Inc.*[15] held that interest-bearing cash accounts and certificates of deposit falling within rule 6-03 are cash items excluded from the calculation under § 3(a)(3). However, it should be noted that in *Fifth Avenue* the Commission took the position that certificates of deposit and interest-bearing cash accounts constitue "investment securities" and not "cash items" if they are held for investment purposes. Furthermore, the Commission has not acquiesced in *Fifth Avenue's*[16] holding to the contrary.

However certificates of deposit and cash accounts may be treated under § 3(a)(3), the staff relies on an alternate definition of

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[10] 15 U.S.C. § 80a-(3)(a)(3) (1970).
[11] 15 U.S.C. § 80a-3(a) (1970).
[12] 15 U.S.C. § 80a-3(a)(3) (1970).
[13] *Id.*
[14] 17 C.F.R. § 210.6-03 (1974).
[15] 435 F.2d 510 (2d Cir. 1970).
[16] *See* SEC Interpretive Letter to Samuel Lippman (available November 19, 1973).

an investment company in § 3(a)(1),[17] in cases where § 3(a)(3) is not clearly applicable. Section 3(a)(1) provides, in part, that an investment company is any company which is "primarily" engaged in investing in securities. Government securities, regardless of their status under § 3(a)(3), are, of course, securities; and under the staff's interpretation, interest-bearing cash items such as certificates of deposit and interest-bearing accounts also fall within the definition of a security.[18] The staff takes the position that any company which, over a significant period of time, invests a substantial amount of its assets in securities (including Government securities and interest-bearing cash items) and receives a substantial part of its total income from such investments, is "primarily engaged in the business" of investing in such securities within the meaning of § 3(a)(1).[19] Therefore, a limited partnership which invests a substantial part of the proceeds of its public offering for a significant period in securities, including Government securities and interest-bearing cash items, may fall within the definition in § 3(a)(1).[20]

B. *The Evolving Staff Position*

Until recently, the staff had taken the position that no question would be raised under the 1940 Act if the proceeds of a public offering were invested in securities during the start up period, so long as such proceeds did not remain invested in securities for a period in excess of ninety days.[21] The staff policy was described as follows:

> If, . . . substantially more than 25 percent of the assets of the Company would be invested in such securities, the Company would be invested in such securities, the Company would be an investment company and would be required to register under the Investment Company Act. Therefore, unless within a relatively short time, not to exceed 90 days, the Company has binding contractual obligations to acquire operating assets and has specific *bona fide* plans to commit enough of the proceeds to operating activities to solve the problem the Company will either then register as an investment company, or if the facts warrant, file an application for exemption . . . . Thus, it may be necessary if no specific plans are made within such 90-day period to commit a sufficient portion of the proceeds

[17] 15 U.S.C. § 80a-3(a)(1) (1970).

[18] Tcherepnin v. Knight, 389 U.S. 332, 340-46 (1967).

[19] This is the basic position adopted in S.E.C. v. Fifth Avenue Coach, discussed, *supra*, text accompanying notes 3 and 4.

[20] 15 U.S.C. § 80a-3(a)(1) (1970).

[21] *See, e.g.*, SEC no-action letter to Boston Financial Rehabilitation Partnership — I (available July 2, 1972).

to operating activities, to hold the uncommitted portion of such proceeds in a non-interest-bearing account pending application thereof.[22]

This position by the staff would, of course, require a partnership to hold most of its uncommitted proceeds in cash if such proceeds could not be used in its real estate activities within ninety days of its public offering. The partnership would thereby lose the interest it could have otherwise earned pending investment. That position was the subject of much criticism.[23] The Real Estate Advisory Committee recommended

> . . . that the Commission consider enunciating a policy permitting such partnerships to use the proceeds from their offerings which are awaiting direct or indirect commitment to real estate to hold (and not trade) securities as defined in §§ 3(a)(2) and 3(a)(3) of the 1933 Act for a reasonable time period. For example, such use would be permitted, provided that not more than 70 percent of such proceeds are so used for more than 365 days and 40 percent for 720 days from the date of the offering.[24]

The staff now appears to be taking a more flexible approach to the start up problem. It has recognized that under certain circumstances the public interest is not served by an insistence that uncommitted proceeds, if not used in the business within a certain period, be retained in cash.[25] The staff has not yet however, adopted the position recommended by the Real Estate Advisory Committee. The authors are advised that the staff currently will raise a question of status under the 1940 Act if the proceeds from the public offering of a partnership are invested in securities for a period in excess of 180 days from the time of the initial public offering. To avoid this problem, the real estate partnership should anticipate making binding contractual commitments to expend uncommitted proceeds for its real estate activities within six months of its public offering or otherwise restructuring its activities so as to avoid the "engaged primarily" test.

II. THE "TWO-TIER" PROBLEM

The so-called "two-tier" problem is related to the exemption

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[22] R.E.A.C. REPORT at 51.

[23] *See, e.g.*, R.E.A.C. REPORT at 52.

[24] *Id.* at 52.

[25] *See, e.g.*, National Rural Utilities Cooperative Finance Corporation, SEC, Investment Companies Act [hereinafter cited as I.C.A.] Rel. No. 6078 (1970), cited in R.E.A.C. REPORT at 52.

found in § 3(c)(5) of the 1940 Act.[26] Real estate partnerships can be viewed as one-tier or second-tier partnerships. A one-tier partnership is one which invests directly in interests in real estate. No problem is raised under the 1940 Act by a single-tier partnership because, under § 3(c)(5)(c) of the Act,[27] companies primarily engaged in the business of purchasing or otherwise acquiring interests in real estate are excepted from the definition of investment company. However, the staff has taken the position that a limited partnership interest in a partnership which invests directly in real estate projects is not itself an interest in the real estate; rather, it is deemed to be a type of security.[28] Therefore, a partnership which invests the substantial part of its assets in limited partnership interests of other real estate partnerships (thus creating the so-called two-tier partnership) may be deemed to be engaged primarily in the business of investing in securities. It is for this reason that the second-tier partnerships raise a question of status under §§ 3(a)(1) and 3(a)(3) of the 1940 Act.[29]

The Commission recently addressed this question in an interpretive release.[30] The release states that in the opinion of the Division of Investment Management Regulation, any issuer which is primarily engaged in the business of investing in limited partnership interests issued by partnerships engaged in the real estate business is an investment company within the meaning of § 3(a)(1) of the Act.[31] A second-tier partnership might, however, not be deemed to fall within 3(a)(1) if other facts indicate that the partnership is, in fact, primarily engaged, through its general partner, in carrying on the business activities of the underlying limited partnerships in which it has invested.[32]

The release goes on to note that the ownership of limited partnership interests might also cause the second-tier partnership to fall within the definition of investment company contained within § 3(a)(3) of the Act[33] if it holds limited partnership interests having a value exceeding forty percent of the value of its total assets and if such limited partnership interests are "investment securities" within the meaning of the Act. Since investment securities are defined to

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[26] 15 U.S.C. § 80a-3(c)(5) (1970).

[27] *Id.*

[28] SEC, I.C.A. Rel. No. 8456, BNA SECURITIES REGULATION & L. REP., No. 265, F-1 (Aug. 9, 1974).

[29] 15 U.S.C. § 80a-3 (1970).

[30] Note 28, *supra.*

[31] 15 U.S.C. § 80a-3(a)(1) (1970).

[32] Note 28, *supra.*

[33] 15 U.S.C. § 80a-3(a)(3) (1970).

exclude securities issued by majority-owned subsidiaries which are not themselves investment companies, the Division will take a "no-action" position if (1) the second-tier partnership owns more than fifty percent of the limited partnership interests in all the underlying limited partnerships in which it invests and has the right to dismiss and replace the general partners of such underlying partnerships, and the limited partners of the second-tier partnership also have the right to dismiss and replace their general partner; (2) the second-tier partnership is not an investment company within the meaning of § 3(a)(1); that is to say, the general partner of the second-tier partnership is primarily engaged in carrying on the business of the underlying limited partnerships; and (3) the second-tier partnership, in reliance upon an opinion of counsel that registration is not required, does not register as an investment company.[34]

If a second-tier partnership does fall within the definition of an investment company contained in § 3(a)(3),[35] it may seek exemption from registration by filing an application for exemption pursuant to § 3(b)(2) of the Act.[36] Section 3(b)(2) in essence provides that, notwithstanding § 3(a)(2), the Commission may exempt any issuer which it finds to be primarily engaged in a business other than investing in securities, either directly or through (A) majority-owned subsidiaries, or (B) controlled companies conducting similar types of businesses. It is the Division's position that a second-tier partnership, even though owning less than fifty percent of the limited partnership interests in the underlying limited partnerships, may nonetheless qualify for exemption under § 3(b)(2) if, in fact, it is directly engaged in the real estate business through its control of the underlying limited partnerships.[37]

Finally, the release notes that the Division may also allow exemptions pursuant to § 6(c) of the 1940 Act for second-tier partnerships which invest in limited partnerships engaged in the development of housing for low and moderate income persons.[38] Since the assets of such second-tier partnerships consist almost entirely of limited partnership interests in local partnerships and since the second-tier partnerships typically are not themselves directly engaged in the business of developing or operating the low and moderate income hous-

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[34] SEC, I.C.A. Rel. No. 8456, BNA SECURITIES REGULATION & L. REP., No. 265, at F-2 (Aug. 9, 1974).

[35] 15 U.S.C. § 80a-3(a)(3) (1970).

[36] 15 U.S.C. § 80a-3(b)(2) (1970).

[37] Note 34, *supra*.

[38] *Id.*

ing, such second-tier partnerships would be subject to registration unless exempted pursuant to § 6(c).[39] Section 6(c) grants the Commission authority to exempt, conditionally or unconditionally, any person from any or all the provisions of the 1940 Act if it finds that such exemption is "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the 1940 Act]."[40]

The Commission has, for a variety of reasons, found that exemption of these second-tier partnerships from all provisions of the 1940 Act meets the requisite public interest standard. First, such partnerships usually promote the construction of federally assisted low and moderate income housing, which Congress has recognized to be in the national interest. Second, investors in such partnerships will be upper tax bracket individuals who presumably are "sophisticated" investors interested primarily in the tax shelter provisions of the Internal Revenue Code.[41] Third, various provisions of the 1940 Act require, among other things, election of independent members of a board of directors and a high degree of security holder control over the affairs of the partnership.[42] Such partnerships cannot comply with these provisions without risking loss of the favorable pass-through tax treatment,[43] which is a principal motive for investment in such partnerships, as well as loss of the investor's limited liability provided under state limited partnership law.[44]

The Commission first considered the second-tier partnership in the exemption application filed with the Commission in 1969 by the National Corporation for Housing Partnerships [the Corporation] and the National Housing Partnership [the Partnership], referred to hereinafter jointly as the N.H.P.[45] The Corporation and Partnership were created pursuant to Title IX of the Housing and Urban Development Act of 1968,[46] with the original incorporators being appointed by the President of the United States. Thereafter, twelve members of the Corporation's board of directors were elected by the shareholders and three additional directors were appointed by the President. The Corporation serves as a general partner of the Partnership, which invests in limited partnership interests issued by local partnerships

[39] 15 U.S.C. § 80a-6(c) (1970).
[40] *Id.*
[41] Note 34, *supra*.
[42] *See, e.g.*, 15 U.S.C. § 80a-16 (1970).
[43] *See* Treas. Reg. 310.7701-2 (1960), *as amended* T.D. 6797, 1965-1 CUM. BULL. 553.
[44] *See* UNIFORM LIMITED PARTNERSHIP ACT § 7.
[45] SEC, I.C.A. Rel. No. 5945, 35 Fed. Reg. 201 (1970).
[46] 42 U.S.C. §§ 3931-40 (1973).

engaged in developing low and moderate income housing under various federal subsidy programs. In light of the unique nature of N.H.P., the Commission found it in the public interest to grant it a complete exemption from the 1940 Act.[47]

Following the granting of the N.H.P. exemption, a number of second-tier partnerships, relying on the N.H.P. precedent, sought and were granted exemptions from the 1940 Act.[48] Although these partnerships were organized to invest in local partnerships involved in federally subsidized housing development, they were not (as was N.H.P.) organized pursuant to an Act of Congress by individuals appointed by the President. Rather, these partnerships were typically organized by a private promoter who served as general partner. On the ground that it was consistent with § 6(c),[49] the Real Estate Advisory Committee recommended that the Commission continue its policy of exempting second-tier real estate limited partnerships where the underlying partnerships are engaged in the construction of low and moderate income housing.[50]

The Commission, however, had certain difficulties with its past exemption policy for such partnerships. To assure their limited liability, relevant state law requires that the limited partners not exercise control of management of the partnership. Therefore, limited partnerships, whether one-tier or second-tier, necessarily require the type of "externalized" management which, in the case of investment companies, is considered to carry the potential for a variety of self-dealing abuses. In light of this potential for such abuses, the Commission has under consideration the regulatory problem involved in all tax-shelter partnerships. This overall regulatory problem is the third area of application of the 1940 Act to real estate syndications, and will discussed momentarily. The problem is mentioned at this point, however, because it is interwoven with the Commission's policy with respect to exemption of the second-tier partnerships involved in low and moderate income housing. In light of the regulatory problem presented by such partnerships, the Commission directed the staff to reconsider its exemption policy with respect to such second-tier partnerships.

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[47] SEC, I.C.A. Rel. No. 5955 (Jan. 17, 1970).

[48] *See, e.g.*, Condren Housing Partners, SEC, I.C.A. Rel. Nos. 6807, 6851 (Nov. 29, 1971); Boston Financial Housing Partnerships, SEC, I.C.A. Rel. Nos. 6822, 6883 (Dec. 9, 1971); Boston Financial Rehabilitation Partnerships — I, SEC, I.C.A. Rel. Nos. 7019, 7075 (Mar. 20, 1972); American Housing Partners, SEC, I.C.A. Rel. Nos. 7178, 7215 (June 5, 1972).

[49] 15 U.S.C. § 80a-6(c) (1970).

[50] R.E.A.C. REPORT at 54.

It was in this context that the exemption application under § 6(c) for N.H.P.-II was filed in August of 1973.[51] In order to qualify for exemption the Commission Release, heretofore referred to, on second-tier partnerships suggests that § 6(c) exemptions henceforth be patterned, more or less, on the conditions agreed to in the N.H.P.-II application. N.H.P.-II was organized by N.H.P., which acts as its general partner. Its principal activity is the purchase of a substantial portion of N.H.P.'s equity interest in government assisted rental housing projects. Therefore, N.H.P.-II, or the local partnerships in which it invests, may engage in transactions with persons or entities affiliated with the general partner or its directors, officers, and employees, or with limited partners of N.H.P. The regulatory concern over such self-dealing transactions was resolved through rather detailed conditions, spelled out in the release of the Commission noticing the N.H.P.-II application for exemption.[52]

N.H.P. agreed to several basic conditions. First, interests in N.H.P.-II would be sold only to "sophisticated" investors.[53]

Second, the interests which N.H.P.-II will acquire and the terms under which it will acquire such interests would be fully stated in its prospectus and would not be made subject to the discretion of management.[54]

Third, N.H.P.-II's investments would be governed by policies which could not be changed except by the vote of the holders of at least a majority of its outstanding interests. Furthermore, the investors in N.H.P.-II were to have voting rights with respect to, among other things, the dissolution of N.H.P.-II, amendments to N.H.P.-II's limited partnership agreement and management contract, and under certain circumstances, the withdrawal of the general partners.[55]

Fourth, N.H.P.-II would enter into transactions with affiliated persons or entities only if management determined that the terms are reasonable and fair and consistent with the policies and purposes of N.H.P.-II, do not involve overreaching on the part of any party, and are no less favorable to N.H.P.-II than those offered by others in the same vicinity. N.H.P.-II would have the right to terminate any contract with any such affiliated person or entity without penalty on sixty day's notice.[56]

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[51] SEC, I.C.A. Rel. No. 7947, 38 Fed. Reg. 22585 (1973).

[52] *Id.*

[53] *Id.*

[54] 38 Fed. Reg. at 22586.

[55] *Id.*

[56] *Id.*

The Commission's two-tier partnership release suggests that its exemption policy under § 6(c)[57] will be available only to second-tier partnerships involved in the development of low and moderate income housing. Thus, other types of second-tier real estate partnerships which do not promote a recognized national public policy may be deemed investment companies and, as such, required to register under the 1940 Act, unless they can qualify for exemption under § 3(b)(2)[58] as being primarily engaged in a business other than investing in securities (either directly or through subsidiary or controlled underlying partnerships). Moreover, whether or not a second-tier partnership is required to register under the 1940 Act, the general partner of such a partnership may be deemed an investment adviser required to register under the Investment Advisers Act of 1940.[59] The term "investment adviser" is defined in § 202(a)(11) of the Advisers Act[60] as any person who, for compensation, engages in the business of advising others as to the advisability of investing in, purchasing or selling securities. Although the staff appears never to have had occasion to consider the applicability of this definition to the general partner of a second-tier real estate partnership, the staff has applied the definition to the general partner of an analogous type of limited partnership — the "hedge" fund.

A hedge fund is a limited partnership in which the contributions of the limited partners are pooled and invested by the general partner in equity securities. Thus, like the second-tier real estate partnership, the hedge fund is a partnership primarily engaged in investing in and holding securities. The staff takes the view that each limited partner, and not solely the partnership itself, is a "client" of the general partner.[61] Hence the general partner of a hedge fund fits the definition of "investment adviser" because (1) the general partner is in the business of deciding, on a discretionary basis, how to invest his clients' contributions in securities (which activity the staff deems to "encompass the act of recommending" such securities), and (2) the general partner's share of the profits of the partnership, in excess of his pro rata share, on the basis of his capital contribution to the partnership, constitutes "compensation" for his investment advisory services.[62] One problem raised by registration as an investment ad-

[57] 15 U.S.C. § 80a-6(c) (1970).

[58] 15 U.S.C. § 80a-3(b)(2) (1970).

[59] 15 U.S.C. § 80b-1 - 80b-21 (1970).

[60] 15 U.S.C. § 80b-2(11) (1970).

[61] Weiss, *Personal Views of SEC Staff Members*, in INVESTMENT PARTNERSHIPS AND "OFFSHORE" INVESTMENT FUNDS (Practising Law Institute, J. McCord, ed. 1969) at 364-65 [hereinafter cited as "PLI"].

[62] PLI at 363-64. The activities of such a limited partnership may also raise a question of

viser is that such a general partner would, among other things, have to conform with 205(1) of the Advisers Act,[63] which prohibits a registered investment adviser from basing his compensation on a share of capital gains upon, or capital appreciation of, the funds of any portion of the funds of the client.

III. The Overall Regulatory Problem

As has been pointed out earlier, the structure of a limited partnership, which in effect, requires the "externalization" of management, raises a potential for self-dealing abuses. It is also fairly apparent that real estate tax-shelter partnerships, whether organized as a one-tier or as a second-tier partnership, raise other regulatory problems. For example, currently under study and debate is the question whether limited partners should receive operational and financial reports and have the right to exercise adequate voting power.[64]

Further, it seems reasonable that the general partner should be required to have a certain minimum level of expertise and to maintain an adequate level of capitalization, and that the formulae used to compensate general partners be reasonable and described in an understandable format. With respect to regulation at the federal level of tax-shelter real estate partnerships, the Real Estate Advisory Committee recommended:

> [T]he Committee believes that, [currently] . . . the Commission should not attempt to regulate, directly or indirectly, the distribution of real estate [partnership] securities, but should continue to compel the full and complete disclosure standards of the 1933 Act and regulatory requirements of the 1934 Act, intensifying disclosure and increasing policing and reporting standards.
> However, if uniform [state] regulation is not achieved, say within a year, we believe the Commission should give serious consideration to sponsoring federal legislation which would permit real estate

its status as a "dealer", which is defined in § 3(a)(5) of the Securities Exchange Act of 1934 as any person engaged in the business of buying and selling securities for his own account. PLI at 374. With respect to the activities of NHP, however, the SEC staff has raised no question of registration as a "broker" or "dealer" on the basis of counsel's opinion that NHP was engaged in the business of developing low and moderate income housing in the manner congressionally mandated by statute. *See* SEC letter to Manuel F. Cohen (Feb. 26, 1971).

[63] 15 U.S.C. § 80b-5(1) (1970).

[64] *See, e.g.*, N.A.S.D. proposed Article III, § 33 of Rules of Fair Practice and proposed regulations to be adopted pursuant thereto in National Association of Securities Dealers, Tax Sheltered Programs (1973); SEC, Securities Exchange Act Rel. No. 10260, BNA Securities Regulation & L. Rep. No. 209, F-1 (July 2, 1973).

[partnership] securities to be sold on a national basis once having been cleared by the Commission in accordance with the regulations deemed appropriate by the Commission.[65]

The Real Estate Advisory Committee suggested that such federal regulatory legislation governing tax-shelter real estate partnerships might be patterned on the SEC's proposed Oil and Gas Investment Act,[66] which would subject tax-shelter oil and gas partnerships to comprehensive federal regulation. The Oil and Gas Investment Act is, to the extent relevant, patterned after the regulatory provisions of the 1940 Act. In addition, the Commission, in a recent release requesting comments on the National Association of Security Dealer's [N.A.S.D.] proposed tax shelter regulations,[67] indicated that it is actively considering the question of regulation at the federal level of tax-shelter partnerships. In this release the Commission stated that "information gathered by the Commission through its surveillance programs and cooperative efforts of the state authorities and N.A.S.D. indicates that additional regulation of tax shelters . . . may well be needed."[68]

The SEC release also asked for comments regarding certain policy issues raised by the N.A.S.D.'s proposal to regulate, indirectly, tax shelters. Under the N.A.S.D.'s proposed regulations,[69] its members would be precluded from selling a partnership interest unless the partnership complied with specified standards and conditions. The N.A.S.D., accordingly, would seem to be indirectly regulating the issuers of securities, as well as the distribution of securities by N.A.S.D. members. In other words, the proposed N.A.S.D. regulations appear to deal with the merits of the securities offerings of partnerships in much the same way as do state blue sky regulations, a proposal inconsistent with a basic premise of the federal securities laws from which the N.A.S.D. must seek its authority. The Commission release accordingly questioned whether the N.A.S.D.'s jurisdiction under the Maloney Act[70] was sufficiently broad to allow the N.A.S.D. to adopt regulations in the nature of blue sky regulations.[71]

The proposed N.A.S.D. regulations also raised a question under

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[65] R.E.A.C. REPORT at 34.

[66] R.E.A.C. REPORT at 4 (Oil and Gas Investment Act, S. 3884, 92d Cong., 2d Sess. (1972), *reintroduced as* S. 1050, 93d Cong., 1st Sess. (1973), as submitted by the SEC.)

[67] SEC, Securities Exchange Act Rel. No. 10260, BNA SECURITIES REGULATION & L. REP., No. 209, F-1 (July 2, 1973).

[68] *Id.* at F-4.

[69] NATIONAL ASSOCIATION OF SECURITIES DEALERS, TAX SHELTERED PROGRAMS (1973).

[70] 15 U.S.C. § 78o (1970).

[71] Note 66, *supra.*

the anti-trust laws. N.A.S.D. members would be prohibited from offering the interests of any tax-shelter partnership which did not comply with the proposed regulations. It could be argued that the N.A.S.D. members would be involved in a group boycott of non-complying partnerships.[72] While the N.A.S.D. is authorized and required to promulgate rules designed to promote just and equitable principles of trade and to protect investors and the public interest,[73] such a group boycott would violate the anti-trust laws, unless it fell within the umbrella of the N.A.S.D.'s anti-trust immunity.[74] While the N.A.S.D. and its members are immune from attack in some of their activities, the precise extent of their anti-trust immunity is unclear. The scope of an anti-trust exemption from the Exchange Act has been construed as being governed by the principles set forth in *Silver v. New York Stock Exchange*,[75] which dealt with action taken by the New York Stock Exchange [N.Y.S.E.] allegedly in fulfillment of its self-regulatory responsibilities under the Exchange Act. In *Silver*, the N.Y.S.E. directed certain of its member firms to discontinue private-wire connections with two nonmember, over-the-counter broker-dealers.[76] The Exchange offered the nonmembers no reason for the action, and it did not give prior notice or an opportunity to be heard. The nonmember broker dealers brought suit against the N.Y.S.E., alleging violation of §§ 1 and 2 of the Sherman Act.[77] The Supreme Court held that absent any justification derived from the policy of another statute, the N.Y.S.E.'s action constituted a group boycott, a *per se* violation of § 1 of the Sherman Act. It stated

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[72] *Cf.*, Silver v. New York Stock Exchange, 373 U.S. 341 (1963).

[73] 15 U.S.C. § 78o-3(b) (1970).

> An applicant association shall not be registered as a national securities association unless it appears to the Commission that —
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> . . . .
>
> (8) the rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanisms of a free and open market; and are not designed to permit unfair discrimination between customers or issuers, or brokers or dealers, to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges.

[74] 15 U.S.C. § 78o-3(n) (1970), which provides:
"[I]f any provision of this section is in conflict with any provision of any law of the United States in force on June 25, 1938, the provision of this section shall prevail."

[75] 373 U.S. 341 (1963).

[76] 373 U.S. at 344.

[77] 15 U.S.C. §§ 1 and 2 (1970).

that the Securities Exchange Act does not provide a complete exemption from the anti-trust laws, but rather that the assertion of an anti-trust claim must yield to the exemption implied by the policy of the Exchange Act in those particular instances of exchange self-regulation which fall within the scope and purpose of the statute. However, the Court noted that self-regulatory action by the Exchange will be deemed implicitly exempt from anti-trust claims ". . . only to the extent necessary to protect the achievement of the aims of the Securities Exchange Act . . . ."[78] The Court held that the Exchange's failure to give the nonmember broker dealers notice and an opportunity to be heard could not be justified as necessary to achieve the aims of the Exchange Act, and hence the Exchange's denial of private-wire connection without notice or an opportunity for hearing was not exempt from the anti-trust claim.

The Fifth Circuit, in *Harwell v. Growth Programs, Inc.*,[79] adopted this view of the N.A.S.D. anti-trust exemption. After discussing *Silver*, the Court in *Harwell* concluded "[i]t seems to us that § 78o-3(n)[80] [the N.A.S.D.'s immunity section] provides no more"[81] than does the *Silver* opinion. Thus, if *Silver* is followed, a group boycott by N.A.S.D. members of tax shelter issuers who fail to meet the N.A.S.D.'s proposed regulations will fall within the N.A.S.D.'s immunity from anti-trust barriers "only if those actions are necessary to make the statutory scheme for regulation for securities dealers work, and then only to the minimum extent necessary."[82] Accordingly, if that is the correct view, one question raised by the N.A.S.D.'s proposed regulations, insofar as they apply to the internal structure and operations of tax-shelter partnerships, is whether regulations directed to the operation, structure and management of tax shelter issuers who are not N.A.S.D. members are "necessary" to make the N.A.S.D.'s regulation of its member securities dealers work.[83]

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[78] 373 U.S. at 361.

[79] 451 F.2d 240 (5th Cir. 1971).

[80] 15 U.S.C. 78o-3(n) (1970).

[81] 451 F.2d at 247.

[82] *Id.*

[83] The scope of the N.A.S.D.'s anti-trust immunity under the *Silver* doctrine has been clarified somewhat in two recent Supreme Court opinions, *Gordon* v. *New York Stock Exchange*, 43 U.S.L.W. 4958 (June 26, 1975), and *U.S.* v. *NASD*, 43 U.S.L.W. 4968 (June 26, 1975). In *Gordon* the Court indicated that where the SEC has, and exercises, direct regulatory jurisdiction over the self-regulatory actions taken by the Exchange (unlike *Silver*, where the SEC had no statutory power to review individual disciplinary actions taken by the Exchange), anti-trust immunity will be implied, as a matter of law, to the extent that the allowance of an anti-trust suit would conflict with the SEC's jurisdiction to oversee such Exchange self-

After reviewing the comments regarding the N.A.S.D. proposed tax shelter rules, the Commission, by letter of May 6, 1974, advised the N.A.S.D. that

> With respect to those rules included in the proposal relating to the operation, structure and management of tax shelter programs, the Commission does not believe, at this time, that the Association should attempt to provide a regulatory structure which impacts, as do those rules, directly on issuers, sponsors and others which are not members of the Association.[84]

Thus, direct regulation of the operations, structure and management of tax shelter partnerships of the type proposed by the N.A.S.D. continues to be the exclusive province of the various state blue sky administrators. The Commission's May 6, 1974 letter, however, went on to note that it is not necessary to conclude that state securities commissions need carry the entire regulatory burden:

> Because of existing and potential abuses in connection with tax shelter programs, the Commission has directed its staff to continue to collect information with respect to abuses involving tax shelter programs and to formulate various proposals, including new rules or guidelines applicable to all packagers and promoters of tax shelter programs, enlarged enforcement programs and suggestions for additional legislation, for the consideration of the Commission so that it will be in a position to determine how best to provide proper regulation.[85]

Thus the Commission's question "how best to provide proper regulation" returns us to our consideration of the applicability of the 1940 Act to tax shelter partnerships. The basic approach to regulation under the securities laws, of course, has been through requiring issuers to provide full and fair disclosure and through vigorous en-

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regulatory actions. In *U.S.* v. *NASD* the Court considered that the SEC oversight jurisdiction under the Maloney Act of the self-regulatory rules and interpretations adopted by the N.A.S.D. was so pervasive as to imply, as a matter of law, immunity from the anti-trust laws for N.A.S.D. rule-making and interpretations adopted with the sanction of the SEC. These decisions emphasize the difficult policy issue faced by the SEC as a result of the N.A.S.D.'s proposed tax shelter regulations. If such regulations are necessary to make the N.A.S.D.'s regulation of its own members work, then the SEC must undertake direct regulatory oversight jurisdiction over the N.A.S.D.'s regulation of a class of issuers. The SEC would thereby be undertaking for tax shelter issuers a regulatory role similar to that of state blue sky authorities, a role the SEC has traditionally eschewed. Only in the case of investment companies and public utility holding companies, where the SEC is given specific statutory authority, has the SEC undertaken direct regulation of the internal structure and operations of issuers.

[84] Letter from SEC to Gordon S. Macklin, President, National Association of Securities Dealers, Inc., BNA SECURITIES REGULATION & L. REP., No. 256, D-1 (May 6, 1974).

[85] *Id.*

forcement of the law's anti-fraud provisions, rather than through direct Commission regulation of the operation, structure and management of issuers. An exception to this approach is found in the 1940 Act which subjects registered investment companies to direct regulation by the Commission. One reason for having adopted this approach in the case of investment companies is that investment companies typically are operated through an externalized management company which is considered a potential source for conflicts of interest. As already noted, tax shelter partnerships likewise are operated through a form of "externalized management." The Commission cited this fact in support of its proposed legislation which would subject tax shelter oil and gas partnerships to federal regulation patterned, insofar as practicable, on the regulatory provisions of the 1940 Act.[86] In exempting certain second-tier real estate partnerships, the Commission similarly has imposed conditions patterned, more or less, on the 1940 Act provisions regulating conflicts of interest. Hence, in considering how best to provide proper regulation of tax shelter partnerships, one source to which the Commission will apparently look is the existing regulatory pattern established in the 1940 Act. Should the Commission conclude that the overall regulatory problem of tax shelter partnerships requires additional legislation, the 1940 Act provisions, modified to fit the structure and method of operations of the tax shelter issuers, would provide one likely regulatory approach.

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[86] Oil and Gas Investment Act, S. 3884, 92d Cong., 2d Sess., (1972), *reintroduced as* S. 1050, 93d Cong., 1st Sess. (1973).