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Tax Sheltered Securities: Is There a Broker-Dealer in the Woodwork?

By Charles W. Murdock*

Recent developments relating to the question of "what is a security" have produced a great deal of discussion with respect to the registration requirements of the Securities Act of 1933. In Volume 25, Issue 2 of the Hastings Law Journal, Messrs. Hannan and Thomas presented an analytic framework for determining the existence or nonexistence of a "security." Charles W. Murdock extends this discussion by pointing out that the vendors of many nonconventional securities may need to be registered as broker-dealers under the Securities Exchange Act of 1934. The author focuses on those economic interests which are sold primarily as tax shelters, and discusses the applicability of the broker-dealer registration requirements in light of the policy of the 1934 Act.

Those interested in legal curiosities have no doubt been intrigued by recent developments relating to the question of "what is a security." The sale of condominiums (under appropriate circumstances) can involve the sale of a security;1 in a similar vein, the sale of lei-

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1. In SEC Securities Act Release No. 5347, January 4, 1973, [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79-163, the Commission announced that the offering of condominium units in conjunction with any one of the following will cause the offering to be viewed as an offering of securities in the form of investment contracts:
   1. The condominiums, with any rental arrangement or other similar service, are offered and sold with emphasis on the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter, from rental of the units.
   2. The offering of participation in a rental pool arrangement; and
   3. The offering of a rental or similar arrangement whereby the purchaser must hold

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sure oriented raw land may also. Even the sale of Scotch whiskey can give rise to a security. In addition, interests in orange groves, cattle breeding and feeding arrangements, beaver ranching, franchises, his unit available for rental for any part of the year, must use an exclusive rental agent or is otherwise materially restricted in his occupancy or rental of his unit. In SEC v. Marasol Properties, [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,159 (D.D.C. 1973), the court granted a permanent injunction forbidding the sale of condominium units for the primary purpose of investment rather than occupancy by the purchasers when coupled with an undertaking to arrange continuing rental of the units for the benefit of the purchasers unless the same were registered under the 1933 Act, and it further enjoined selling activity by the defendants unless registered as broker-dealers under the 1934 Act. In a somewhat related vein, see 1050 Tenants Corp. v. Jakobson, [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,177 (S.D.N.Y. 1973), where the court held that shares in a cooperative were not only securities on their face but that the total transaction also constituted an investment contract. In addition to owner occupied apartments, there was also space available for professional offices and substantial sponsor control of the project existed.

2. See McCubbrey v. Boise Cascade, Inc., [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,414 (N.D. Cal. 1972), for a summary of a complaint in which it was alleged that investments in California recreational community developments constituted a security in that the plaintiffs were investing in a common scheme from which they could expect profits without efforts on their part and through the efforts of others. According to the summary, the investors were to provide the money and the defendant corporations were to provide financing, management, development of common areas and community facilities.

In addition, the land purchase contract of the prospective buyer, when sold by the promoter to other investors, may constitute a security. See SEC v. Lake Havasu Estates, 340 F. Supp. 1318 (D. Minn. 1972).


4. One of the most frequently cited Supreme Court decisions dealing with the question of what is a security, SEC v. W.J. Howey Co., 328 U.S. 293 (1946), involved the sale of orange groves, coupled with service contracts to cultivate and manage the groves. The sale of orange groves to unsophisticated investors through high pressure selling tactics in situations where such an investment was wholly inappropriate for the investor was the subject of a recent and well publicized Commission investigatory proceeding. See American Agronomics Corp., SEC Litigation Release No. 5667 (Dec. 11, 1972).

pyramid sales arrangements⁸ and many other interests that the general practitioner might not recognize as "securities" have been held to be securities.

Many, though not all, of these nonconventional securities involve what is known as a tax shelter⁹ and because this characteristic adds


7. In a very well reasoned opinion, the Attorney General of California took the position that, under certain circumstances, the sale of a franchise could involve the sale of a security. 49 OP. CAL. ATT'Y GEN. 124 (1967). His reasoning, however, failed to persuade one court. See Mr. Steak, Inc. v. River City Steak, Inc., 324 F. Supp. 640 (D. Colo. 1970), aff'd, 460 F.2d 666 (10th Cir. 1972). Legislation in some jurisdictions has given separate protection for franchise investors. See Franchise Investment Law, CAL. CORP. CODE §§ 31000-31516 (West Supp. 1973); Franchise Investment Protection Act, WASH. REV. CODE ANN. tit. 19, §§ 19.100.010-19.100.940 (1972 Supp.).

8. The courts are looking less favorably upon a cousin of the franchise, the pyramid sales arrangement. These arrangements involve "a sales pitch which stresses the amount of money a participant can make on the recruitment of others to participate in the plan" according to the SEC. Applicability of the Securities Laws to Multi-level Distributorships and Pyramid Sales Plans, SEC Securities Act Release No. 5211, Nov. 30, 1971 [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,446 at 80,974; see SEC v. Glen W. Turner Enterprises, Inc., 348 F. Supp. 766 (D. Ore. 1972), aff'd, 474 F.2d 476 (9th Cir. 1973); State v. Hawaii Market Center, Inc., 485 P.2d 105 (Hawaii 1971). In the Glen Turner case, the court of appeals held that the expectation of profit need not come "solely" from the efforts of others but rather that the word "solely" must be construed realistically, so as to include within the definition of security those schemes which involve in substance, if not form, securities. Such reasoning could tend to undermine the River City Steak case, 324 F. Supp. 640 (D. Colo. 1970), aff'd, 460 F.2d 666 (10th Cir. 1972).

9. Tax shelters are business ventures that are so structured that "tax deductions produced by the business will flow directly to the investors who can use these deductions in offsetting taxable income from other sources." DROLLINGER, TAX SHELTERS AND TAX FREE INCOME FOR EVERYONE 1 (1972) [hereinafter cited as DROLLINGER]. Another author has discussed the nature of tax shelters as follows: "One of the incentives for an investor in such diverse areas as subsidized housing, oil and gas drilling, cattle feeding and breeding, agriculture and equipment leasing, is the tax benefits afforded thereby. Such benefits range from the simple deferment from one year to the next of payment of ordinary income taxes (as in a single cattle feeding program) to the relatively 'deep' shelter advantages involved in an oil and gas drilling program which finds vast oil reserves, permitting dramatic long-term capital appreciation on soft dollars as well as continuous annual tax-free cash payouts to the investor. 'Shelter' from tax is intended herein to cover this full range of tax benefits. 'Shelter' has also been used to refer narrowly to the effect of depreciation deductions in 'sheltering' from tax the cash flow from operations until the 'cross-over' point. We shall treat 'shelter' in this sense as well." R. HAFT, TAX SHELTERED INVESTMENTS Intro. 1 (1973) [hereinafter cited as HAFT].

Every tax shelter does not involve a security. As a simple example, if a doctor
another dimension to the sale of securities, this article will concern itself primarily with the sale of such securities.

The focus of discussion with respect to these nonconventional securities has been primarily on the Securities Act of 1933 (1933 Act): If the sale of a security involves the use of interstate facilities, the securities must be registered unless the securities are exempt or the transaction is exempt from registration. A prima facie case under section 12(1) of the 1933 Act is established simply by showing that (1) a security has been sold, (2) interstate facilities were involved, and (3) the securities were not registered. The appropriate remedy is recission or its equivalent. Thus, an after-the-fact, or more precisely "after-the-sale," determination that a particular interest is a security has rather untoward consequences. In effect, the buyer is given a "put" if he acts within the one year statute of limitations.

In one publicized incident, the seller of investment condominiums in Hawaii was required to make an offer of rescission to 152 purchasers, to refund over $200,000 and to resell forty-eight previously sold units.
Impact of the 1934 Act

Once an economic interest is deemed to be a security, problems arise not only with respect to registration of the security under the 1933 Act but also with respect to the multi-faceted provisions of the Securities Exchange Act of 1934 (1934 Act). While certain provisions of that act, such as the registration requirements of section 12, will generally not be applicable in connection with the sale of tax sheltered securities, other provisions of the act not only will be applicable but will have some very unpleasant consequences, at least when seen through the eyes of the members of the tax shelter industry. Thus, vendors of tax sheltered securities may well need to be registered pursuant to section 15 of the 1934 Act and subject to the reporting requirements of section 17; moreover, the extension of credit on such securities may well be subject to the strictures of sections 7 and 11(d)(1) of the act. In addition, if interstate instrumentalities are used in connection with the sale, the antifraud provisions of section 10 and Rule 10b-5 may come into play. The scope of

18. Section 12 of the 1934 Act, 15 U.S.C. § 78l (1970), generally provides that it is unlawful for a member of an exchange or a broker or a dealer to effect a securities transaction on a national securities exchange unless the security is registered on such exchange. Section 12 also provides that with respect to a security which is not registered on an exchange, an issuer with total assets exceeding one million dollars and a class of equity security held of record by 500 or more persons shall register such security with the Securities and Exchange Commission.

[T]he time, cost and problems attendant to condominium registration with the Securities and Exchange Commission alone were considered by most participants at the conference as extremely burdensome on a condominium development. The licensing requirements of broker-dealers for sale of the investment contract package were also considered very detrimental to developers of condominium projects. Finally, the restrictions placed on advertising by the Securities Act of 1933 because of the investment contract aspects of rental condominium offerings were viewed as unreasonable restraints upon the marketing and promotion of what is predominately a real estate interest." Schwartz, supra, at 33.
22. 15 U.S.C. §§ 76g, k(d)(1) (1970); see Haft, supra note 9, at § 2.05[2]; Schwartz, supra note 10, at 443.
this article will be limited to a consideration of the impact of section 15 once a particular economic interest is classified as a security.

The Scope of Section 15

Section 15 requires the registration of any broker or dealer selling any security, with certain specified exceptions, assuming, as will almost invariably be the case, that the broker or dealer uses interstate instrumentalities to effect or induce the sale.24

The first exception relates to the conduct of a business which is "exclusively intrastate." In many circumstances involving the sale of tax sheltered securities, this exemption clearly will not be available. In addition to the fact that the exemption is construed very narrowly,25 the sale of tax shelters often involves an issuer located in one state selling to an investor located in another. For example, in the sale of investment condominiums, the condominium is normally located in a recreational area (e.g., Hawaii, Lake Tahoe, Colorado Springs), whereas the investor is located in a major metropolitan area. If the condominium were located close at hand, the investor probably would not need to enter into a rental pooling arrangement which is the factor converting the condominium from a mere real estate investment into a security.26 Since the policy underlying the intrastate exemption for brokers or dealers is analogous to that underlying the intrastate exemption with regard to the registration of securities—local financing of local businesses by local citizens is not within the purview of federal regulation—any interstate activity by the broker or dealer will destroy his exemption.27

24. As the Commission's staff has stated, "the type of conduct deemed to involve the use of jurisdictional means are quite broad. Thus, for example, the use of the mails at any stage of a securities transaction to transmit a purchase agreement [Schoenbaum v. Firstbrook, 405 F.2d 200 (2nd Cir. 1968)] or a confirmation [U.S. v. Wolfson, 405 F.2d 779, 784 (2nd Cir. 1968)] would be sufficient and, specifically for purposes of section 15 of the Act, the use of the mails, a telephone or other facilities of interstate commerce at any integral step in the course of inducing the purchase or sale of a security would involve the utilization of the jurisdiction means [Roe v. U.S., 316 F.2d 617 (5th Cir. 1963)]." Hoare & Co. v. Govett, Ltd., SEC Div. Mkt. Reg. No-Action Letter (Sept. 28, 1973).

25. As Mr. Haft has stated, "[T]his exemption is as illusory as the intrastate exemption under the 1933 Act . . . . [T]he administrative interpretations of this exemption have effectively eliminated the exemption in most instances." HAFT, supra note 9, § 2.05[1], at 2-22 to -23.

26. See note 1 supra.

27. As Ezra Weiss has stated: "Manifestly, the 'exclusively intrastate' business exemption is based on the local and limited character of the broker's or dealer's business. The term 'exclusively' is therefore given its literal meaning." E. WEISS, REGIS-
The second exemption relates to the sale of an "exempted security" or commercial paper. Section 3(a)(12)\(^{28}\) of the Act enumerates various securities which are classified as "exempt" and goes on to authorize the Securities and Exchange Commission (the commission),\(^{29}\) to exempt other securities "either unconditionally or upon specified terms and conditions or for stated periods" from the operation of any one or more sections of the statute which do not, by their terms, apply to exempted securities. Since section 15 provides for such exemption, it would be possible for the commission to treat tax sheltered securities as exempt securities for purposes of section 15 and thereby to eliminate the need for registration of those who limit their broker or dealer activity to such securities. To date, however, the commission has not so acted.\(^{30}\)

The last exemption deals with securities which are traded on a national securities exchange. With the exception of real estate investment trusts, there is little after market activity in tax sheltered securities and accordingly this exemption is of little significance in the present context.\(^{31}\)

In addition to the exceptions set forth in section 15(a)(1) of the Act, section 15(b)(2) permits the commission, by rule, reg-

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\(^{29}\) The Securities and Exchange Commission was created pursuant to section 4 of the 1934 Act, 15 U.S.C. § 78d (1970).

\(^{30}\) An example of exemptive action by the Commission is found in SEC Rule 3a-12-1, 17 CFR § 240.3a-12-1 (1973), in which mortgages, as defined in section 302(d) of the Emergency Home Finance Act of 1970, 12 U.S.C. §§ 1451 et seq., which have been sold by the Federal Home Loan Mortgage Corporation are exempted from the operation of such provisions of the Act which by their terms do not apply to exempted securities.

Because of the extension of credit problems created by sections 7 and 11(d)(1) of the 1934 Act, 15 U.S.C. §§ 78g, k(d)(1) (1970), the Commission may in the future exempt tax sheltered securities. See Schwartz, supra note 10, at 443. This would also have the effect of exempting brokers who limit their business solely to the distribution of tax sheltered securities from registration pursuant to section 15 and thereby remove them from the coverage of the Securities Investors Protection Act. Whether that Act ought to apply to vendors of tax sheltered securities is debatable.

ulation or order, to exempt a particular broker or dealer, or a class of brokers or dealers, from the registration requirements of section 15(a)(1) "either unconditionally or upon specified terms and conditions or for specified periods." But, once again, the commission has not taken any action with regard to the sale of tax sheltered securities

The Policy Considerations

With the foregoing perspective in mind, the question of the distribution of tax sheltered securities can now be considered from a policy standpoint. This requires an analysis of the role played by the various intermediaries in the course of the investor ultimately acquiring a tax sheltered security, and an examination of the policy reasons underlying the registration process, in order to determine who ought to be registered as a broker-dealer and whether the commission should exercise its exemptive power, either conditionally or unconditionally. The first step, of course, must be an examination of the legislative purpose in providing for registration of brokers and dealers.

The Purpose of Registration

The statutory and regulatory scheme with respect to the registration of brokers and dealers is aimed at insuring their character, competence and financial stability. In the 1963 Report of Special Study of Securities Markets of the Securities and Exchange Commission, it was stated:

More than a generation of experience with the Federal securities laws has demonstrated, moreover, that it is impossible to regulate effectively the conduct of those in the securities industry, unless would be members are adequately screened to the point of entry . . . . The right to carry on those functions of the industry which involve the public investor should be available only to those who shall have demonstrated their ability to meet at least minimal standards of integrity, competence, and financial responsibility. In his transmittal letter to Congress, enclosing the first part of the Special Study, Chairman Cary, in discussing the weaknesses brought to light by the Special Study, stated:

The report begins where regulations must begin—the point of entry into the business. It is self-evident that the standards of conduct of the securities industry are vitally dependent on the integrity and competency of its personnel. Obviously, no system can be

33. Id. pt. 1, at 150.
devised which eliminates all potential wrongdoers. But the Report of the Special Study concludes that the minimal controls furnished by existing regulations are inadequate. Notable ease of entry is apparent under both Federal law and rules of the National Association of Securities Dealers, Inc., the self-regulatory agency for the over-the-counter market. With the exception of the major exchanges, significant standards of character, competence, and minimal capital have not been generally imposed. . . . Furthermore, certain sectors of the industry, including most importantly certain distributors of mutual fund and real estate securities and also investment advisors, are not subject to the discipline of self-regulation.34

The response of Congress was the extensive amendments adopted in 1964.35 While the 1964 amendments also dealt extensively with the regulation of securities traded in the over-the-counter market, both the Senate and the House Reports accompanying the respective bills recognized that the quality of selling practices was a co-equal concern. The Senate Report stated that one of the two principle purposes was to "strengthen the standards of entrance into the securities business, enlarge the scope of self-regulation, and strengthen disciplinary controls over brokers, dealers, and their employees,"36 while the House Report stated that one of the two major purposes was to "strengthen qualification standards and disciplinary controls with respect to securities industry personnel, particularly those engaged in the over-the-counter market."37

It is thus clear that an essential thrust of the securities laws is to insure that the investing public deals with qualified personnel in the course of making and consummating an investment decision.

Policy Considerations in the Sale of Tax Sheltered Securities

The question may then be raised as to whether these concerns are of any less import in connection with the sale of tax sheltered securities or, conversely, whether the general policy of insuring that the sales effort in connection with the sale of securities is conducted by persons of high integrity and competence is all the more important when dealing with the subject of tax sheltered securities. A consider-

34. Id. pt. 1, at v.
35. Securities Acts Amendments of 1964, Act of Aug. 20, 1964, Pub. L. No. 88-467, 78 Stat. 565. The preamble to the Act states that its purposes are "to extend disclosure requirements to the issuers of additional publicly traded securities, to provide for improved qualification and disciplinary procedures for registered brokers and dealers, and for other purposes."
ation of the nature of tax sheltered securities indicates that the latter consideration is the operable one.

The Nature of a Tax Sheltered Security

The term "tax shelter" encompasses a broad spectrum of which tax sheltered securities comprise only a part.\(^{38}\) Encompassed within the ambit of tax sheltered securities are a wide variety of economic interests ranging from real estate investments (both subsidized and unsubsidized), oil and gas programs, equipment leasing programs, "farming" activity (including both livestock and crops) and even more exotic activities among which are investments in movies, plays and Scotch whiskey.\(^{39}\)

In discussing tax sheltered securities, each commentator invariably is constrained to point out that such securities typically involve a higher degree of risk than other types of investments.\(^{40}\) Failure to appreciate the nature of tax sheltering may cause investors to "learn to their sorrow that what is represented to them to be a tax shelter may in fact be a tax trap."\(^{41}\) It has been stated: "Effective tax sheltering requires matching the tax characteristics of the investors with the tax characteristics of the investment. Both sets of characteristics are complex, and they interrelate in complicated and sometimes surprising ways."\(^{42}\)

The Special Study itself recognized that in the late 50's there was a significant change toward more speculative ventures in the nature of

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\(^{38}\) See note 9 supra.

\(^{39}\) Extensive discussion of each of these forms of tax shelter is found in DROLLINGER, supra note 9 and HAFT, supra note 9. See also HOW TO USE TAX SHELTERS TODAY (I. Schreiber, ed. 1973) [hereinafter cited as Schreiber].

\(^{40}\) One attorney who has viewed tax sheltered investments from the vantage point of attorney for the syndicator, as well as attorney for the investor and as an investor himself, has stated: "A lot of people buy tax shelter who have no business doing so. Tax sheltered investments, by and large, have a significantly higher degree of risk than ordinary investments. One has to be able to benefit substantially from the tax benefits to offset the risk. Therefore, I would not recommend a tax sheltered investment (other than a REIT) to anyone in less than a 50% income bracket." Pircher, TAX SHELTERED INVESTMENTS: WHAT, WHO, WHEN AND WHICH? 28 Bus. Law. 897, 913 (1973). Another commentator has stated: "Any person who seeks to invest in a tax shelter deal solely for the tax benefits is bound to lose. Obviously, the greater the tax shelter, the less the need for underlying investment value, but the transaction must in all events make substantial business and economic sense. Even an investment in federally subsidized housing with its extremely advantageous tax benefits will turn into an absolute nightmare if the project does not make sound real estate sense." HAFT, supra note 9, at Intro-3. See text accompanying notes 41 & 42 infra.

\(^{41}\) Calkins & Updegraft, Jr., Tax Shelters, 26 TAX LAW. 493 (1972-1973).

\(^{42}\) Id. at 493-94.
the tax shelters being sold to the public, at least in the area of real estate syndication:

Securities offered to the public in early years of syndication largely represented ownership of office buildings and apartment buildings. As the success of the early ventures generated more and more competition for properties available for syndication, syndicators turned from office buildings and residential properties to commercial and industrial properties, to hotels, motels, bowling alleys, shopping centers and to properties not already constructed.\(^4\)

This trend has continued in the late 1960's and early 1970's and now encompasses the development of recreational areas and resort properties.\(^4\) The Special Study recognized that in these situations the investor's risks are substantially increased as contrasted to the security afforded when the investment consists of prime commercial or residential property, particularly when secured by long term leases from triple A tenants.\(^4\)

The risks of tax sheltered securities are extenuated by the fact

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44. Schwartz, *supra* note 10, at 26-27. The fine tuning necessary in connection with the sale of tax sheltered securities is well illustrated by one of the more recent phenomena, investment condominiums. Developers of resort properties have hit upon the concept of condominiums as a mechanism for financing the development of properties that otherwise might not be economically feasible to develop. The resort property is constructed with the intention of selling the units to a large number of investors, each of whom will procure his own financing and bear the economic risk of the enterprise, thereby permitting the promoter to walk away with the construction profit, free of any long term liability and yet to retain an essentially riskless interest in the enterprise through a management contract with the individual investors associated together.

Looking at the transaction from the vantage point of the investor, the purchase of the condominium is one which is normally not justified on the basis of individual use; nor would it be justified on the basis of the potential economical return flowing from participation in a rental pooling agreement covering the period when the investor is not making personal use of his property; nor is the "tax shelter" alone sufficient to justify the investment. It requires the coalescence of these three factors to produce the justification for the investment. If any of these factors, all of which are high risk, fail to materialize, the investor will be disenchanted, to say nothing of his out of pocket loss. For example, see the discussion in SEC Registration No. 2-46702, Resort One, at 3-5. *See also* Schreiber, *supra* note 39, at 104-05.

In KAIC-I, SEC Registration No. 2-48126 at 24, it is pointed out that at 15% occupancy the investor would lose approximately $1,500 but with 30% occupancy the investor would obtain an after tax net cash flow at a break even point. However, if there is a determination by the IRS that the ownership and operation of the unit is not actively engaged in for profit, tax benefits are lost, the after tax net cash deficit at a 15% occupancy rate would be almost $3,000 and at a 30% occupancy rate would now be a deficit of almost $1,400.

that there is little after-market activity in such securities. This is in part due to the fact that the value of the security is a function of the shelter provided which, in turn, is constantly changing over time. Moreover, the rate of depreciation itself may change when the "security" changes hands, losing its character as new construction and thereby being subject to the more restrictive rules dealing with used properties. The Special Study also recognized this problem as one pointing toward the need for increased investor protection:

While limited partnership interests are generally transferable (usually subject to the consent of the general partners), as a rule there is no market for such interests after their original distribution. An investor who wishes to dispose of a limited partnership interest occasionally may do so through the original syndicator or underwriter, who will act as his agent in placing the interest for a brokerage commission, but there is no general over-the-counter trading in such interests. Indeed, the tax complexities involved in such interests make valuation for trading purposes highly difficult, since the extent of the 'tax shelter' constantly changes with amortization payments and depreciation deductions.

More recently, the 1972 Report of the Real Estate Advisory Committee summarized the risks involved in the sale of real estate tax sheltered securities as follows:

An analysis of the risks inherent in the real estate limited partnership security, therefore, must take into account the lack of liquidity and necessarily long term investment which it affords. Some other risks inherent in this type of security include: pos-

46. See Calkins & Updegraft, Jr., Tax Shelters, 26 Tax Law. 493, 507-08 (1972-1973). The authors state: "A basic rule is that an investor should never invest in a long-term leverage shelter without insisting on reviewing the arithmetic through the entire term of the investment, showing the consequences if the property should be sold, or the nonrecourse obligation foreclosed, at various dates. Normally, this arithmetic will show a substantial tax liability arising in a future year. This liability, discounted to present value, must be considered in evaluating the economic merits of the proposed investment. Sophisticated shelter proposals will indicate the amount of funds the investor should set aside in what we call a payback sinking fund, for instance in tax exempts, so as to have the cash with which to pay the taxes due in the future." Id. at 508.

47. See HAFT, supra note 9, at § 1.06[5]: "[A] 'sale or exchange' of fifty percent or more of the total interest in the partnership capital and profits within a period of twelve consecutive months will cause a termination of a partnership for federal tax purposes. In such event, a partnership's right as 'first user' to avail itself of the double declining balance method for computing its allowance for depreciation is terminated and the 'successor' partnership is limited to computing its allowance for depreciation under the 125 percent declining balance method."


49. See Dickey Report, supra note 31.
sible changes in the federal tax laws or regulations or interpretations thereunder; the investor's inability to stay in a certain tax bracket; development or construction cost overruns; operation losses caused by delayed rent up or subsequent vacancy factors; financial capabilities of users (particularly in government subsidized housing projects); specialized management problems; rise in operating expenses; limited partners' inability to participate in management decisions; partnership for tax purposes ceases under certain events; transferability limitations; and tax consequences in the event of foreclosure or other disposition.

In addition, the Real Estate Advisory Committee devoted an entire section to the conflicts of interest that often inhere in real estate syndication and which, in part, stem from the many roles which the syndicator or those affiliated with him may assume, such as builder, underwriter, manager, mortgage broker, insurance agent or lawyer.

In view of the foregoing, it is clear that the general policy concern that investors be serviced by qualified sales personnel is heightened when the security in question involves a tax shelter. The only countervailing consideration would be the argument that purchasers of tax sheltered securities are more sophisticated and thus are better able to fend for themselves in the transaction; the need for competency and integrity on the part of the salesman in the transaction is thereby reduced. With a record that is replete with examples such as the sale of orange groves to persons retired and living on Social Security pensions, this argument simply does not hold water.

50. Id. at 11.
51. Id. at 40-46.
52. American Agronomics Corp., SEC Litigation Release No. 5667 (Dec. 11, 1972). With respect to this litigation, former Chairman Casey has stated: "Over emphasis on tax factors produces unhappy consequences. With disconcerting frequency tax sheltered deals in real estate, oil, gas, cattle, [and] citrus fruits are being sold to widows, retired people, and other persons of modest means who desperately need ordinary income and for whom such adventures are usually unsuitable. That, of course, is more than a disclosure problem. It is a selling practice problem. The SEC and the securities industry's own organizations have been trying valiantly for decades to elevate the ethical standards of those who sell securities and to make their trade the profession that it ought to be. Without depreciating what has been done along this line, I find myself constrained to observe that marketing practices in the tax shelter field reveals how much remains to be done.

The point is much on my mind at the moment. Perhaps that is so because of one pending case in which tax-sheltered agricultural deals were sold (sold fraudulently and deceptively, we at the Commission think) to substantial numbers of people whose circumstances were so very modest as to render the concept of tax shelter ludicrous. Some of these people were actually at the poverty level, although they did happen to have small amounts of capital that belonged in savings banks not in risky and sophisticated packages originally tailored for persons who could afford to bear losses with equanimity. Fortunately, it appears that the Commission's efforts will result in some measure of restitution. Schreiber, supra note 39, at 104.
Status of Participants in the Distribution of Tax Sheltered Securities

At the risk of oversimplification, there are essentially three categories of participants involved in the distribution of tax sheltered securities: (1) The promoter or issuer, its employees, and those affiliated with it; (2) Professional securities personnel subject to the self-discipline of the NASD\(^53\) or SECO\(^54\) and (3) Members of the real estate brokerage community or other professional sales personnel not regulated within the securities industry. Considerations involved with the status of the first category will receive the primary emphasis in this article; however a brief word on the second and third categories is in order.

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53. "NASD" refers to the National Association of Securities Dealers, Inc., the only association of brokers or dealers which has registered with the Commission pursuant to the authority of section 15A of the 1934 Act, 15 U.S.C. § 78o-3 (1970). In order for an association to be allowed to register with the Commission, it is necessary that: "[t]he 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 in the public interest, and to remove impediments to and perfect the mechanism of a free and open market . . . ." Section 15A(b)(8), 15 U.S.C. § 78o-3(b)(8) (1970). In addition, it must appear that: "(9) the rules of the association provide that its members and persons associated with its members shall be appropriately disciplined, by expulsion, suspension, fine, censure, or being suspended or barred from being associated with all members, or any other fitting penalty, for any violation of its rules. (10) the rules of the association provide a fair and orderly procedure with respect to the disciplining of members and persons associated with members and the denial of membership to any broker or dealer seeking membership therein or the barring of any person from being associated with a member." Securities Exchange Act of 1934 § 15A(b)(9)-(10), 15 U.S.C. § 78o-3(b)(9)-(10) (1970).

54. "SECO" is the abbreviation for Securities and Exchange Commission Only. In other words, it refers to those brokers or dealers who are not members of the NASD and who, prior to the 1964 amendments to the 1934 Act, were not subject to self discipline. At present, section 15(b)(8) of the 1934 Act, 15 U.S.C. § 78o(b)(8) (1970), provides that a broker or dealer who is not a member of the NASD shall not engage in the securities business "unless such broker or dealer and all natural persons associated with members and the denial of membership to any broker or dealer seeking membership therein or the barring of any person from being associated with a member." Securities Exchange Act of 1934 § 15(b)(9)-(10), 15 U.S.C. § 78o-3(b)(9)-(10) (1970).
Self Regulation by the NASD in the Tax Shelter Area

On May 9, 1972, the NASD published for comment an informal proposal to amend its "Rules of Fair Practice" so as to establish standards in connection with the distribution of tax shelter securities by NASD members. The proposed rules, which run over fifty pages in length, cover a broad spectrum. In particular, the proposed rules would require a minimum amount of experience and expertise by NASD members who would sponsor a tax sheltered program, a favorable tax ruling or opinion of independent counsel as to the tax benefits of the program, a stringent suitability standard, a disclosure mandate for sales literature, and inhibitions against conflicts of interest. With respect to suitability, a customer considering a high risk investment would need to be in a 50 percent tax bracket and would need to have a sufficient net worth to be able to sustain possibility of loss of the investment. With respect to sales literature, it would be required that the literature include a statement of the factors relevant to the suitability of the security and an accurate statement of the tax aspects of the program.

While these rules have not as yet even been formally proposed so as to precipitate a position by the Securities and Exchange Commission, they indicate a professional view as to the appropriate standards in connection with the sale of tax sheltered securities. Moreover, the investor who deals through an NASD member is already protected by

55. In addition to the May 9, 1972 proposed revision which would have the effect of adding article III, section 33 to the rules of fair practice, there has also been a September 18, 1972 and a March 19, 1973 revision. The NASD proposals are contrasted with the present New York law in Haft, supra note 9, at App. -55 to -58. The proposals are also discussed in the Dickey Report, supra note 48, at 24-35. The Dickey Report, in a series of tables contrasts the NASD proposed rules with those proposed by the Midwest Securities Commission Association and the California Department of Corporations, as well as with the present New York law.

56. The text of the proposed rules is available at the Securities and Exchange Commission's Public Reference Room or from the NASD itself, 1735 K Street, N.W., Washington, D.C. 20006. See note 55 supra.

57. Section 15A(j) of the 1934 Act, 15 U.S.C. § 78o-3(j) (1970), provides that every registered securities association shall file any modifications to its rules and that such rules shall become effective upon the 30th day after filing with the Commission unless the Commission would enter an order disapproving such change or addition. The proposed rules referred to in note 55 supra have not as yet been formally proposed, but it is expected they will be shortly.

One of the concerns with the proposed rules is that they in effect deal with the merits of the security and thus, by excluding NASD members from participating in the distribution of securities which do not meet the standards of the rules, embody a demarcation from the general thrust of the federal securities laws to require disclosure but not to go to the merits of a security.
the training and supervision requirements of the NASD rules and the obligation to consider the suitability of the investment for the client.\textsuperscript{58}

The Role of Real Estate Brokers

At present, tax sheltered securities are often sold through the medium of real estate brokers (or other professional salesmen without a securities background) who are either responsible for consummating the transaction or who act as “finders” in the transaction.\textsuperscript{59} If a promoter of tax sheltered securities sells such securities through a real estate broker, it would seem clear that such individual should be registered as a broker-dealer under the 1934 Act.\textsuperscript{60} Even if his role is only that of “finder,” the commission has generally taken the position that, if the finder does anything more than merely introduce the parties, he also should be registered.\textsuperscript{61} This conclusion is mandated not only by the need of the public for control over the character and competency of the sales representatives with whom it deals, but also as an insurance that the regulatory scheme operates evenhandedly. In

\textsuperscript{58} See, e.g., NASD Bylaws, art. I §§ 1, 2 & Schedule C, NASD Manual ¶ 1101-02A; NASD Rules of Fair Practice, art. III § 2, NASD Manual ¶ 2152. See notes 53 & 54 supra.


\textsuperscript{60} Id.; see Haystack Hotel Assoc. Inc., SEC Div. Tr. & Mkt. No-action Letter (Feb. 16, 1971), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,049. But see Dart Industries, SEC Div. Tr. & Mkt. No-action Letter (Mar. 9, 1972), discussed in Schwartz, supra note 10, at 439-40. One commentator has stated: “Thus, the broker/dealer definition net is broad enough to encompass general partners of limited partnerships who act as such with a reasonable degree of frequency and who offer limited partnership interest therein to others, and ‘real estate brokers’ under certain circumstances.” Haft, supra note 9, § 2.05[1], at 2-22.

With respect to other professional persons, Ezra Weiss has stated that problems could arise where broker-dealers “circulate invitations to attorneys and accountants, upon the inducement of a commission, to sell to their clients the securities being offered by such broker-dealers [since] acceptance of these proposals would result in the accountants and attorneys becoming engaged in the business of effecting transactions in securities for the account of others, and thereby becoming brokers.” Weiss, supra note 27, § 1-2, at 7.

other words, the securities broker-dealer community would be competitively disadvantaged if it were subject to constraints that did not apply to others involved in the distribution of tax sheltered securities.

The argument has been made that, since real estate brokers are subject to state licensing requirements, they should not also be subject to federal regulation as broker-dealers. Such an argument is not persuasive. Members of the securities industry are subject to dual regulation, both state and federal and, while registration might be particularly onerous for the small real estate broker, it is equally so for the small securities broker-dealer. Moreover, it is unlikely that a small real estate broker would be chosen to distribute tax sheltered securities.

It is assumed, without research, that the quality of real estate licensing differs from state to state. In addition, it can hardly be gainsaid that examination designed to measure the competency to sell residences is at all relevant or adequate when the product is a tax sheltered security. As discussed above, it is particularly important to the investing public that the purveyors of these securities should have a special competence with respect to their special characteristics and should be aware of the concepts of fraud and fiduciary responsibility which exist in the securities industry and which arguably are a cut above that which prevails, as a general rule, in the real estate industry. One can look in vain in the real estate field for anything even comparable to the commission and NASD proceedings disciplining securities broker-dealers for unethical selling activities.

If the generalized securities examination for broker-dealers is in part irrelevant for those real estate brokers who limit their activities in

62. See Schwartz, supra note 10, at 34-35. See also the Dickey Report, supra note 48, which recommended: "Licensed real estate brokers and salespersons and/or those otherwise exempt under local law from licensing as real estate brokers or salespersons should be exempt from the broker-dealer reporting and regulatory requirements under the 1934 Act where their sales of real estate securities are limited to interests in condominiums and cooperatives." Id. at 75.

63. See text accompanying notes 38-52 supra.

64. See, e.g., NASD MANUAL 701 et seq. In addition, almost any issue of the Wall Street Journal will note disciplinary action by either the NASD or the Commission. See, e.g., Wall Street Journal, Dec. 31, 1973, at 2, col. 2; id., Jan. 24, 1974, at 30, col. 2. The absence of attendant publicity in the real estate field might indicate that the character of real estate salesmen exceeds that of securities salesmen. One can form his own conclusion on this point.

It is interesting to note, however, that the Office of Interstate Land Sales Registration has found it necessary to adopt new and stronger regulations governing disclosures as a result of public hearings last year which revealed numerous instances of false and misleading sales activity. See id., at 30, col. 1.
the securities field to tax shelters, then the solution is to tailor an appropriate examination rather than to eschew regulation. As the Special Study stated:

Any licensing program should recognize, to the extent not found at present the different competence needs of salesmen of different types of securities . . . . It should be possible to establish a licensing system permitting a person to sell a particular type of security upon demonstration of his competence to sell it, but at the same time limiting his activities to that type of security.65

There is, however, one situation in which real estate brokers should be permitted to sell tax sheltered securities and that is in connection with isolated sales by the original purchasers. Since there is no formal aftermarket for tax sheltered securities66 and since no concentrated selling effort by a promoter will attend a resale by the original investor, the regulatory process should not lock him into his investment by restricting the limited opportunity he will have to dispose of his investment.

**Status of the Issuer, Its Employees and Affiliates**

The most troublesome area with respect to registration requirements in connection with the sale of tax sheltered securities involves the status of the issuer and its employees and affiliates. The conventional wisdom is that the issuer need not be registered as a broker-dealer because of the so-called "issuer's exemption" and that, as a concomitant to the issuer's exemption, employees need not register since the issuer, at least if it is organized under the corporate form, can only act through its agents. Thus, the issuer's exemption would be meaningless if its employees also were not exempt.

It would appear, however, that in connection with the sale of tax sheltered securities, logic and policy might indeed dictate that the issuer, besides registering the securities it is promoting, should also be registered as a broker-dealer or that, failing to persuade on that point,

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65. Special Study, supra note 32, pt. 1, at 157. The Special Study also stated: "[E]ven a sophisticated investor may have difficulty in evaluating the tax aspects of an offering, or the factors of risk and promoters' benefits, and the best investment analysts and counselors have little if any expertise in the real estate securities field. . . . There is substantial evidence that many unqualified persons engage in selling real estate securities. In the discussion of qualifications for entry into the securities business the conclusion has already been indicated that salesmen of real estate securities should be within the licensing requirements there outlined, and that the suggested testing requirements take account of the special attributes of real estate securities." *Id.* at 588.

66. See text accompanying notes 46-48 supra.
as a bare minimum the employees of the issuer should be obliged to register—as should any subsidiary organized by the issuer for purposes of carrying on the selling activity.

Status of the Issuer—Form

In point of fact, there is no express statutory exemption from registration as a broker-dealer for the issuer. Rather, the so-called “issuer’s exemption” proceeds implicitly from an examination of the definition of broker in section 3(a)(4) and the definition of dealer in section 3(a)(5) of the 1934 Act. Broker is defined to mean “any person engaged in the business of effecting transactions in securities for the account of others,” whereas dealer is defined to mean “any person engaged in the business of buying and selling securities for his own account . . . but does not include . . . any person insofar as he buys or sells securities for his own account . . . but not as a part of a regular business.”

Thus, arguably, an issuer is not a broker because it effects transactions in securities for its own account, not for the account of others, nor is it a dealer because, though it sells securities for its own account, it does not buy such securities and the act appears to require that to be a dealer one must both buy and sell. Moreover, most issuers also would be outside the definition of dealer because they do not sell securities as a part of a regular business.

The foregoing interpretation finds solid support. Ezra Weiss, former Chief Counsel of the commission, has stated that “[c]ontrasted with the activity which might render a person a broker acting on behalf of others, a dealer’s activity must include both the buying and selling of securities.” Professor Loss has stated that “even if it [an issuer] is considered to be engaged in the ‘business’ of selling securities, [it] does not do any buying as required by the definition.” In his 1969 supplement, Professor Loss goes even further and states:

By contrast, one of the consequences of the ‘buying and selling’ phrase in the definition of ‘dealer’ is that, in the light of the non-applicability of the definition of ‘security’ to entire oil or gas leaseholds . . . a promoter who buys an entire leasehold (or enters into a lease himself) and then creates and sells fractional inter-

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69. Weiss, supra note 27, § 1-1, at 3.
70. 2 L. Loss, SEcurITIES REGulation 1298 (2d ed. 1961), (Supp. 1969) (emphasis in original).
TAX SHELTERED SECURITIES

ests is only selling securities, not buying them, and hence need not register as a dealer.71

The foregoing comments of Mr. Weiss and Professor Loss relate to the question of whether the issuer can be a dealer; they do not consider the question of whether an issuer can be a broker, apparently on the basis that it is self-evident that the issuer is acting for itself and not for the account of others.

Status of the Issuer—Substance

With due deference to the statutory definitions and the commentary thereon by Mr. Weiss and Professor Loss, it is nonetheless submitted that in many instances the conventional wisdom is wanting when applied to a consideration of the distribution of tax sheltered securities. By way of contrast, the normal corporate issuer is engaged in business activity to which the sale of its securities is merely ancillary; in other words, it sells its securities to procure the capital base from which to carry on its business activities. Moreover, the securities which it sells involve a proprietary (or creditor) interest in itself. On the other hand, the issuer of a tax sheltered security is often a promoter whose primary business it is to “create” such securities and to distribute the same to the public. Moreover, the securities sold provide an equity interest, not in the issuer itself, but in some third party entity.

A few examples may help illustrate the foregoing point. Quite often, the business of a general partner in a real estate limited partnership consists in large part of finding investment properties and forming limited partnerships to own them.72 The same holds true with respect to the developer of investment condominiums who, on a recurring basis, constructs projects in resort areas and sells the condominiums, together with a rental pooling management contract, to investors.73 In a slightly different vein, the promoter of cattle breeding or feeding programs is continually assembling herds of cattle and selling the same overlaid with a management contract.74 Accordingly,

71. 5 L. Loss, Securities Regulation 3355 (Supp. 1969) (emphasis in original).


not only is a principal business of the issuer that of selling securities, but also the securities sold carry with them no proprietary interest in the issuer itself but rather in the third party entity which the issuer has created. In other words, the security in question is the product of the issuer rather than a proprietary interest in the issuer.\textsuperscript{75}

The question then arises as to where this line of reasoning would take us. If the definition of "dealer" were "any person engaged in the business of effecting transactions in securities for his own account" (the approach taken in the Uniform Securities Act),\textsuperscript{76} it would seem quite clear that the typical promoter-issuer of tax sheltered securities would fall within the ambit of this definition. Unfortunately, this is not the definition used in the 1934 Act. Thus, if we are to require registration of such an issuer as a broker or dealer, we must either (1) find such activity as would constitute the buying of a security so as to make him a dealer or (2) find another entity in the transaction such that it can be said that the promoter-issuer is acting for the account of such other entity.

\textit{The Issuer As a Dealer}

As previously stated, the difficulty with suggesting that the issuer may also be a dealer is the fact that the statutory definition of dealer in the 1934 Act speaks of one who both buys and sells securities. While the promoter-issuer in the tax sheltered area will be selling securities, difficulty arises with the question of whether or not he "buys" securities.

Notwithstanding Professor Loss' example in which he suggests that the purchase of an entire lease-hold which is then fractionated does

\begin{footnotes}
\item[75] In the Dickey Report, it was stated that it was not necessary for the prospective investor that the financial statements of the developer and/or promoter be audited since "the purchaser is not acquiring an interest in the developer and/or promoter, but, on the contrary, is acquiring the product itself." Dickey Report, \textit{supra} note 48, at 86.
\item[76] Section 401 (c) of the Uniform Securities Act defines a broker-dealer to mean "any person engaged in the business of effecting transactions in securities for the account of others or for his own account." The definition goes on, however, to exempt an issuer. The draftsmen's commentary to section 401 (c) recognizes that many states require an issuer selling its securities without the intervention of the broker-dealer to register as a broker-dealer itself. However, since the security must be registered and since an employee of the issuer who sells securities for the issuer must be registered as an agent under section 401 (b), it was thought to be unnecessary to require also that the issuer register as a broker-dealer. \textit{See L. Loss & E. Cowett, BLUE SKY LAW} 332-36 (1958).
\end{footnotes}
not constitute the "buying" of a security,\(^7\) the definition of "buy" in section 3(a)(13) of the 1934 Act, which includes any contract to buy, purchase, or "otherwise acquire" a security,\(^8\) could be interpreted to encompass the creation of a security. Thus, when a promoter-issuer constructs a condominium and affixes a rental pooling arrangement to it, or purchases a herd of cattle and affixes a management contract to it, it is arguable that such "manufacturing" of a security is a form of "otherwise acquiring" a security within the definition of "buy" in the act. It is obvious that such a method of producing a security differs significantly from the activity of the normal corporate issuer in selling additional proprietary interests in itself.

Support for this approach can be found from the position of the commission, with respect to investment contracts, that the security encompasses both the contract and the underlying subject matter.\(^9\) Since the promoter-issuer very often purchases the underlying asset in connection with the tax sheltered security (the real estate for the condominium or the cattle for a feeder or breeder program), and since the component parts of the security are indivisible, it would also seem arguable that such purchase would satisfy the requirement in the definition of dealer that the dealer be engaged in both the buying and selling of securities. Again, this situation is in sharp contrast with that of the conventional issuer, for example, a corporation issuing its stock, in which the corporation need acquire nothing (save for a charter from the appropriate governmental body) in order to "issue" its securities. This fundamental difference in the way in which the "issuer" comes into possession of the securities which it would issue would justify treating the promoter-issuer as a dealer.

The Issuer As a Broker

The difficulty in suggesting that an issuer may be a broker is that, presumptively, the issuer is effecting transactions in securities for its own account and not for the account of another. While this certainly

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\(^7\) See text accompanying notes 70-71 supra.


\(^9\) In footnote 1 to SEC Securities Act Release No. 5347, January 4, 1973, [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,163, the Commission reiterated that "where an investment contract is present, it consists of the agreement offered and the condominium itself." It appears that the Federal Reserve Board is about to adopt the Commission's position in proposed amendment (1) to § 220.6 of Regulation T. Credit by Brokers and Dealers, 12 C.F.R. § 220.6 (1973). It states that for the purpose of financing an investment contract security such as a cattle feed program or investment condominium, credit arranged on any part would be deemed to be credit ar-
holds true with respect to the conventional corporate issuer, in many instances the issuance of a tax sheltered security involves several legal entities with the resultant possibility that the promoter-issuer may in fact be effecting transactions in securities for others as well as for itself. For example, in the investment condominium area, it will be necessary to incorporate a nonprofit corporation to administer the common areas and the detail involved in condominium ownership of property. Moreover, once a rental pooling arrangement is entered into, in effect the owners of the individual condominium units will have formed a partnership to operate the leasing of their units. Thus, the action of the promoter-issuer in arranging for membership in the nonprofit condominium association, or in putting together a partnership (in which it does not participate) for the purpose of pooling rentals, obviously involves the promoter-issuer in effecting transactions for the account of others.

In a similar vein, the promoter-issuer of cattle breeding and feeding arrangements often is entitled, pursuant to the management agreement, to exchange the investor's cattle for other cattle, or to pool the investor's cattle with cattle of other investors to take advantage of lower costs or better care, or to arrange for loans against the cattle or possibly even to draw upon an account set up by the investor for the expenses of maintaining the herd or to augment the herd. Thus, while the initial sale of the herd to the investor may have been solely a transaction for the account of the promoter-issuer, thereafter it engages in much activity for the account of the investor and such activity may well bring it within the definition of a broker.

With respect to limited partnerships, in reality the limited partnership is the entity which is issuing the security and the promoter-issuer, who acts as general partner, is thereby effecting a transaction for the account of a limited partnership when it solicits investors to become limited partners. While the argument can be made that the limited
partnership can only act through its agents, of which the general partner is one,\textsuperscript{83} nonetheless an agent who, as a regular part of its business, is continually putting together a series of limited partnerships is certainly engaged in the business of effecting transactions for the account of others. To hold otherwise would be to be blind to the realities of the situation.\textsuperscript{84}

**The Status of Employees of the Issuer**

Prescinding from the status of the issuer, let us consider what ought to be the status of employees of the issuer when they engage in the distribution of tax sheltered securities. While such employees most likely will not be in the business of "buying and selling" securities such as to constitute themselves dealers, they most certainly effect "transactions in securities for the account of others." Thus, in order to make a judgment as to whether their activity mandates registration as a broker-dealer, the critical element will be whether they are also "engaged in the business" of effecting such transactions within the meaning of such section 3(a)(4) of the 1934 Act.

**The General View**

Much of the "authority" which has thus far considered the question evidences a reluctance to treat employees of the issuer as "engaged in the business of effecting transactions in securities for the account of

\textsuperscript{83} This is the argument that was made in Choice Communities, Inc., SEC Div. Mkt. Reg. No-action Letter (Nov. 29, 1972) [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. \$ 79,203, and which was apparently accepted by the Commission.

\textsuperscript{84} As Mr. Haft had stated, "the broker/dealer definition net is broad enough to encompass general partners of limited partnerships who act as such with a reasonable degree of frequency and who offer limited partnership interests therein to others . . . ." \textit{Haft, supra} note 9, \$ 2.05[1], at 2-22. \textit{See also} Hofheimer, Gartlit, Gottlieb & Gross, SEC Div. Mkt. Reg. No-action Letter (Oct. 12, 1972), [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. \$ 79,098 (investor who regularly invested in limited partnership interests and on various occasions assigned some of the same was denied a no-action letter to the effect that he need not register as a broker-dealer).

In addition, Mr. Weiss has stated: "What has been stated with reference to a director or officer of a corporation applies equally to general partners of a limited partnership who effect or participate in the public offering of interests by the limited partnership." \textit{Weiss, supra} note 27, \$ 1-2, at 5. While the tests that Weiss suggests with respect to an officer or director would generally not require that the officer or director register as a broker-dealer, the same tests, when applied to a general partner, could well require his registration as a broker-dealer. For example, the general partner often does receive special compensation for selling the securities (this is one of the factors that give rise to conflict of interest problems in this area, \textit{see} Dickey Report, \textit{supra} note 48, at 40-46) and the general partner very often assumes sole or primary responsibility for the distribution. \textit{See text accompanying note 86 infra.}
others” so as to require their registration as a broker-dealer. Professor Loss, in summarily discussing the problem, applies the simplistic test of whether or not the individual in question is a “servant” or “independent contractor” at the common law.\(^8\) Along the same line, former Commissioner Gadsby, in his treatise, after stating that an issuer need not register as a dealer because it does not buy its own stock, states with respect to employees:

Similarly, the Act does not apply to an officer of a corporation who is selling stock in a company, certainly if he gets no special compensation for the activity. Even if he does get a commission on sales, he is probably exempt if such activities are part of his employment.\(^8\)

On the other hand, Mr. Weiss accepts the possibility that an employee may need to be registered:

The more troublesome problems are posed, however, by the issuer’s directors, officers, and employees who receive special compensation for soliciting subscriptions for the securities. It may be that any such person is an underwriter as defined in Section 2(11) of the Securities Act. Nevertheless, he would not be a “broker” if he is under the issuer’s supervision and control, he devotes his full time in rendering services for the issuer and he neither was previously engaged in the sale of securities, nor proposes to do so following the completion of the offering . . . . If a director or officer of an issuer has an arrangement that he is to assume the responsibility for sale of the entire issue in return for a commission on sales, and if the selling expenses, including the compensation of salesmen, are to be borne by him, he is manifestly in business as a “broker.” Purchase by an officer or director of the securities from the issuer as principal, for resale to the public, would result in his being “engaged in the business” and thus being a “dealer.”\(^8\)

Along the same lines, Mr. Raymond R. Dickey, one of the most knowledgeable practitioners in this area,\(^8\) has recognized that whether a person is a bona fide employee of the issuer is a question to be determined on a case by case basis and has suggested the following criteria for consideration:

1. Whether the issuer pays Social Security taxes and Unemployment Compensation premiums with respect to the “employee”;

2. Whether the employee receives a salary from the issuer or is compensated on a commission basis;

\(^8\) Mr. Dickey was Chairman of the Advisory Committee whose report is cited in note 48 supra.

87. Weiss, supra note 27, § 1.2, at 4-5.
88. Mr. Dickey was Chairman of the Advisory Committee whose report is cited in note 48 supra.
(3) Whether the employee has been associated with the issuer for some time prior to the offering;
(4) Whether he intends to remain in the employ of the issuer following the completion of the offering;
(5) Whether the employee performs other duties for the issuer in addition to the sales of securities; and
(6) The business background of the employee.\(^9^8\)

Until recently, the commission itself appeared willing to issue a no-action letter that registration of the employees would not be required if the employees were bona fide employees who would continue in the employ of the issuer, particularly if they had other duties than selling tax sheltered securities and if they were not compensated wholly on a commission basis.\(^9^9\)

The Reality

It would be difficult to quarrel with Mr. Weiss' position that corporate treasurers "who purchase stock in the market for company employees pursuant to stock purchase plans," but who enter into no other securities transaction, ought not to bear the burden of being registered as broker-dealers.\(^9^1\) This would be a classic example of incidental activity by a corporate employee who has substantial other duties and engages in the securities transactions only as an incident to such other duties.

On the other hand, an entirely different situation is presented when the issuer in question is engaged in the business of "producing" securities on a regular basis and marketing such securities through its employees. In such a situation, the status of the employee more nearly approaches that of an employee of an investment banker as contrasted to the status of an employee of an employer engaged in a commercial business other than the distribution of securities. Quite obviously, employees of an investment banker are not shielded from registration as registered representatives by virtue of the fact that they are bona fide employees. The question is not whether they are employees but rather whether they are regularly engaged in the business of selling securities for the account of others.\(^9^2\)

Recent no-action letters from the commission indicate a change in

\(^{89}\) Schwartz, supra note 10, at 437.
\(^{91}\) Weiss, supra note 27, § 1-2, at 6.
\(^{92}\) HAFT, supra note 9, at § 2.05[1].
attitude and emphasis.\textsuperscript{93} It appears that the commission is now focusing not so much on the regularity of employment but rather the regularity of the selling activity in connection with tax sheltered securities. This is as it should be. Moreover, the fact that an employee may also perform substantial other duties for the employer is not inconsistent with his obligation to register as a broker-dealer. As Mr. Weiss has stated:

> It may be observed that there is nothing in the definitions of broker and dealer which would warrant a conclusion that a person cannot be engaged in the business in respect of securities merely because such business is only a minor part of the person’s activities or merely because the income from it represents only a small fraction of his total income. On the contrary, if the activity is engaged in for commissions or other compensation with sufficient recurrence to justify the inference that the activity is part of the person’s business, he will be deemed to be “engaged in the business” within the meaning of that term as used in the definitions of broker and dealer.\textsuperscript{94}

Whether the employee has prior experience in the securities industry should also be an immaterial factor, notwithstanding the view of some commentators and language in some no-action letters intimating that such lack of experience was one of the factors justifying the issuance of the letter.\textsuperscript{95} If it were otherwise, the issuer could avoid the registration of its employees by hiring those with the weakest credentials, namely, those who have no prior experience in connection with the sale of securities. It hardly seems that the public policy of protecting the public from incompetent salesmen is served by a policy which would encourage the hiring of the least competent people.

In summary, the fact that a promoter-issuer which is in the business of effecting transactions in securities for its own account might be outside the registration requirements for a dealer because of a literal reading of the definition of dealer should not have the effect of extending the umbrella of exemption to employees of such issuer who are regularly engaged in selling tax sheltered securities. Common law niceties, such as the distinction between independent contractor and employee, should not be permitted to thwart one of the purposes of

\textsuperscript{93} See, e.g., Wainoco Oil Ltd., SEC Div. Mkt. Reg. No-action Letter (July 18, 1973), dealing with the sale of limited partnerships for the fourth consecutive year, in which the Commission issued a no-action letter conditioned upon the organization of a subsidiary which would register as a broker-dealer and the officers of which would become qualified as registered representatives.

\textsuperscript{94} Weiss, supra note 27, § 1-3, at 7-8.

the 1934 Act, namely, to insure that the investing public is serviced by sales personnel who are trained and competent and whose character is "supported" by the discipline of self-regulation.

Conclusion

The public interest in requiring registration of those engaged in the selling effort in connection with the distribution of tax sheltered securities cannot be gainsaid. Not only is the public entitled to expect that the regulatory process will impact upon those dealing with the public so as to insure, to the extent possible, their competence and character but also the regulated part of the securities industry which also engages in the sale of tax sheltered securities is entitled to expect that regulation will bear equally upon all those engaged in the distribution of such securities.

On the other hand, it is also quite clear that many of the reporting and financial obligations of a broker-dealer would be particularly onerous to a promoter-issuer engaged in the tax sheltered security business. This is particularly true for a company engaged in developing real estate since it would be impossible for such a company to comply with the net capital requirements applicable to broker-dealers. However, these problems could be surmounted by the promoter-issuer organizing a subsidiary to carry on the selling effort. Thus, it would be the subsidiary which would be registered as a broker-dealer, the employees of which would be registered representatives. While this might produce the anomalous result that the customer will have, from a financial standpoint, a less substantial entity responsible to him, it could be that section 20 of the 1934 Act, imposing liability upon controlling persons, to wit, the parent corporation, would obviate this concern. Otherwise, recourse against the promoter-issuer could be assured by requiring it to undertake financial responsibility for the selling practices of its subsidiary along the lines of the approach in Rule 15c 3-1


In addition, the reporting requirements stemming from being registered as a broker-dealer could be quite onerous. See, e.g., SEC Advisory Committee Study on Broker-Dealer Reports and Registration Requirements, Dec. 15, 1972, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,147.
(b)(1) which conditions exemption from net capital on such an undertaking.\textsuperscript{97}

Thus, if the commission were to take a fresh look at the selling practices in the tax sheltered security industry, it should be possible to create a structure which would assure protection to the investing public, even-handed regulatory treatment of all those who participate in the distribution of tax sheltered securities and reasonable restraints and requirements of that part of the industry which is not now regulated.