NEWS

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 755-4846

THE SEC DISCLOSURE SYSTEM: REAL ESTATE AND OIL AND GAS

An Address by

William J. Casey, Chairman

Securities and Exchange Commission

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TEXAS BAR ASSOCIATION
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It is a pleasure for me to come here to Houston to talk about the SEC with a large group of Texas lawyers. Although I have not been here in your state in my capacity as Chairman of the SEC, I feel close to you. We get a lot of help from your senior Senator John Tower, who is on our Senatorial oversight subcommittee. We have a large SEC contingent based in Fort Worth which is diligent and eager to work with your bar in enforcing the securities laws and maintaining an atmosphere of investor confidence based on business and professional responsibility.

At the Commission we count on you to interpret and enforce the rules we develop to protect investors and we have an obligation to make those rules as definite and certain as possible. The true value of our disclosure requirements depends on the accuracy and precision of your work on registration and proxy statements. As we require new rules, or as disclosure is needed on new activities, or in greater depth, we need your help in making these requirements practical and effective.

We have set a high priority on making the rules which govern securities transactions more definite and certain. I think we've made progress on that objective with new Rules 144 and 145. We are now trying to develop a Rule 146 which will provide more certainty with respect to the availability of the private offering exemption.

Another major objective is to convert disclosure documents from insurance policies against liability into useful communications about the plans and prospects of the business. Our inquiry into hot issues has shown how useless "boiler plate disclosure" has become. We are taking the position that stock phrases or boiler plate relating to such subjects as the company's chances of success, its competition, or the status of material litigation is not meaningful disclosure. Statements of this type will have to be extended to explain their basis, spell out the specifics and their effect on the business of the registrant. On new ventures, we plan to require detailed estimates, with the basis for them, on how long the funds being raised will last.

Much of our time these days is devoted to breaking new ground in the disclosure and regulatory problems of the

tax-free package. In February of this year we created a tax-shelter branch in the Division of Corporation Finance to process tax shelter registration statements other than oil and gas and REIT's. Such tax shelters include real estate syndications, cattle feeding, cattle breeding, citrus and pistachio groves and other agri-businesses. Our purpose was to develop expertise and greater uniformity of treatment due to the specialized nature of these products and make disclosure more meaningful to the investment decision.

The number of tax shelter programs filed with the Commission has increased substantially. For example, in April there were nine such programs filed as compared to 21 in the month of May. At present there are 50 filings aggregating about $470 million pending in various stages of processing which has somewhat delayed our comment schedule. We hope to be back to a 30-day cycle by August 15.

It is interesting to note that cattle offerings show the largest increase in filing frequency of the various types of tax shelter programs. As to real estate syndications, the trend seems to be strongly in the direction of "blind pools"--

i.e., programs which do not have any specific properties or contracts to acquire specific properties. In this regard, we have been requesting undertakings to the registration statement whereby the company agrees to file post-effective amendments and send reports to its security holders disclosing information with respect to any material acquisition of property.

The type of disclosure generally that we have been emphasizing relates to fees and payments to the general partner and his affiliates, conflicts of interest, track record of the general partner, and delineation of the program's investment objectives.

Let me isolate two of these areas -- namely, real estate syndications and oil and gas programs -- and discuss some of the problems we see might be faced in practice by a conscientious lawyer. Let me start with the real estate syndication.

In May of this year, I appointed a Real Estate Advisory Committee to assist the Commission in the review of our disclosure procedures and policy objectives in the areas of

real estate interests. That committee is going to look into and make recommendations to us by the end of September. The committee is chaired by Raymond R. Dickey, a Washington attorney. The other members are Francis Grey, a partner in the accounting firm of Lybrand, Ross Bros. & Montgomery; two New York lawyers, David L. Schwartz and Milton Young; and Ralph C. Hocker, Associate Director of the Commission's division of Corporation Finance. They have requested the views of your Texas Bar Association by letter and memorandum in four specific areas, so you will also have an opportunity to make the views of your association know to us.

To recapitulate, the main areas of question are:

1. The applicability of federal securities laws to the public financing of real estate with a view to, first, enhancing investor protection; second, minimizing the burden of duplicatory regulations, and third, developing a broader understanding of the obligations of those engaged in the public offerings of real estate interests.

2. Special approaches to disclosure to reflect any special aspects of the conflicts of interest, tax problems

and special risks inherent in some types of real estate offerings.

3. Novel questions regarding the qualifications and licensing of salesmen, underwriting fees and sales loads in connection with real estate ventures, and

4. Recommendations to improve the Commission's policies and practices in the area and more effectively interrelate its activities with those of other agencies involved in this field.

As you know, developers and syndicators are becoming increasingly aware of the securities problems inherent in their money raising activities. Even the promoters who operate on a relatively small, local scale can no longer ignore the potential impact of the federal and state securities laws on their business. Failure to register, or take the steps necessary to preserve an exemption, produces tragic consequences.

Most real estate ventures take the form of joint ventures or limited partnerships. The limited partnership can be either one tier or two, that is, the limited partnership can invest directly in the property or invest in another limited partnership which in turn invests in the property. The partnerships

may invest in specific, identified properties or take the form of a "blind pool", as I indicated previously. Much work is needed to illuminate the blind pool: There are no doubt operating advantages to them, in that the operators can make quick deals when they find suitable properties, but it is hard to square our objective of providing investors with an informed decision with the concept that they be allowed to invest in a pool with no specified investment objectives.

The 1933 Act defines virtually everything as a "security". There interests clearly fall under its purview as "profit sharing agreements" or "investment contracts", and thus must be registered in the absence of an exemption. The two most commonly relied upon in the real estate field are the "private offering" under Section 4(2), and the "intrastate exemption" of Section 3(a)(11). There is also Regulation A, but that can sometimes prove to be as expensive, complicated and time consuming as the filing of a full registration statement. The consequences of a failure to register are well known: buyers have a put back to their

sellers even after the sale has gone through.

The standards imposed under the anti-fraud provisions require full and fair disclosure. They require that material facts not be omitted or misstated. I am sure that many of you have been involved in real estate syndications where your client has prepared something he calls a "confidential memo", "prospectus" or offering circular. These rarely give full, complete and fair disclosure of the facts of a transaction. In order to avoid coming within the purview of the anti-fraud provisions, all known or knowable facts concerning the property and the deal itself should be presented: an investment in a partnership is not liquid by nature; risks of loss; tax consequences of foreclosure and recapture; zoning and sewer problems, if any; and, most important, all management agreements, mark-ups and fees paid for the syndication itself. In other words, do not attempt just to paint a beautiful landscape. Disclose as many of the problem areas as possible for your own good.

The scope of the private offering exemption and the meaning of "public offering" has been the subject of much litigation and controversy, and we have a current project

underway, as I indicated, to see what can be done so that people will know when and if they can rely on the private offering circular with some degree of certainty. Some of the problems arise from differences in the types of issuers, from the major conglomerate like ITT to the start-up technological corporation; and in investor sophistication, from Morgan Guaranty to the gas station attendant who's just received a $40,000 negligence settlement or the renowned widows and orphans.

With respect to real estate transactions, as with respect to all other securities transactions, it should be carefully remembered that the civil liability and anti-fraud provisions of Section 12 and 17 apply, whether or not an exemption is in fact, available.

Now that I've suggested to you the difficulties of exemption from registration and the potential liability even where an exemption exists, let me outline a few of the problems faced by the lawyers preparing a real estate deal for registration.

There are a number of states which have imposed by statute stringent registration and disclosure rules. These statutes are directed to the fairness of the transaction. In California for example, the sale of real estate partnership interests

comes under both the Syndicate Act, administered by the Commissioner of Real Estate, and the California Corporate Securities Law, administered by the Commissioner of Corporations. Rules have been adopted under these acts which set forth the provisions which must be contained in limited partnership agreements and establish standards for what is fair compensation for promoters.

In those states which do not provide limited partners with specific powers by statute, the limited partnership may be destroyed by an attempt to give them a voice in the management -- as required by California and other states to be in the partnership agreement -- and this destruction raises serious questions as to their limited liability. In addition, what is presumed to be fair management compensation in one state could carry the opposite presumption in another.

The Midwest Securities Commissioners Association Committee on Real Estate Limited Partnerships, co-chaired by the Director of Securities Registration Division of Texas, Steve Randle, has recommended that "projections", the presentation of predicted future results of operations, be encouraged and

contained in the prospectus. Many lawyers take the view that no informed investment decision can be made without the use of projections.

The proper use of projections, no doubt facilitates the investment decision. However, it is imperative that sound standard assumptions upon which they are based be developed and that those assumptions be relevant, accurate and clearly disclosed.

The problem of when a condominium development becomes a security subject to registration is another area the Commission will be considering over this summer. Our Real Estate Advisory Committee will be making a recommendation in this area, at least partly based on input from the industry. Clearly the so-called hotel condominium, which finances the building project by selling its rooms as condominium units -- which the investor may reserve only one month out of the year subject to giving 90 days notice to management, is an investment contract within the meaning of the securities law. The "second home" resort condominium with no rental agreement is at the other end of the spectrum. However, it is apparent that the

Commission will have to draw the line somewhere in between and establish clear guidelines as to the criteria involved in determining under what circumstances a condominium project is subject to registration.

But let me now turn to oil and gas. Our proposed "Oil Investment Act of 1972", transmitted to Congress on June 14, 1972 pursuant to its directive, is no doubt of interest to many of you. This proposed bill resulted from the efforts of the staff with splendid cooperation of the Oil Investment Institute and the Independent Petroleum Association of America.

Whatever other effect the proposed legislation will have, members of the Commission's staff are convinced that the amount of midnight oil burned during the drafting has conferred a significant economic benefit on the petroleum industry already.

If our experience with the mutual fund industry is a guide, enactment of this kind of legislation could confer a substantive benefit upon the oil and gas industry, in terms of increased public confidence and investment dollars.

At the same time that our nation's demands for energy are increasing, increasing amounts of capital are required to find the oil and gas to help to meet that demand. From an economic point of view, we as a nation cannot afford to have investment funds artificially diverted from the oil and gas drilling industry because of investor sentiments (right or wrong) that in evaluating an investment in a drilling program they must add the risk of being treated unfairly to the inherent risks of drilling for oil and gas. The Commission feels that in addition to protecting investors, therefore, the proposed bill would bring needed capital to the oil and gas drilling industry and benefit the economy as a whole.

Who would be directly affected and how would all of this be accomplished?

The proposed bill is intended to deal only with oil programs which provide flow-through federal tax treatment to their investors and which generally offer their securities or participations to the public. Thus, conventional operating oil corporations are not within the definition of "oil program" in the proposed bill. Moreover, the proposal specifically excepts from that definition, among other things, certain

arrangements used by many small independent oil operators to finance their activities. In this connection, the bill excludes: (1) Arrangements which have a limited number of investors -- that is, 35 or less -- and are not offering their participations to the public; and (2) arrangements which offer and sell direct fractional undivided interest in oil and gas rights in specified properties if such interests are registered under the Securities Act of 1933 or exempt from registration by Regulation B under that Act. With respect to the latter cases, the Commission found considerable difficulty in drawing an absolute distinction between the kind of oil program with which the Congress had indicated concern and oil exploration ventures of a more traditional character. An oil fund or program can readily be designed as an oil exploration venture involving direct ownership in oil or gas rights have the same potential conflict of interest and be sold to the public. To deal with these borderline situations as they develop the Commission would be given authority to impose conditions on the exception for ventures consisting of undivided fractional interests by appropriate rules to protect investors.

At the present time, we envision rules to ensure that issuers of fractional undivided interests would adhere to the same standards as those which would be required of non-exempted oil programs with regard to standards of suitability for an investment in such programs for a particular person and requirements concerning the content of sales literature. Should significant conflict of interest problems develop in this area the Commission would also consider subjecting them to Sections 8, 21, 23 and 24 of the proposed bill, which prohibit certain persons from serving as officers or directors, make larceny or embezzlement from such an entity a federal crime, prohibit the use of misleading names, and require the filing of documents with the Commission in certain civil actions.

The legislative proposals would provide for protection of investors in publicly offered oil and gas programs by requiring the registration of oil programs with the Commission and denying the facilities of interstate commerce to unregistered programs. The regulatory provisions of the proposed bill include, among other things, specific controls designed to prevent conflicts of interest and unfair transactions between oil programs and

their managers and to insure financial responsibility of program managers. The proposed bill would also prohibit changes in fundamental policies of an oil program without the approval of the holders of program participations. It would require that a person acting as a program manager do so pursuant to a written contract which contained certain provisions and that material changes in such contracts be approved by program participants. Certain protections could be afforded to investors in programs which issue program participations with repurchase and assessment features and to investors to whom offers of exchange are made by managers and certain other persons. Some provisions of the proposal would be administered primarily by the National Association of Securities Dealers ("NASD") with Commission oversight. They include specific authorization for NASD rulemaking in the area of sales charges, sales literature, suitability of an investment and a classification system for the various forms of management compensation.

By no means do we think that this legislative recommendation cannot be improved upon. Indeed, as in the past, we call upon you, the members of the bar with special expertise and

appreciation of industry practices and problems for your frank criticism and hard questioning. It is only by this process that a final product will emerge which ensure fairness to all concerned: the investor, the industry and the general public.