

NASD NOTICE TO MEMBERS 97-8

SEC Approves Quotation And Transaction Reporting Of Direct Participation Programs

Suggested Routing

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Executive Summary

On January 7, 1997, in Release No. 34-38132, the Securities and Exchange Commission (SEC) approved NASD[®] rules permitting the quotation of Direct Participation Programs (DPPs or limited partnerships) in the OTC Bulletin Board[®] Service (OTCBB) and requiring all transactions in DPPs to be reported through the Automated Confirmation TransactionSM Service (ACT). Quotations will be permitted in the OTCBB and transactions will be required to be reported beginning May 15, 1997. NASD members are encouraged to review the SEC release approving the rule changes. The text of the relevant rule amendments is attached.

Background

Ninety billion dollars worth of DPP securities have been purchased by approximately 10 million investors over the past 15 years. Although these securities were not originally intended to be liquid and tradable, the NASD has found that a fragmented secondary market has nonetheless developed that, in the aggregate, transfers ownership of an estimated \$250 to \$300 million worth of public partnership securities annually. The NASD's determination to include DPPs in the OTCBB and to require the reporting of DPP transactions by NASD members is in response to this existing secondary market for DPP securities.

At the time of original sale of DPP securities, liquidation of the partnership was often contemplated to occur within five to seven years. However, as the holding period has lengthened due to weakness in the underlying value of many partnership assets, events such as estate sales by trustees due to the death of a limited partner, liquidation of IRAs, divorce, and unexpected or extraordinary expenses such as major medical or

post-secondary education, have forced limited partners to sell partnership units. This partnership secondary market will continue to exist as many investors continue to find it necessary for financial and other reasons to liquidate their investments prior to termination of the program.

Given those facts, the NASD believes that its primary concern should be ensuring that the partnership secondary market that has evolved operates efficiently and in a manner that protects public investors. The display of pricing information in the OTCBB will benefit investors by offering increased transparency and price discovery through a consolidated mechanism for assessing current prices for and interest in partnership securities, as opposed to the fragmented and inefficient methods that currently exist. It is hoped that the OTCBB will allow customers to evaluate the quality of executions received and allow dealers and other participants to price partnership securities more effectively and to facilitate compliance with their best execution responsibilities. By increasing transparency, investors will have a more visible and less fragmented secondary market. Investors will also have an improved ability to assess the overall supply and demand for a particular DPP security and to transfer partnership interests at optimal prices.

The NASD notes that the inclusion of DPPs in the OTCBB and the reporting of DPP transactions are an important part of the NASD's larger efforts to improve the DPP secondary market. For example, since May 15, 1996, NASD members have used standardized transfer forms developed by the NASD when facilitating transactions in DPP securities. The forms, which include a Transferee, Transferor, and Distribution Allocation Form, bring much-needed conformity to the DPP transfer process.

The NASD has also petitioned the SEC to amend or clarify Rule 10b-17 to make capital and regular DPP distributions subject to the reporting provisions of Section 12 of the Securities Exchange Act of 1934. The proposed changes to Rule 10b-17 would facilitate the orderly transfer of DPP securities by greatly reducing the number of disputes concerning distribution claims that lead to arbitration and litigation. The SEC is expected to publish the petition for public comment soon.

Tax Implications For DPPs Displayed In The OTCBB

The NASD is aware of the potential adverse tax implications for partnerships that are deemed “publicly traded partnerships” by the Internal Revenue Service (IRS). The IRS defines “publicly traded partnership” as a partnership that is either (1) traded on an established securities market; or (2) readily tradable on a secondary market or substantial equivalent thereof. Although the NASD believes that IRS Notice 88-75 and the recently adopted amendments to the Income Tax Regulations (Regulations) concerning the definition of publicly traded partnerships are sufficiently clear, the NASD has nonetheless received a private letter ruling (Ruling) from the IRS to clearly establish that a partnership quoted in the OTCBB would not be considered a publicly traded partnership solely as a result of such display. Together, the Regulations and the Ruling provide confirmation that partnerships will not suffer negative tax consequences as a result of being quoted in the OTCBB.

The IRS Ruling confirms that the display of pricing information for partnerships in the OTCBB is the same as the computerized display service described in example 2 of the Regulations at Section 1.7704-1(j)(2).¹ Accordingly, the display of partner-

ship interests in the OTCBB will not, in and of itself, result in the partnership being publicly traded. Therefore, partnerships may transfer interests pursuant to the use of the OTCBB without being publicly traded if the transfers meet the requirements of any applicable safe harbor in IRS Notice 88-75 or the Regulations.² Specifically, in its Ruling, the IRS stated that:

(1) The OTCBB is not an established securities market for purposes of section 7704(b) of the Internal Revenue Code and section 1.7704-1(b) of the Income Tax Regulations;

(2) Because the OTCBB undertakes to display partnership interests in compliance with example 2 of section 1.7704-1(j)(2), a partnership whose interests are displayed in the OTCBB will not be considered to be publicly traded solely by reason of being displayed in the OTCBB and may rely on this ruling provided it is not revoked and the OTCBB continues to operate in a manner consistent with the facts as represented;

(3) Calculations relating to qualification for any applicable safe harbor in section 1.7704-1 or in IRS Notice 88-75 remain the responsibility of the partnerships whose interests are traded and are not the responsibility of the NASD, The Nasdaq Stock Market, Inc., the OTCBB, or NASD Regulation, Inc.; and

(4) Although the OTCBB does not meet the requirements to be a qualified matching service under section 1.7704-1(g),³ qualified matching services eligible for participation in the OTCBB may utilize the OTCBB to display non-firm prices and unpriced indications of interest without disqualifying themselves as a qualified matching service, provided that they otherwise meet all requirements for a qualified matching service in section 1.7704-1(g). Compliance with the

requirements for a qualified matching service would be the sole responsibility of the matching service, not the NASD, The Nasdaq Stock Market, Inc., OTCBB, or NASD Regulation, Inc.

The IRS Ruling is fully reproduced at the end of this Notice.

Quotation Of DPPs In The OTCBB

Under the IRS Ruling, NASD members will be permitted to insert only non-firm quotes or unpriced indications of interest (*bid wanted* or *offer wanted* and *name only* entries) into the OTCBB. These non-firm quotes or indications of interest will provide the basis for negotiation necessary to complete a transaction in a DPP security. The OTCBB display screen would reflect, among other things, the inside market, previous close, and distribution information if available. The OTCBB display screen will clearly state that all priced entries are not firm quotes, but rather indications only.

The OTCBB, which operates during regular market hours, permits authorized NASD members to enter and update information in the OTCBB through authorized Nasdaq Workstation II™ devices. Subscribers may view non-firm quotes and unpriced indications of interest for limited partnership securities through Nasdaq Workstation devices or through an additional 290,000 market data vendor terminals.⁴

How To Apply For Quotation

Members wishing to place unpriced entries or indicative quotes in the OTCBB for partnership securities must do so in accordance with Securities Exchange Act Rule 15c2-11 and NASD Rule 6740. These rules are intended to prevent brokers and dealers from furnishing initial quotations in the absence of information

about the issuer. To comply with Rule 15c2-11, a member must gather, review, and retain in its files specified information about the issuer before initiating or resuming a quotation in any quotation medium. To ensure that members have complied with the information gathering and maintenance requirements, Rule 6740 requires NASD members to submit a Form 211 to the NASD prior to initiating a quotation of a DPP in the OTCBB, unless an exemption applies.

Additional information on SEC Rule 15c2-11 and Form 211 requirements can be found in *Notices to Members 90-40, 91-36, and 92-50*.

Net Capital Requirements

The NASD notes that members that insert indicative quotes in the OTCBB for DPPs on behalf of customers or themselves are not subject to the same requirements applicable to registered Market Makers in Nasdaq[®] securities concerning firm quotes, display size, execution, and the maintenance of continuous, two-side quotations. Therefore, members that insert quotes will not generally be required to maintain net capital equal to that of Market Makers as prescribed in SEC Rule 15c3-1(a)(4). Members are encouraged to refer to SEC no-action letters clarifying the application of the net capital requirements and procedures for protecting customer funds when engaging in the business of brokering limited partnership interests.⁵

Reporting Transactions In DPPs

Subject to certain exclusions under the reporting requirements, all secondary market transactions in DPPs will be required to be reported to the NASD, without regard to whether the DPP was the subject of a quotation in the OTCBB. Transactions must be reported through ACT, and the information will be used by

NASD RegulationSM to enhance its oversight and surveillance of this market. Thus, ACT will not provide assistance or in any way be used to facilitate clearance and settlement of these securities notwithstanding the possibility that a particular DPP eligible for inclusion in the OTCBB may also be eligible for clearing with a clearing agency.

Although standardized forms have been developed by the NASD to assist members and general partners in the transfer process, the OTCBB itself will not provide assistance to parties with the completion of transfer documents and other forms necessary to clear and settle a partnership transaction. NASD members representing buyers and sellers would be responsible for processing the paperwork to complete the transfer. General partners would retain their right under most partnership agreements to approve or reject transfers.

Pursuant to Rule 6920, NASD member firms will be required to report transactions on the day following the date on which the trade was executed (T+1), designate the transaction "as of" the previous day, and include the time of execution. For this purpose, the execution date is defined in Rule 6910(b) as the date when the parties to a transaction have agreed to the essential terms of the transaction. This is distinguished from the date on which the DPP security is ultimately transferred or approved for transfer. Member firms that have the operational capability to report transactions within 90 seconds of execution may do so.

The NASD recognizes that some member firms that participate in the limited partnership secondary market may not be subscribers to Nasdaq Workstation II and thus may not have the facility to report transactions through ACT. Members without

direct access to ACT will have the option of reporting through the ACT Service Desk if the member averages a limited number of transactions in DPPs. As set forth in Rule 6920, a member may use the ACT Service Desk if it averages five or fewer trades per day during the previous calendar quarter. For this purpose, any calculation of the average number of trades per day shall include transactions in any security, not just DPPs.

All members shall report to the Market Regulation Department in Rockville, MD on Form T, all transactions in DPPs that were not transmitted through ACT for whatever reason, either on the trade date or the next business day. Form T shall be used exclusively as a backup mode whenever electronic entry or trade data is not feasible due to system malfunctions or other unusual conditions.

In transactions between two members, only the member representing the sell side shall report. In transactions between a member and a customer, the member shall always report. Each transaction report shall indicate whether the transaction is a buy, sell, or cross; the number of units; the symbol of the security; the price of the transaction; an indication of whether the transaction is executed as principal, riskless principal, or agent; the time of execution; and the contra broker, if any. All trade tickets for transactions and DPPs shall be time stamped at the time of execution, which is defined as the time the parties have agreed to the essential terms of the transaction.

Rule 6920(d) sets forth the procedures for reporting price and volume. For agency transactions, members required to report would report the number of units and the price excluding any commission or service charge. For dual agency transactions,

members would report the number of units only once, and report the price excluding any commission or service charge. For principal transactions, members would report each purchase and sale transaction separately and report the number of units and the price. For principal transactions that are executed at a price which includes a markup, markdown, or service charge, the price reported shall exclude the markup, markdown, or service charge. Such reported price shall be reasonably related to the prevailing market, taking into consideration all relevant circumstances including, but not limited to, market conditions with respect to the DPP, the number of units involved in the transaction, the published bids and offers with size displayed in any quotation system at the time of execution, the cost of execution, and the expenses involved in clearing the transaction. For riskless principal transactions, members report as one transaction in the same manner as agency transactions, excluding markup, markdown, or service charge.

The following transactions are not required to be reported under the foregoing procedures; (1) transactions made in reliance on Section 4(2) of the Securities Act of 1933; (2) transactions where the buyer and seller have agreed to a price substantially unrelated to the current market for the DPP, *e.g.*, to enable the seller to make a gift; and (3) transactions executed on a registered national securities exchange or through Nasdaq.

Trade Reporting Options

Members with the appropriate level of service may report directly through the Nasdaq Workstation II. As noted above, certain members with a limited number of trade reports are eligible to subscribe to the ACT Service Desk. Members may also engage other members or service bureaus to report on their behalf.

Symbol Directory

The OTCBB has assigned five-character symbols to identify limited partnerships and differentiate them from the foreign and domestic equity securities that are already included in the OTCBB. A Direct Participation Programs symbol directory will be distributed to NASD members prior to commencement of the OTCBB service for partnerships. In addition, an on-line lookup directory is currently available. Members may also request a copy of the directory on disk by calling (203) 378-0166.

The symbol directory will initially include symbols for approximately 3,000 partnerships. Due to the large number of limited partnerships, it was not possible to assign symbols in the familiar phonetic system. Consequently, the symbols assigned do not have an alphabetical resemblance to the name of the partnership. Members that need to report a trade in a DPP for which a symbol has not yet been assigned should request a symbol by contacting the Market Data Integrity Department at (203) 375-9609.

Applicability Of Other NASD Rules: Markups And Markdowns

In October 1990, the NASD, through its Direct Participation Programs/Real Estate Committee (DPP Committee), initiated a study of the nature and functioning of the secondary market for public partnership securities (DPP Study). The DPP Committee learned during its study that many firms engaged in secondary market activities involving DPP securities may not be complying with the NASD Mark-Up Policy (Policy) as set forth in NASD Rule 2440. The DPP Committee published the results of its study, along with a discussion of the NASD markup/markdown policy as it pertains to customer transactions in DPP securities, in *Notice to Members 91-69* (Notice).

As to markups and markdowns, the Notice stated that the 5 percent Policy applied to customer purchases and sales of all securities traded on Nasdaq and over-the-counter markets, including DPP securities.⁶ As to transactions in DPP securities, the Notice stated that fixed expenses (*i.e.*, general partnership fees, settlement charges, and state transfer charges) required by the general partner or state law may be passed on to customers as a separate charge or expense provided that they are fully documented, not shared in by the member, and are fully disclosed prior to the transaction. Member charges to customers that seek to defray overhead or internal charges of the member, however, would be considered inappropriate and may not be passed on to the customer directly or indirectly, or used as a basis for justifying a markup or markdown in excess of 5 percent.

In addition, the DPP Study also indicated that, generally speaking, dealers in the DPP secondary market did not act as "Market Makers" as that term is defined in the Securities Exchange Act of 1934⁷ and as interpreted by existing case law. If a dealer is engaged in a riskless principal transaction and is not considered a Market Maker with respect to a particular transaction, then the dealer's contemporaneous cost is generally considered the best evidence of the prevailing market price, absent countervailing evidence. Under this analysis, contemporaneous cost is presumed to reflect the current market price because the prices paid for a security by a dealer in actual transactions closely related in time to the dealer's sales are normally a highly reliable indication of the prevailing market.⁸

In summary, the Policy is fully applicable and must be complied with by members when determining the markup or markdown of DPP securi-

ties in customer transactions. The Policy provides comfort to members that a markup or markdown of 5 percent or less will be acceptable for the vast majority of DPP trades with customers. If a member reasonably expends additional time or incurs additional costs in effecting a trade because of the limited availability of the DPP securities, the flexibility of the Policy may permit a markup or markdown of greater than 5 percent. In fact, the Policy acknowledges that markups in DPP securities may be higher than for sales of common stock. But, the member should be fully prepared to support the reasons for the higher markup or markdown with adequate documentation of each transaction.

As stated earlier in this Notice, the OTCBB will permit members to insert only non-firm quotes or unpriced indications of interest for DPP securities. As a result, it is important to remind members that under the current Policy, non-firm quotations may not be used as sole evidence of the retail market price of a security. Under most circumstances, a member will be required to validate these non-firm quotes with other contemporaneous inter-dealer transactions in determining the prevailing market price of the DPP security.⁹

Lastly, the NASD strongly encourages all members executing over-the-counter customer transactions in DPP securities to carefully review *Notices to Members 91-69* and *92-16*.

Best Execution Obligation

Under NASD Rule 2320, members are required in any transaction for or with a customer to use reasonable diligence to ascertain the best inter-dealer market for the subject security (including DPP securities) and buy or sell in such a market so that the resultant price to the customer is as

favorable as possible under the prevailing market conditions.

In addition, NASD Rules 2320(g) and 3110(b)(2) require members, among other things, to contact and obtain quotations from at least three dealers (or all dealers if three or less) to determine the best inter-dealer market price for a non-Nasdaq security (including DPP securities).

The quotation and dealer information is required to be recorded on the member's books and records, and this information traditionally appears on the customer's order ticket.

Contact Persons

The following persons may be contacted for additional information concerning the quotation and reporting of limited partnerships.

General Information:

Peter G. Salmon, Associate Director,
The Nasdaq Stock Market, Inc.
(202) 728-8455

Richard Fortwengler, Associate
Director, Corporate Financing,
NASD Regulation, Inc.
(301) 208-2700

Markups/Markdowns:

David Spotts, Office of General
Counsel, NASD Regulation, Inc.
(202) 728-8071

Filing of Form 211:

OTC Compliance Unit, Market
Regulation, NASD Regulation, Inc.
(301) 208-2802

Net Capital Requirements:

Sam Luque, Associate Director,
Compliance, NASD Regulation, Inc.
(202) 728-8472

Workstation II Installation:

Subscriber Services
(800) 777-5606

ACT Service Desk Subscriptions:
Nasdaq Market Operations
(203) 378-0166

**Obtaining a Symbol for Reporting
Trades in DPPs Without a Symbol:**
Market Data Integrity
(203) 375-9609

Trade Reporting:
MarketWatch
(800) 211-4953

Implementation

The effective date for the inclusion of partnership quotations in the OTCBB is May 15, 1997. Additionally, on that date, the trade-reporting obligations for all secondary market transactions in DPP securities are in effect.

Text Of Rule Changes

*(Note: New text is underlined;
deletions are bracketed.)*

6500. OTC BULLETIN BOARD[®] SERVICE

6530. OTCBB-Eligible Securities

The following categories of securities shall be eligible for quotation in the Service:

(a) through (c) No change.

(d) any Direct Participation Program as defined in Rule 6910 that is not listed on Nasdaq or a registered national securities exchange in the U.S.

6540. Requirements Applicable to Market Makers

(a) No change.

(b) No change.

(1) Permissible Quotation Entries

(A) No change.

(B) No change.

(C) A priced bid and/or offer entered into the Service for a foreign equity security, [or] an ADR, or a Direct Participation Program security shall be non-firm.

The balance of (b)(1)(C) remains unchanged.

6550. Transaction Reporting

Member firms that effect transactions in OTCBB-eligible securities shall report them pursuant to the requirements of Rule 6600, except for transactions in Direct Participation Program securities, which shall be reported pursuant to the requirements of Rule 6900.

6900. REPORTING TRANSACTIONS IN DIRECT PARTICIPATION PROGRAMS

All secondary market transactions by members in Direct Participation Program securities other than transactions executed on a registered national securities exchange or through Nasdaq shall be reported to the Association in accordance with the procedures set forth below. All trade tickets shall be time-stamped at the time of execution.

6910. Definitions

The following terms shall have the following meanings for purposes of Rule 6900.

(a) “Automated Confirmation Transaction Service,” or ACT, is the service that, among other things, accommodates reporting of transactions in Direct Participation Programs (DPPs). The ACT comparison function will not be available for those DPPs that are both eligible for quotation in the OTC Bulletin Board

and eligible for clearance and settlement through the facilities of the National Securities Clearing Corporation. However, ACT will support the entry and inclusion of transaction data on such securities for reporting purposes.

(b) “Date of execution” means the date when the parties to a transaction in a Direct Participation Program have agreed to all of the essential terms of the transaction, including the price and number of the units to be traded.

(c) “Direct participation program” or DPP, means a program which provides for flow-through tax consequences regardless of the structure of the legal entity or vehicle for distribution including, but not limited to, oil and gas programs, real estate programs, agricultural programs, cattle programs, condominium securities, Subchapter S corporate offerings and all other programs of a similar nature, regardless of the industry represented by the program, or any combination thereof. A program may be composed of one or more legal entities or programs but when used herein, the term shall mean each of the separate entities or programs making up the overall program and/or the overall program itself. Excluded from this definition are real estate investment trusts, tax qualified pension and profit sharing plans pursuant to Sections 401 and 403(a) of the Internal Revenue Code and individual retirement plans under Section 408 of that Code, tax sheltered annuities pursuant to the provisions of Section 403(b) of the Internal Revenue Code, and any company, including separate accounts, registered pursuant to the Investment Company Act of 1940.

(d) “Riskless principal transaction” means a principal transaction where a member, after having received from a customer an order to buy, purchases the security as principal from another

member or customer to satisfy the order to buy or, after having received from a customer an order to sell, sells the security as principal to another member or customer to satisfy the order to sell.

(e) “Time of execution” means the time when the parties to a transaction in a Direct Participation Program have agreed to all of the essential terms of the transaction, including the price and number of the units to be traded.

6920. Transaction Reporting.

(a) When and How Transactions are Reported

(1) Reports of secondary market transactions in Direct Participation Programs shall be transmitted through ACT on the next business day (“T+1”) after the date of execution between 8:00 a.m. and 1:30 p.m. Eastern Time, be designated “as of” trades to denote their execution on a prior day, and be accompanied by the time of execution. The party responsible for reporting on T+1, the trade details to be reported, and the applicable procedures shall be governed, respectively, by paragraphs (b), (c), and (d) below. Member firms that have the operational capability to report transactions within 90 seconds of execution, between the hours of 8:00 a.m. and 5:15 p.m. Eastern Time, may do so at their option. If a firm chooses this option, it need not report the same transaction(s) on T+1 as prescribed above.

(2) Members that do not have access to an ACT terminal and average five or fewer trades per day during the previous calendar quarter may use the ACT service desk for trade reporting. Such members shall be required to provide all information required by paragraph (c) of this Rule to the ACT service desk within the same time frames set forth in

paragraph (a)(1) above.

(3) All members shall report to the Market Surveillance Department in Rockville, Maryland on Form T, reports of transactions in DPPs that were not transmitted through ACT, for whatever reason, either on the trade date or the next business day. Form T shall be used exclusively as a back-up mode whenever electronic entry of trade data is not feasible due to system malfunctions or other unusual conditions.

(4) A pattern or practice of late reporting without exceptional circumstances may be considered conduct inconsistent with high standards of commercial honor and just and equitable principles of trade, in violation of Rule 2110.

(b) Which Party Reports Transactions

(1) In transactions between two members, only the member representing the sell side shall report.

(2) In transactions between a member and a customer, the member shall report.

(c) Information To Be Reported

Each transaction report shall contain the following information:

(1) A symbol indicating whether the transaction is a buy, sell, or cross;

(2) Number of Units;

(3) Symbol of the DPP;

(4) Price of the transaction as required by paragraph (d) below;

(5) A symbol indicating whether the transaction is as principal, riskless principal, or agent;

(6) Time of execution; and

(7) Contra broker.

(d) Procedures for Reporting Price and Volume

Members that are required to report pursuant to paragraph (b) above shall transmit transaction reports for all purchases and sales in DPPs in the following manner:

(1) For agency transactions, report the number of units and the price excluding any commission or service charge.

(2) For dual agency transactions, report the number of units only once, and report the price excluding any commission or service charge.

(3) For principal transactions, except as provided under subparagraph (4) below, report each purchase and sale transaction separately and report the number of units and the price. For principal transactions that are executed at a price which includes a mark-up, mark-down or service charge, the price reported shall exclude the mark-up, mark-down or service charge. Such reported price shall be reasonably related to the prevailing market, taking into such consideration all relevant circumstances including, but not limited to, market conditions with respect to the DPP, the number of units involved in the transaction, the published bids and offers with size displayed in any quotation system at the time of the execution (including the reporting firm's own quotation), the cost of execution and the expenses involved in clearing the transaction.

(4) For riskless principal transactions, report as one transaction in the same manner as an agency transaction, excluding the mark-up, mark-down, or service charge.

(e) Transactions Not Required To Be Reported

The following transactions are not required to be reported under the foregoing procedures:

(1) Transactions made in reliance on Section 4(2) of the Securities Act of 1933;

(2) Transactions where the buyer and seller have agreed to trade at a price substantially unrelated to the current market for the DPP, e.g., to enable the seller to make a gift; and

(3) Transactions executed on a registered national securities exchange or through Nasdaq.

Endnotes

¹ Example 2 of the Regulations describes a computerized video display service on which subscribers view and publish non-firm price quotes and unpriced indications of interest. Because there are no firm quotes that commit any person to buy or sell a partnership interest, the service is not considered an established securities market or interdealer quotation system as those terms are defined in the Regulations. Therefore, partnerships whose interests are listed and transferred on the service are not publicly traded as a result of such listing or transfers.

² The IRS has established certain safe harbors for preserving the tax status of limited partnerships by limiting the volume of partnership transfers in any tax year.

³ A qualified matching service (QMS) typically involves the use of a computerized or printed listing system that lists customers' bid and/or ask prices to match partners who want to dispose of their partnership interests with persons who want to buy such interests. Matching services may be provided by the general partner of the partnership, the underwriter that handled the issuance of the interests, or an unrelated third party. QMSs are subject to numerous technical requirements and procedures and actively participate in the transfer by completion of paperwork and settling of transactions. The OTCBB is a passive display only and was not intended to qualify as a QMS.

⁴ In all, 18 market data vendors will carry

OTCBB information on partnerships, including: ADP Brokerage Information Services Group; A-T Financial Inc.; Beta Systems Inc.; Bloomberg LP; Bridge Information Systems; Data Broadcasting Company; ILX Systems Inc.; PC Quote; Real-Time Quotes, Inc.; Reuters Information Services; S&P Comstock; Shark Information Services Corp.; Telekurs North America; Telemet America Inc.; Telerate Systems, Inc.; Telesphere Corporation; Track Data Corp.; and UniLink Network, Inc.

⁵ See, e.g., SEC no-action letters to *Abbott Securities Incorporated*, SEC No-Action Letter, 1992 WL 140265 (S.E.C.) (April 16, 1992) and *Chicago Partnership Board, Inc.*,

SEC No-Action Letter, 1989, WL 245934 (S.E.C.) (February 17, 1989).

⁶ In addition to *Notice to Members 91-69*, members are advised to read and review *Notice to Members 92-16* which explains the NASD markup/markdown policy in greater detail.

⁷ See Section 3(a)(38) of the Securities Exchange Act of 1934, as amended.

⁸ Under certain circumstances, the SEC has looked at other contemporaneous indicia to establish the prevailing market price, including inter-dealer transactions away from the firm or published quotation. See, for example, *Bison Securities, Inc.*, Securities Exchange Act Release No. 32034 (March 23, 1993).

⁹ Under traditional markup/markdown analysis, a dealer can not use ask quotations as a basis for establishing its retail prices unless there existed an active and competitive market for the security and the reliability of the quoted offers could be validated by comparing the quotes with actual inter-dealer transactions during the period at issue. See *Kenneth L. Lucas*, Securities Exchange Act Release No. 33922 (April 19, 1994) and *Steven B. Theys*, Securities Exchange Act Release No. 32358 (May 24, 1993).

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Internal Revenue Service (IRS)
Private Letter Ruling
October 7, 1996

PLR 9701044

National Association of Securities Dealers, Inc.
1735 K Street, NW
Washington, DC 20006

This letter responds to your submission of June 19, 1996, requesting rulings under section 7704 of the Code and the regulations thereunder.

Facts

The Nasdaq Stock Market, Inc. (Nasdaq) is a domestic stock market that is wholly owned by the National Association of Securities Dealers, Inc. (NASD), a domestic association of securities dealers. Nasdaq also operates the OTC Bulletin Board (OTCBB), an electronic bulletin board, which displays pricing information for various domestic and foreign securities not otherwise listed on Nasdaq or another primary domestic exchange. The NASD proposes to allow its members to display certain pricing information for partnership securities on the OTCBB. The proposal incorporates several restrictions designed to prevent the OTCBB from becoming an established securities market under section 1.7704-1(b).

No quotes at which any person is committed to buy or sell a partnership interest will be displayed on the OTCBB for partnership securities. Members will be permitted to enter non-firm bids and/or offers, solicit a bid or offer without entering any quote, or advertise a general interest in buying or selling a particular partnership security on their own behalf or on behalf of a customer or customers. The OTCBB will clearly state that all price quotes are not firm prices, but rather indications only. Symbols assigned to partnership interests displayed on the OTCBB will differentiate them from the other equity securities already included on the OTCBB. Current and historical price, volume, and distribution information may be provided on the OTCBB, if available.

The OTCBB will operate during regular market hours, and will allow subscribers to view non-firm prices and unpriced indications of interest for partnership securities. Members of the NASD will be permitted to enter and update information on the OTCBB through certain workstations authorized by the NASD. Members can also request authorization for a "view only" capability, or view information displayed on the OTCBB through certain independent vendors that provide such information.

The participation by members of the NASD in the OTCBB is voluntary. Members electing to participate will initiate non-firm quotations or indications of interest without the consent of the partnership. Partnerships may not apply for listing on the OTCBB or take any other affirmative action to have their interests quoted on the OTCBB. Only NASD members are eligible to post non-firm quotes and indications of interest on the OTCBB.

Unlike the operating rules of Nasdaq, members of the NASD displaying non-firm quotes or indications of interest on the OTCBB will have no obligation to execute at posted prices or display and maintain continuous quotes. There will be no market maker for partnership interests displayed on the OTCBB. Non-firm quotes and unpriced indications of interest will be permitted to be withdrawn from the OTCBB at any time, and no disciplinary action will be taken by the NASD if a member refuses to honor a price quote.

Although standardized forms have been designed by the NASD to assist partnerships in the transfer process, the OTCBB itself will not provide assistance to parties with the completion of transfer documents and other forms necessary to clear and settle a partnership transaction. The OTCBB will provide no order execution, comparison, or settlement capabilities. Members of the NASD representing buyers and sellers

will be responsible for the processing of paperwork to complete the transfer. Managing partners will retain any rights granted in their partnership agreements to approve or reject transfers.

Compliance with any safe harbors that protect the tax status of partnerships under section 1.7704-1 will continue to be the responsibility of individual partnerships, and not the NASD, Nasdaq, the OTCBB, or NASD Regulation. However, to assist partnerships in complying with these safe harbors, the NASD will make partnership transaction data available to partnerships on an as requested or subscription basis.

Analysis

Section 7704(a) provides that a publicly traded partnership will be treated as a corporation. Section 7704(b) provides that for purposes of section 7704, a publicly traded partnership means any partnership if interests in the partnership are (a) traded on an established securities market, or (b) readily tradable on a secondary market or the substantial equivalent thereof.

Section 1.7704-1(b) provides that for purposes of section 7704(b), an established securities market includes: (1) a national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (1934 Act); (2) a national securities exchange exempt from registration under section 6 of the 1934 Act because of the limited volume of transactions; (3) a foreign securities exchange that, under the law of the jurisdiction where it is organized, satisfies regulatory requirements that are analogous to the regulatory requirements under the 1934 Act; (4) a regional or local exchange; and (5) an interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise.

Section 1.7704-1(c)(1) provides that for purposes of section 7704(b), interests in a partnership that are not traded on an established securities market are readily tradable on a secondary market or the substantial equivalent thereof if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market.

Section 1.7704-1(c)(2) further clarifies that interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof if: (1) interests in the partnership are regularly quoted by any person, such as a broker or dealer, making a market in the interests; (2) any person regularly makes available to the public (including customers or subscribers) bid or offer quotes with respect to interests in the partnership and stands ready to effect buy or sell transactions at the quoted prices for itself or on behalf of others; (3) the holder of an interest in the partnership has a readily available, regular, and ongoing opportunity to sell or exchange the interest through a public means of obtaining or providing information of offers to buy, sell, or exchange interests in the partnership; or (4) prospective buyers and sellers otherwise have the opportunity to buy, sell, or exchange interests in the partnership in a time frame and with the regularity and continuity that is comparable to that described in the other provisions of this section 1.7704-1(c)(2).

Section 1.7704-1 provides certain safe harbors (described in paragraphs (e), (f), (g), (h), and (j) of section 1.7704-1) that allow certain types of transfers of partnership interests to be disregarded in determining whether interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof. However, these safe harbors do not apply to any transfers of partnership interests on an established securities market.

Section 1.7704-1(g) provides a safe harbor for partnership interests transferred pursuant to the use of a qualified matching service. A matching service generally consists of a computerized or printed listing system that lists customers' non-firm bid and/or ask quotes in order to match partners who want to sell their interests in a partnership with persons who want to buy those interests. A matching service must meet several requirements to be a qualified matching service for purposes of this safe harbor, for example, maintaining waiting periods of 15 days between the date an interest is listed and the date a binding agreement is entered into, and 45 days between the date an interest is listed and the closing of the sale. In addition, the

safe harbor requires that the sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership [other than in private transfers described in section 1.7704-1(e)] does not exceed 10 percent of the total interests in partnership capital or profits.

Section 1.7704-1(j) provides a safe harbor for partnerships that have a lack of actual trading. This section provides that interests in a partnership are not readily tradable on a secondary market or the substantial equivalent thereof if the sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership [other than in transfers described in section 1.7704-1(e), (f), or (g)] does not exceed 2 percent of the total interest in partnership capital or profits.

Example 2 of section 1.7704-1(j)(2) describes a computerized service (ABC Service) that displays price quotes of partnership interests. ABC Service allows subscribers to view and publish non-firm price quotes that do not commit any person to buy or sell a partnership interest and unpriced indications of interest in a partnership interest without an accompanying price. ABC Service does not provide firm quotes at which any person (including the operator of ABC Service) is committed to buy or sell a partnership interest. ABC Service may provide prior pricing information, transactional volume information, and information on partnership distributions. The operator's fee may consist of a flat fee for use of ABC Service, a fee based on completed transactions, or any combination thereof. ABC Service is not an established securities market for purposes of section 7704(b). Specifically, ABC Service is not an interdealer quotation system as defined in section 1.7704-1(b)(5) because it does not disseminate firm buy or sell quotations. Therefore, partnerships whose interests are listed on ABC Service are not publicly traded for purposes of section 7704(b) as a result of such listing or transfers if the sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership [other than in transfers described in section 1.7704-1(e), (f), or (g)] does not exceed 2 percent of the total interests in partnership capital or profits. In addition, if ABC Service complies with the necessary requirements, ABC Service may qualify as a matching service described in section 1.7704-1(g).

Section 1.7704-1 generally applies to partnership taxable years beginning after December 31, 1995. However, for partnerships that were actively engaged in an activity before December 4, 1995, section 1.7704-1 applies to taxable years beginning after December 31, 2005, unless the partnership adds a substantial new line of business after December 4, 1995, in which case section 1.7704-1 applies to taxable years beginning on or after the addition of the new line of business. Partnerships that qualify for this transition period may continue to rely on the provisions of IRS Notice 88-75, 1988-2 C.B. 386, for guidance regarding the definition of readily tradable on a secondary market or the substantial equivalent thereof.

IRS Notice 88-75 provides that a secondary market or the substantial equivalent thereof exists if investors are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on established securities markets. IRS Notice 88-75 also provides safe harbors similar to those contained in section 1.7704-1(e), (f), (g), (h), and (j). In addition, IRS Notice 88-75 provides that interests in a partnership will not be considered readily tradable on a secondary market or the substantial equivalent thereof within the meaning of section 7704(b) for a taxable year of the partnership if the sum of the percentage interests in partnership capital or profits represented by partnership interests that are sold or otherwise disposed of (including redemptions) during the taxable year does not exceed 5 percent of the total interest in partnership capital or profits. Transfers will be disregarded for purposes of this 5 percent safe harbor if they satisfy a private transfers' safe harbor similar to section 1.7704-1(e).

The NASD's proposal to display pricing information for partnerships on the OTCBB is the same as the computerized display service described in example 2 of section 1.7704-1(j)(2). Accordingly, the listing of partnership interests on the OTCBB will not, in and of itself, result in the partnership being publicly traded. In addition, partnerships may transfer interests pursuant to the use of the OTCBB without being publicly traded if the transfers meet the requirements of any applicable safe harbor in either section 1.7704-1 or IRS Notice 88-75. The OTCBB is not attempting to qualify as a matching service described in section 1.7704-1(g).

Rulings

Accordingly, based solely on the facts as represented, we rule as follows:

- 1) The OTCBB is not an established securities market for purposes of section 7704(b) and section 1.7704-1(b).
- 2) Because the OTCBB undertakes to display partnership interests in compliance with example 2 of section 1.7704-1(j)(2), a partnership whose interests are displayed on the OTCBB will not be considered to be publicly traded solely by reason of being displayed on the OTCBB and may rely on this ruling provided it is not revoked and the OTCBB continues to operate in a manner consistent with the facts as represented.
- 3) Calculations relating to qualification for any applicable safe harbor in section 1.7704-1 or in IRS Notice 88-75 remain the responsibility of the partnerships whose interests are traded and are not the responsibility of the NASD, The Nasdaq Stock Market, Inc., the OTCBB, or NASD Regulation, Inc.
- 4) Although the OTCBB does not meet the requirements to be a qualified matching service under section 1.7704-1(g), matching services eligible for participation in the OTCBB may utilize the OTCBB to display non-firm prices and unpriced indications of interest without disqualifying themselves as a qualified matching service, provided that they otherwise meet all requirements for a qualified matching service under section 1.7704-1(g). Compliance with the requirements for a qualified matching service will be the sole responsibility of the matching service, not the NASD, The Nasdaq Stock Market, Inc., the OTCBB, or NASD Regulation, Inc.

Except as specifically ruled upon above, we express no opinion concerning the federal income tax consequences of this transaction under any other provisions of the Code or Regulations.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,

William P. O'Shea
Chief, Branch 3
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)