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For the Commission, by the Divisions of Market Regulation, pursuant to delegated authority.¹²

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Deputy Secretary.

[FR Doc. 97-901 Filed 1-14-97; 8:45 am]

BILLING CODE 8010-01-M

[Release No. 34-38132; File No. SR-NASD-96-08]

**Self-Regulatory Organizations;
National Association of Securities
Dealers, Inc.; Order Granting Approval
to Proposed Rule Change and Notice
of Filing of, and Order Granting
Accelerated Approval to, Amendment
No. 1 to the Proposed Rule Change
Relating to Quotation and Reporting
Requirements of Direct Participation
Programs**

January 7, 1997.

I. Introduction

On March 12, 1996, the National Association of Securities Dealers, Inc. ("NASD") submitted to the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to permit the quotation of Direct Participation Programs ("DPPs") on the OTC Bulletin Board Service ("OTCBB" or "OTC Bulletin Board") and require all transactions in DPPs to be reported through the Automated Confirmation Transaction Service ("ACT").

The proposed rule change was published for comment in the Federal Register on April 25, 1996.³ The Commission received seven comment letters concerning this proposal.⁴ The

NASD initially responded to these comments in a letter dated October 16, 1996.⁵ On November 26, the NASD submitted Amendment No. 1 to the proposed rule change.⁶ After careful consideration of all of the comments, the Commission has decided to approve the proposal, including Amendment No. 1 on an accelerated basis.

II. Background

In response to findings by the NASD's Direct Participation Programs Committee ("DPP Committee" or "Committee") and recently issued Internal Revenue Service ("IRS") regulations, the NASD submitted a proposed rule change to permit the quotation of DPPs⁷ on the OTCBB by NASD members and, subject to a few exceptions, require that all transactions in DPPs be reported through ACT.

A. NASD Study of DPPs

The NASD has contemplated the implementation of a system that

1996 ("Fotenos & Suttle Letter"); letter from James Frith, Jr., President, CPB, to Jonathan G. Katz, Secretary, SEC, dated June 10, 1996 ("CPB Letter No. 2") (concentrating primarily on the Qualified Matching Service Safe Harbor); letter from James Frith, Jr., President, CPB, to Jonathan G. Katz, Secretary, SEC, also dated June 10, 1996 ("CPB Letter No. 3") (focusing on the NASD's standardized Distribution Allocation Agreement form); letter from George E. Hamilton, President, NAPEX, to Jonathan G. Katz, Secretary, SEC, dated June 10, 1996 ("NAPEX Letter"); letter from Gregory S. Paul, President, American Partnership Services ("APS"), to Jonathan G. Katz, Secretary, SEC, dated June 10, 1996 ("APS Letter"); letter from Laura J. Lacey, President, Nationwide Partnership Marketplace Inc. ("NPM"), to Jonathan G. Katz, Secretary, SEC, dated June 26, 1996 ("NPM Letter").

⁵ See letter from Joan Conley, Corporate Secretary, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, SEC, dated October 16, 1996 ("NASD Response").

⁶ See letter from Joan Conley, Corporate Secretary, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, SEC, dated November 26, 1996 ("Amendment No. 1"). Amendment No. 1 explained when a DPP trade needs to be reported, made technical corrections to the proposal so that it now conforms with the NASD Manual's new format, clarified the implementation schedule for these new rules, and extended the time period for Commission action.

⁷ The NASD defines a DPP as a program that 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, agriculture programs, condominium securities, Subchapter S corporate offerings and all other programs similar in nature, regardless of the industry represented by the program, or any combination thereof. Excluded from the 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 Section 403(b) of the Internal Revenue Code, and any company including separate accounts, registered pursuant to the Investment Company Act of 1940. Proposed NASD Rule 6910(a); NASD Rule 2810(a)(4).

facilitates the dissemination of information concerning DPPs for quite some time. In fact, the NASD began examining this issue as early as 1980 when it solicited its members' opinions on this topic in the form of a voluntary questionnaire mailed to all of its members.⁸ The positive reaction to the questionnaire prompted the NASD to design the "Electronic Bulletin Board" system, draft the necessary rules, and solicit comments from its members regarding these rules and "the overall concept of such a system."⁹ The NASD received eighteen comment letters, most of which supported the concept.¹⁰ After considering these comments, the NASD filed a proposed rule change with the Commission on January 20, 1983.¹¹ After notice of this proposed rule change was published by the Commission, additional comment letters were received.¹² Subsequently, the NASD decided to further analyze the issues raised in the comment letters and withdrew the proposal on August 21, 1985.¹³

The NASD revisited this issue in 1990. At the direction of the DPP Committee, NASD staff undertook a study of the nature and operation of the secondary market for limited partnership securities.¹⁴ This study indicated that approximately \$90 billion was invested in public DPPs in the 1970s and 1980s by more than ten million investors. The programs were organized to invest in a variety of

⁸ Dennis C. Hensley, A Study of the NASD "Electronic Bulletin Board" for Limited Partnerships in American Bar Association, Section of Corporation, Banking and Business Law, Committee on Partnerships and Unincorporated Business Organizations, Publicly Traded Limited Partnerships IV-25 (Aug. 2, 1983). Nearly 20% of the NASD membership responded. *Id.* of those members, 68% favored the development of such a system. *Id.* Among those members who dealt in DPPs, the percentage of those in favor of the idea rose to be over 80%. *Id.*

⁹ NASD Notice to Members 82-13.

¹⁰ Although most of the concerns raised by the commenters were specific to that proposal, some of the comments focused on issues that are pertinent to the current rule proposal (e.g., potential tax law implications, appropriate level of general partner involvement, and costs). See File No. SR-NASD-83-1 (comment letters attached as Exhibit 2 to the Form 19b-4).

¹¹ File No. SR-NASD-83-1.

¹² Securities Exchange Act Release No. 19675A (May, 9, 1983), 48 FR 21693 (publishing notice of File No. SR-NASD-83-1).

¹³ Letter from Frank J. Wilson, then-Executive Vice President, Legal and Compliance, NASD, to Stuart J. Kaswell, then-Branch Chief, Over-the-Counter Regulation, SEC, dated August 20, 1985.

¹⁴ See NASD Notice to Members 91-69 ("NTM-91-69") (publishing the Committee's findings and noting that the primary concern of the study was to determine how the market currently operates, whether it functions efficiently, and whether NASD members are in compliance with the applicable securities laws and rules).

¹² 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Securities Exchange Act Release No. 37131 (Apr. 19, 1996), 61 FR 18452.

⁴ See letter from James Frith, Jr., President, Chicago Partnership Board, Inc. ("CPB"), to Jonathan G. Katz, Secretary, SEC, dated May 14, 1996 ("CPB Letter No. 1"); letter from James F. Fotenos, Attorney, Fotenos & Suttle, P.C., to Jonathan G. Katz, Secretary, SEC, dated May 22,

industries including, but not limited to, real estate, oil and gas, cable television, commodities, and equipment leasing. Although these securities were not intended to be liquid and tradeable, the study found that a secondary market in DPP securities nevertheless had developed.¹⁵

In addition, the Committee found that some market participants were miscalculating markups, markdowns, spreads, and expenses in the DPP market; were making little effort to determine an investor's suitability to purchase DPP securities; had no knowledge as to the applicability of transaction reporting requirements; and were violating NASD rules concerning predatory pricing practices, best execution, and due diligence on behalf of customers.¹⁶ The Committee also found that some members were not complying with the requirement to file sales literature with the NASD and were improperly doing business with nonmember broker-dealers. In addition, some members were not properly disclosing expenses being charged in connection with the purchase or sale of a DPP, conflicts of interest the broker-dealer may have with a customer, and the basis on which the member was recommending the price at which the securities were being bought or sold.

B. Tax Status of DPPs

In formulating a response to the Committee's findings, the NASD was aware that facilitation of a more centralized means for the quotation of DPPs could cause these securities to be deemed "publicly traded partnerships" under the Internal Revenue Code ("IRC" or "Code").¹⁷ This would lead to the unintended result of DPPs being treated as corporations for federal tax purposes.¹⁸ To assist partnerships wishing to avoid this result, the IRS issued regulations in December 1995 that clarified the circumstances under which interests in partnerships may be

quoted without negatively affecting their tax status.¹⁹

For tax purposes, a publicly traded partnership is defined as a partnership whose interests are traded on an established securities market, a secondary securities market, or the substantial equivalent of a secondary market.²⁰ An established securities market includes: national securities exchanges registered pursuant to Section 6 of the Act; national securities exchanges exempt from registration because of the limited volume of transactions conducted thereon; foreign securities exchanges; and interdealer quotation systems that regularly disseminate firm quotations by identified brokers or dealers by electronic means or otherwise.²¹ A secondary market or the substantial equivalent thereof is an entity or arrangement that, based on all of the facts and circumstances, readily permits partners to buy, sell, or exchange their partnership interests in a manner that is economically comparable to trading on an established securities market.²²

The broad reach of this expansive definition is tempered by five nonexclusive safe harbor provisions.²³ These safe harbors include transfers not involving trading (private transfers);²⁴ redemption or repurchase agreements meeting certain requirements;²⁵ transfers through a qualified matching service ("QMS");²⁶ certain private placement transactions;²⁷ and a 2% *de*

¹⁹ See 60 FR 62026 (Dec. 4, 1995) (adopting Treas. Reg. § 1.7704-1 and discussing the definition of a publicly traded partnership under Section 7704(b) of the Code).

²⁰ I.R.C. Section 7704(b); Treas. Reg. § 1.7704-1(a)(1).

²¹ Treas. Reg. § 1.7704-1(b).

²² *Id.* Section 1.7704-1(c)(1). For example, a partnership interest is readily tradable if it is regularly quoted by persons such as brokers or dealers who are making a market in the partnership interests; the holder of the partnership interest has a readily available and ongoing opportunity to sell or exchange the partnership interest through a public means of obtaining or providing information of offers to buy, sell, or exchange the partnership interest; or prospective buyers and sellers otherwise have the opportunity to buy, sell, or exchange the partnership interest in a time frame and with the requisite regularity and continuity described above. *Id.* Section 1.7704-1(c)(2).

²³ *Id.* Section 1.7704-1(c)(3).

²⁴ *Id.* Section 1.7704-1(e) (listing transfers not involving trading). Among the types of transfers included on this list are transfers at death, including transfers from an estate or testamentary trust; transfers between members of a family; and transfers involving distributions from a qualified retirement plan or an individual retirement account.

²⁵ *Id.* Section 1.7704-1(f) (listing the necessary qualifications for a redemption or repurchase agreement).

²⁶ *Id.* Section 1.7704-1(g) (detailing the requirements that a QMS must abide by).

²⁷ *Id.* Section 1.7704-1(h) (exempting partnership interests issued pursuant to certain private placement transactions).

minimus rule.²⁸ Transfers that qualify for one of the safe harbors are disregarded when determining whether interests in a partnership are readily tradable on a secondary market or substantial equivalent thereof.

III. Description of the Proposal

The NASD believes the majority of DPP resale transactions are necessitated by events that force the sale of the partnership unit upon the limited partner. Such events include estate sales by trustees due to the death of a limited partner, liquidation of IRA accounts, divorce, and unexpected or extraordinary expenses such as major medical procedures or a post-secondary education. From this, the NASD concludes that the inefficiencies of the fragmented secondary market for DPPs tend to disproportionately affect investors who need liquidity, rather than investors who are merely seeking liquidity.

According to the NASD, the proposed changes to its rules concerning ACT and the OTCBB address this concern and the concerns raised in the DPP Committee's report. Moreover, the NASD believes the changes reflect the requirements contained in the IRS regulations so that the quotation of DPPs on the OTC Bulletin Board would not, by itself, have negative tax status consequences for the issuers or the holders of these securities.

A. Quotes on the OTC Bulletin Board

Generally, the treatment of DPPs quoted on the OTC Bulletin Board will be similar to that of foreign securities and ADRs currently—no firm prices will be displayed. NASD members will be permitted to insert only nonfirm prices or unpriced indications of interest ("bid wanted" or "offer wanted" and "name only" entries). These nonfirm prices or indications of interest will provide the

²⁸ *Id.* Section 1.7704-1(j). Under this safe harbor provision, there is no actual trading in a partnership's interests if the sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership does not exceed 2% of the total interests in partnership capital or profits. Private transfers, transfers pursuant to redemption and repurchase agreements meeting the specified requirements, and transfers pursuant to a QMS are disregarded for purposes of applying the 2% rule.

For partnerships that were actively engaged in an activity before December 4, 1995, this rule applies for taxable years beginning after December 31, 2005. Until then, these partnerships may continue to rely on Notice 88-75, 1988-2 C.B. 386, including its 2%-5% safe harbor. This transitional relief expires, however, if the partnership adds a substantial new line of business within the meaning of Treas. Reg. § 1.7704-2. *Id.* § 1.7704-1(j)(2).

¹⁵ The NASD estimated at the time that approximately two dozen participants acted as principal or agent for customers in a fragmented secondary market that, in the aggregate, transferred ownership of an estimated \$250 to \$300 million worth of limited partnership securities annually. *Id.*

¹⁶ See also William Power, Market for Limited Partnerships Is Rife with "Predatory Pricing," NASD Finds, Wall St. J., Nov. 18, 1991, at C1 (discussing the DPP Committee's findings).

¹⁷ 15 U.S.C. 1-9602.

¹⁸ I.R.C. Section 7704(a) providing that a publicly traded partnership is treated as a corporation for federal tax purposes unless the partnership meets the 90% qualifying income test of Section 7704(c) or qualifies as an "existing partnership" as defined in Treas. Reg. § 1.7704-2).

basis for the negotiations that will take place in order to complete a transaction in a DPP security. The OTCBB display screen will reflect the inside market, last sale, previous close, volume and, if available, distribution information.

In addition, only NASD members will be permitted to apply to place unpriced entries or indicative quotes on the OTC Bulletin Board. The requirements of Rule 15c2-11 will apply and, thus, firms generally will be required to submit Form 211 prior to initiating a quotation of a DPP on the OTC Bulletin Board, unless an exemption applies.²⁹ Finally, there is no provision for any automatic executions of DPPs on the OTCBB.

B. ACT Trade Reporting

Subject to certain limited exceptions,³⁰ 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 on the OTCBB.³¹ Firms will report the transaction on "T+1,"³² designate it "as of" the previous day, and include the time of execution. Member firms that have the operational capability to report transactions within ninety seconds of execution, however, may do so. The NASD has prepared a symbol directory to facilitate transaction reporting in DPPs.

The transactions will be reported through ACT for reporting purposes only.³³ Thus, ACT will not be used to facilitate clearance and settlement of these securities notwithstanding the possibility that a particular DPP eligible for inclusion on the OTCBB also may be eligible for clearing with a clearing agency. Moreover, the OTCBB will not assist parties in completing the transfer documents and other forms necessary to

²⁹ See 17 CFR 240.15c2-11 (governing the initiation or resumption of quotations by a broker-dealer for over-the-counter securities in a non-Nasdaq interdealer quotation medium).

³⁰ The proposed reporting requirements do not apply to (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. gifts), or (3) transactions executed on a registered national securities exchange or through Nasdaq. See proposed NASD Rule 6920(g).

³¹ Certain minor changes have been made to the definition of the term "ACT eligible security" to clarify that transactions in Nasdaq SmallCap and certain other OTC securities must be reported through ACT as well.

³² The date of the trade plus one.

³³ The NASD's understanding is that members who effect transactions in DPPs predominately act in the capacity of agent. For reporting purposes, the concepts of agency and principal have the same meaning as those terms are commonly used or understood, unless otherwise noted in proposed NASD Rule 6900.

clear and settle a transaction in a DPP security.

The NASD recognizes that some member firms who participate in this market may not have the capability to report transactions through ACT. Members without direct access to ACT may report such transactions through the ACT Service Desk if the member averaged a limited number of transactions per day during the previous calendar quarter.³⁴ Alternatively, such members may consider obtaining a computer-to-computer interface ("CTCI") or a Nasdaq Workstation.

IV. Summary of Comments

The Commission received seven comment letters concerning this proposal. Although the commenters discussed a number of different topics, their comments generally addressed one of two categories: tax issues and clearing issues. The NASD responded to these comments in letters dated October 16, 1996 and November 26, 1996.

A. Tax Issues

1. IRS Private Letter Ruling

Several commenters noted that the NASD did not obtain a ruling from the IRS assuring the NASD that the proposal would not run afoul of Section 7704 of the IRC and the regulations promulgated thereunder.³⁵ The commenters stated that this is particularly important in light of the fact that the NASD sought such a ruling from the IRS on a prior occasion concerning a similar five percent safe harbor as set forth in IRS Notice 88-75, 1988-2 C.B. 386. Without such a ruling, they claimed that the liquidity and efficiency of the market would be reduced.³⁶ Therefore, the commenters maintained that, due to the importance of the proposal to the secondary market, its approval should be conditioned upon the NASD obtaining a favorable ruling from the IRS.

In response, the NASD asserted that the IRS regulations were clear and unambiguous in that the inclusion of

³⁴ As proposed, NASD Rule 6920 provides that a member may use the ACT Service Desk if it averaged five fewer trades per day during the previous calendar quarter. In calculating the average number of trades per day, transactions in any security must be included, not just transactions in DPPs.

³⁵ See Fotenos & Suttle Letter, *supra* note 4; CPB Letter No. 2, *supra* note 4; APS Letter, *supra* note 4.

³⁶ See CPB Letter No. 2, *supra* note 4 (asserting that an IRS ruling is required to allow QMSs to participate in the OTCBB without affecting their status as a QMS); APS Letter, *supra* note 4 (claiming that certain general partners will use the absence of such a ruling as an excuse to restrict the trading of their DPPs).

quotations on the OTCBB would not constitute an established securities market, a secondary securities market, or the substantial equivalent thereof and, therefore, a ruling from the IRS was not necessary to approve the proposal. Nevertheless, the NASD obtained a private letter ruling from the IRS to gain absolute certainty regarding the impact of this proposal on the tax status of DPPs. Specifically, the IRS ruled that: (1) the OTCBB is not an established securities market for purposes of Section 7704(b) of the IRC and Section 1.7704-1(b) of the Income Tax Regulations; (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 because the OTCBB undertakes to display partnership interests in compliance with Example 2 of Treasury Regulation 1.7704-1(j)(2); (3) such partnerships may rely on this ruling provided it is not revoked and the OTCBB continues to operate in a manner consistent with the facts represented; (4) calculations relating to qualification for any applicable safe harbor in Treasury Regulation 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., NASD Regulation, Inc., or the OTCBB; and (5) notwithstanding that the OTCBB does not meet the requirements to be a QMS under Treasury Regulation 1.7704-1(g), matching services eligible for participation in the OTCBB may utilize the OTCBB to display nonfirm prices and unpriced indications of interest without disqualifying themselves as a QMS, provided that they otherwise meet all of the requirements for a QMS under Treasury Regulation 1.7704-1(g).³⁷ Compliance with the requirements for a QMS will be the sole responsibility of the matching service, not the NASD, The Nasdaq Stock Market, Inc., NASD Regulation, Inc., or the OTCBB.

2. Procedural Safeguards

One commenter requested that the NASD provide additional information concerning the procedures the NASD would employ to reasonably assure general partners that the DPP securities of the partnerships they manage would not afoul of the safe harbors in Treasury

³⁷ See letter from William P. O'Shea, Chief, Branch 3, Office of the Assistant Chief Counsel, IRS, to Richard G. Ketchum, Executive Vice President and Chief Operating Officer, NASD, dated October 7, 1996 and attached as Exhibit 3 to the NASD Response ("IRS Ruling").

Regulation 1.7704-01.³⁸ The NASD addressed this comment by noting that virtually all partnership agreements require that general partners first approve all transfers of partnership interests and grant the general partner the authority to reject transfers that may jeopardize the tax status of the partnership. The NASD explained that the proposal would not affect the fiduciary responsibility currently born by general partners of ensuring the tax status of their DPPs. Thus, the monitoring of the safe harbor threshold levels would continue to be the responsibility of the general partners.³⁹

3. Qualified Matching Services

One comment letter discussed the potential impact the proposal might have on the QMS safe harbor.⁴⁰ The commenter alleged that a shadow of uncertainty would be cast on the status of QMSs that also wished to publish quotes on the OTCBB because the OTCBB was not a QMS. The commenter claimed that such dual participation would jeopardize the QMS status of those members. In order to protect their QMS safe harbor status, the commenter predicted that QMSs would not publish quotes on the OTCBB and thereby lead to further fragmentation of the DPP market. In addition, the commenter asserted that this uncertainty would disadvantage those firms that made the investment in becoming qualified as a QMS because some general partners will simply suspend all trading at the 2% level, regardless of who is involved in the trades. To avoid these problems, the commenter suggested that the NASD modify the rules of the OTCBB to accommodate different turnover levels and obtain a private letter ruling from the IRS that specified that publishing nonfirm quotes on the OTC Bulletin Board would not disqualify a system as a QMS.

The NASD responded by noting that the proposal would have no effect whatsoever on the application of the QMS safe harbor because a QMS could maintain its status by simply complying with that safe harbor's requirements while utilizing the OTCBB.⁴¹ Moreover, the NASD asserted that QMSs may actually enjoy some advantages over non-QMS participants utilizing the OTCBB because QMSs could continue

to utilize the OCTBB until the 10% QMS safe harbor level was reached, while other OCTBB participants will be effectively capped by the IRS regulations at the 2% *de minimis* level.

B. Clearing Issues

1. Timing of Trade Reports

The commenters requested further guidance concerning the timing of DPP trade reporting.⁴² The commenters explained that transfers in the DPP secondary market differ significantly from transfers in other secondary securities markets in that these contracts are subject to a number of unique contingencies.⁴³ These contingencies often cause significant delays in the transfer process. As a result, many "trades" fail. Therefore, the commenters requested that the NASD reconsider when a trade takes place for ACT reporting purposes.

The NASD explained that an obligation to report a transaction in a DPP security is triggered on the day following the "date of execution."⁴⁴ Once an agreement to trade has been reached, the NASD expects the appropriate member to report the transaction. The NASD believes delaying the transaction report until a later date when the transfer actually occurs could mislead market participants and regulators who need to access the current value of a DPP.

In addition, the NASD does not believe it is necessary for the reporting member to submit a correction or fail to notice if a transfer does not take place after a transaction is reported. The NASD maintained that the subsequent events that may impair the process of transferring a DPP do not negate the circumstances surrounding the events that initially gave rise to the intent to trade the security.

2. OTC Bulletin Board Symbols

The commenters questioned the ability of the NASD's current six digit symbol format to sufficiently service all of the DPPs in existence, inquired

⁴² See Fotenos & Suttle Letter, *supra* note 4; NAPEX Letter, *supra* note 4.

⁴³ For example, transfers in the DPP secondary market are subject to the approval of the general partner(s), which often impose informational requirements. In addition, the prior consent of a state regulator may be required under certain circumstances. See Dudley Muth et al., *Transferring Limited Partnership Interests, Real Est. Sec. J.* Winter 1981, at 51 (detailing the transfer process of a DPP).

⁴⁴ See Amendment No. 1, *supra* note 6. Proposed NASD Rule 6910(e) defines the "date of execution" as "the date when the parties to a transaction in a DPP have agreed to all of the essential terms of the transaction, including the price and number of units to be traded."

whether it would be necessary to report a DPP transaction through ACT if a NASD symbol did not exist, and request that the NASD provide a symbol directory at least sixty days prior to the final implementation of this proposal so that NASD members would have ample time to input this information into their computer systems.⁴⁵

In response to these comments, the NASD assured the Commission that it will announce the effective date of the proposed rule change in a Notice to Members no later than forty-five days following commission approval of the proposed rule change and, in no event, will that effective date be sooner than forty-five days after Commission approval of the proposal.⁴⁶

3. Associated Costs

One commenter asserted that the proposal would increase its costs and reduce its allowable compensation.⁴⁷ The commenter attributed the increase in costs to the proposal's reporting requirement, the need for additional equipment, and reduced spreads.

4. Standardized Transfer Forms

Several commenters contended that the NASD's standardized transfer forms, including the standardized distribution allocation agreement, contain flaws that render them useless.⁴⁸ The commenters maintained that distribution terms are extremely material to the quoted price and, therefore, quotations on the OTC Bulletin Board should not be allowed until this matter is resolved.

In response, the NASD emphasized the importance of the standardized forms, but also acknowledged the difficulty of bringing total uniformity to every transfer in this market.⁴⁹ As a result, the NASD has filed a proposed amendment to NASD Rule 11580 that would permit members to modify the forms after receiving authorization from NASD Regulation staff.⁵⁰

⁴⁵ See CPB Letter No. 1, *supra* note 4; NAPEX Letter, *supra* note 4.

⁴⁶ See Amendment No. 1, *supra* note 6. The NASD also indicated that the effective date will be no later than 90 days following the publication of that Notice to Members. Should this schedule need to be revised, the NASD stated that it will immediately notify the Commission.

⁴⁷ See NAPEX Letter, *supra* note 4.

⁴⁸ See CPB Letter No. 3, *supra* note 4; NAPEX Letter, *supra* note 4; APS Letter, *supra* note 4. For example, one commenter asserted that it is often necessary to prepare two sets of transfer documents to effect transactions because many general partners refuse to honor the NASD's forms. NAPEX Letter, *supra* note 4.

⁴⁹ NASD Response, *supra* note 5.

⁵⁰ See Securities Exchange Act Release No. 38042 (Dec. 11, 1996), 61 FR 66339 (publishing notice of

³⁸ See Fotenos & Suttle Letter, *supra* note 4.

³⁹ See Amendment No. 1 *supra* note 6; IRS Ruling, *supra* note 37. To assist the general partners with such compliance, the NASD will make transaction reporting information available for a nominal fee.

⁴⁰ See CPB Letter No. 2, *supra* note 4.

⁴¹ See Amendment No. 1 *supra* note 6. See also IRS Ruling *supra* note 37.

V. Discussion

The Commission finds that the proposed rule change is consistent with the requirement of the Act and the rules and regulations thereunder applicable to a national securities association. Specifically, the Commission believes the proposed rule change is consistent with Section 15A(b)(6)⁵¹ because it is designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts, to perfect the mechanism of a free and open market, and, in general, to protect investors and the public interest. In making this finding, the Commission notes that the proposal should promote more efficient regulation of the DPP market, as well as enhance transparency, liquidity, and competition in that market.⁵² The Commission also believes the proposed rule change is consistent with Section 15A(b)(2)⁵³ because it improves the NASD's ability to regulate the DPP market by increasing its surveillance capabilities.⁵⁴

During the 1980s, over \$150 billion of public limited partnership interests were sold to approximately eleven million U.S. investors, most of whom were retail investors with an average investment of ten thousand dollars.⁵⁵ Investors usually purchased these securities with the understanding that they were long-term, illiquid investments to be held until the holding period expired and the partnership was liquidated.⁵⁶ The holding period of

many of these securities, however, had to be extended beyond the originally anticipated five to ten year holding period due to weakness in the underlying value of many partnership assets. This extended holding period has contributed to the development of a viable secondary market for DPP securities.⁵⁷ Given the size and nature of this market, it is important that it operate efficiently and fairly. In this regard, the proposal represents a positive, evolutionary change in the DPP market.⁵⁸ It increases transparency without adversely affecting the tax status of the quoted securities or inhibiting the clearance and settlement process.

A. Benefits of the Proposal

By increasing transparency, the proposed rule change should enhance investor protection and increase the actual and perceived fairness of the DPP market. The proposal should benefit investors by improving their ability to secure better prices in DPP transactions and by making it easier for them to monitor the quality of executions they receive from their intermediaries. Moreover, the increased transparency should assist regulators by expanding their market oversight capabilities and their ability to monitor member handling of DPP transactions and markups. Finally, the increased transparency should assist NASD members to fulfill their regulatory

responsibilities and help prevent overreaching by certain members of other, previously less informed members.

In addition, the proposal should promote liquidity in the DPP market by encouraging greater investor participation.⁵⁹ For example, a more transparent market can reduce trading costs by decreasing spreads and, as noted previously, facilitate the investors' ability to monitor the quality of executions they receive. This should foster investor confidence in the DPP market and, as a result, investors should be more willing to participate.⁶⁰ This increased participation should elevate the level of liquidity in the DPP market.⁶¹

⁵⁹ See Securities Exchange Act Release No. 37619A, 61 FR 48289 n.58, n.122 (Sept. 12, 1996) (adopting the "Order Execution Obligation Rules" and noting that past Commission enhancements to transparency have resulted in improved liquidity). One commenter claimed that the proposal will harm liquidity because it will reduce spreads which, in turn, will decrease members' compensation and, ultimately, cause market participants to reevaluate the services that they wish to provide. NAPEX Letter, *supra* note 4. The Commission recently addressed a similar concern in connection with its adoption of the Order Execution Obligation Rules. By mandating the display of customer limit orders under most circumstances, the Commission recognized that increased transparency may reduce market maker profits through the narrowing of spreads and, as a result, may force less efficient competitors to stop making markets in some of the securities that they then quoted. Nevertheless, the Commission did not believe the Order Execution Obligation Rules would have a significant negative impact on the market because customers are the ultimate source of liquidity for the markets. Order Execution Obligation Rules, *supra* note 59, at n.118. See also "Why Protect Investors?" Remarks by SEC Chairman Arthur Levitt Before the Commonwealth Club, San Francisco, California (May 17, 1996) available on SEC World Wide Web site at "www.sec.gov/news/spchindx.htm#chair" (noting that a market can exist without brokers, but it cannot exist without investors). Similarly, the Commission believes the proposal's benefits of increased investor protection, elevated liquidity, and improved efficiency outweigh its associated costs, including the potential loss of liquidity provided by market makers.

⁶⁰ One commenter expressed concern that approval of the proposal will cause the volume of DPP transactions to explode and unduly exacerbate certain clearance and settlement issues that currently exist in this market. See NPM Letter, *supra* note 4. So also Muth et al., *supra* note 43 (detailing the complicated clearance and settlement process). The Commission disagrees. Although more investors, traders, and dealers may be willing to participate in a fairer, more transparent, more competitive DPP market, any potential increase in the volume of transactions that may occur in this market is limited by the applicable IRC provisions and the rules and regulations promulgated thereunder. Furthermore, this inhibition on volume should prevent these long-term investments from being converted into short-term speculative securities and minimize any potential effect on the primary market for DPPs.

⁶¹ SEC, Division of Market Regulation, Market 2000: An Examination of Current Equity Market Developments IV-3 (Jan. 1994) ("Market 2000

File No. SR-NASD-96-42). Currently, NASD Rule 11580 does not allow NASD members to modify the NASD's standardized forms concerning limited partnership interests.

⁵¹ 15 U.S.C. 78O-3(b)(6).

⁵² 15 U.S.C. 78c(f) (as added by the "National Securities Markets Improvement Act of 1996").

⁵³ 15 U.S.C. 78O-3(b)(2).

⁵⁴ The Commission notes that the proposal also promotes many of the same policy considerations Congress found appropriate for the development of the National Market System. For example, the proposal should improve the efficiency of DPP market operations, broaden the distribution of market information, enhance the NASD's market oversight capabilities, and foster competition among market participants through the use of new data processing and communications techniques. See 15 U.S.C. 78k-1(a)(1).

⁵⁵ *Senate Comm. on Banking, Housing, and Urban Affairs, Limited Partnership Rollup Reform Act of 1993, S. Rep. No. 121, 103d Cong., 1st Sess., 4 (1993)*. See also Deborah A. DeMott, *Rollups of Limited Partnerships: Questions of Regulation and Fairness*, 70 Wash. U. L.Q. 617 (1992) in *Limited Partnerships: Hearings on H.R. 617 Before the Subcomm. on Telecommunications and Finance of the House Committee on Energy and Commerce*, 103d Cong., 1st Sess., 114-15 (1993) (classifying the limited partnership interests sold by broker-dealers as an overwhelmingly "retail" product because 8 million of the 11 million purchasers of these securities were individual investors).

⁵⁶ *House Comm. on Energy and Commerce, Limited Partnership Rollup Reform Act of 1993, H.R. Rep. No. 21, 103 Cong., 1st Sess., 7 (1993)*;

Securities Exchange Act Release No. 29883 (Oct. 30, 1991), 56 FR 57237 (adopting rules intended to enhance the quality of information provided to investors in connection with transactions involving rollups of limited partnerships). See also C. David Chase, *Mugged on Wall Street* 195 (1987) (espousing the author's personal opinion that it is easier to divorce one's spouse than to separate from a partnership).

⁵⁷ The longer the holding period, the more likely an event requiring a limited partner to sell his interest will occur (e.g., death, liquidation of an IRA account, divorce, or an extraordinary expense such as a major medical procedure or post-secondary education). See also NASD Response, *supra* note 5 (asserting that, in the aggregate, this market transfers an estimated \$250 to \$300 million worth of DPP securities annually).

⁵⁸ One commenter suggested that the Commission delay its consideration of the proposed rule change until it had rendered a decision regarding two pending NASD petitions for rulemaking. See NPM Letter, *supra* note 4 (discussing the NASD's pending rulemaking petitions concerning the applicability of Rules 10b-17, 17Ad-2, 17Ad-3, 17Ad-4, and 17Ad-6 to the DPP market). The NASD withdrew its request concerning the modification of SEC transfer agent rules under Section 17A of the Act on December 23, 1996. See letter from Suzanne E. Rothwell, Associate General Counsel, NASD Regulation, Inc., to Jonathan G. Katz, Secretary, SEC, dated December 20, 1996 (File No. 4-387) Although the pending rulemaking petition addresses important issues, the Commission believes the issues presented in the proposed rule change may be addressed independently of those matters.

The proposal also fosters market efficiency by helping unite the extremely fragmented DPP market. The current structure of this market requires the DPP securities be traded "in the dark" (*i.e.*, with little or not transparency for those trades). This prevents investors from assessing the overall supply and demand for a particular DPP security and, consequently, hampers their ability to determine that security's optimal price. Furthermore, this opaque trading makes price competition difficult and inefficient.⁶²

The proposal addresses both of these inefficiencies. First, by requiring that all transactions in DPP securities be reported through ACT⁶³ and permitting quotes and market information to be disseminated via the OTC Bulletin Board, the proposal provides investors with valuable information that enhances their ability to accurately determine the current value of a DPP, discern the direction of recent trading activity, and determine whether significant trading is occurring between, or outside of, the displayed nonfirm quotes. Second, the proposed rule change fosters price competition in this market⁶⁴ because

Study"); Securities Exchange Act Release No. 37273 (June 4, 1996), 61 FR 29438 (noting that the depth and liquidity of any particular security is dependent on numerous variables, including the degree of customer buying and selling interest in the security and the quality and capitalization of the issuer).

⁶² American Bar Association, Committee on Partnerships and Unincorporated Business Organizations, Publicly Traded Limited Partnership, 39 Bus. Law. 717-18 (1984) (explaining that secondary sales of limited partnership often result in a "haphazard search" to find a buyer for the unit).

⁶³ See *supra* note 30 (listing the limited exemptions from the reporting requirement).

⁶⁴ One commenter asserted that utilizing nonfirm quotes and unpriced indications of interest will encourage market participants to place unrealistic bids to attract sellers. See NAPEX Letter, *supra* note 4. This assertion, however, overlooks at least three policing mechanisms inherent in a competitive market.

First, the existence of other quotes limit the ability of a market participant to place an unrealistic quote to attract interest and then move away from this quote once negotiations begin. Assume, for example A, B, and C each place a bid on the OTCBB for a particular DPP at \$1050, \$1025, and \$1000 respectively. Naturally, a prospective seller would begin negotiating with the most favorable bidder, in this case A. If A attempts to reduce its bid lower than \$1025, A risks losing the transaction because A does not know B's intentions—B may be willing to pay \$1025.

Second, members are under a duty to provide their customers with best execution as to price. NTM-91-69 points out that this requires a member to obtain quotations from at least three dealers to determine the best interdealer market price for a non-Nasdaq security. For example, if W, X, Y, and Z each place a bid on the OTCBB for a particular DPP at \$1050, \$1025, \$1000, and \$975 respectively, the seller's broker would contact, at a minimum, W, X, and Y. If W, X, and Y are only willing to trade

pricing information will be more readily available.⁶⁵

In sum, the increased transparency should reduce the effects of fragmentation and encourage competition.⁶⁶ Thus, the Commission believes that proposal's benefits of increased transparency for the DPP market outweigh its potential costs.⁶⁷

B. Tax Issues

Although most of the commenters' concerns⁶⁸ are explicitly addressed in Treasury Regulation 1.7704-1,⁶⁹ the NASD obtained a private letter ruling that, among other things, specifically addresses each of their tax concerns.⁷⁰ In that ruling, the IRS explained that (1) the OTCBB is not an established securities market, a secondary securities market, or the substantial equivalent thereof and (2) the calculations relating to qualification for any applicable safe

at prices below Z's bid, the broker should contact Z as well.

Third, the Commission notes that NASD Rule 3310 prohibits members from publishing any quotation for any security without having reasonable cause to believe that such quotation is a bona fide quotation and is not published for any deceptive or manipulative purpose.

⁶⁵ This information will be accessible from almost 6,000 Nasdaq Workstations and an additional 290,000 market data vendor terminals. NASD Response, *supra* note 5.

⁶⁶ Market 2000 Study, *supra* note 61, at IV-1.

⁶⁷ One commenter claimed that the reporting requirement would increase members' costs by requiring them to procure additional equipment. See NAPEX Letter, *supra* note 4. The Commission does not believe the proposal will have a significant impact on the NASD's membership as a whole because this justifiable cost will be limited to a relatively small group of members. Cf. NTM-91-69, *supra* note 14 (finding that the DPP market was consisted primarily of two dozen participants acting as principal or agent); CPB Letter No. 2, *supra* note 4 (claiming to have effectuated one-third of all transactions reported to independent sources since 1992); NASD Response, *supra* note 5 (noting that the NASD interviewed all identifiable participants in the secondary market for DPPs). Moreover, the Commission notes that members that average five or fewer trades per day for the previous calendar quarter will not need to acquire any additional equipment because they may utilize the ACT Service Desk to report their trades. Proposed NASD Rule 6920. Thus, of this already limited group, only active members who do not already possess the necessary equipment will be affected. See also *supra* note 59 and accompanying text (discussing the costs associated with increased transparency).

⁶⁸ As noted above, the commenters raised several concerns regarding the potential tax implications they believed the proposed rule change could have. Specifically, the commenters requested that: (1) the NASD obtain a private letter ruling from the IRS stating that the inclusion of a DPP on the OTCBB would not, by itself, transform that DPP into a publicly traded partnership; (2) the NASD detail what procedural protections were going to exist to ensure that the IRS safe harbor provisions were not exceeded; and (3) the NASD consider the potential impact the proposal could have on QMSs.

⁶⁹ See Treas. Reg. § 1.7704-1(j)(2) (setting forth in Example 2 a hypothetical situation that is virtually identical to the NASD's proposed rule change).

⁷⁰ IRS Ruling, *supra* note 37.

harbor in Treasury Regulation 1.7704-1 or IRS Notice 88-75 are the sole responsibility of the partnerships whose interests are traded.⁷¹ Thus, there is no need for the NASD to make any additional modifications to the OTCBB.⁷²

The IRS also clarified that a QMS may utilize the OTCBB without jeopardizing its status as a QMS, as long as the QMS continues to comply with all of the applicable safe harbor provisions.⁷³ Hence, a member that has made the capital investment to become a QMS may enjoy an advantage over those members that are not a QMS because the IRS regulations permit QMSs to facilitate transactions until the 10% QMS safe harbor threshold is met, while members relying on the *de minimis* safe harbor are capped at 2%.⁷⁴ This advantage should promote competition and increase the market's liquidity by encouraging other NASD members to become QMSs.

C. Clearing Issues

1. Trade Reporting

Notwithstanding the unique contingencies that exist in a DPP transaction, the Commission believes it is appropriate for the NASD to require its members to report transactions in DPP securities as soon as an agreement to trade has been reached. By reporting transactions by T+1, the member will be reporting the current trading interest in a particular DPP. If the reporting requirement were postponed until the date the transfer actually takes place, investors would be receiving information that was several weeks, or possibly months, old. The usefulness of such information to parties attempting to ascertain the current value of a DPP

⁷¹ IRS Ruling, *supra* note 37.

⁷² Nevertheless, the NASD has indicated that it will assist general partners by making transaction data available to them for a nominal fee. The Commission notes, however, that the NASD's rules currently do not contain the formula by which such charges will be calculated. Therefore, the NASD must submit a proposed rule change to the Commission pursuant to Section 19 of the Act before charging such a fee. Moreover, given that this fee will be imposed on non-NASD members, it must be submitted for full notice and comment because it does not qualify for immediate effectiveness pursuant to Section 19(b)(3)(A) of the Act. See 15 U.S.C. 78s(b); Securities Exchange Act Release No. 35123 (Dec. 20, 1994), 59 FR 66692 (amending Rule 19b-4 and stating that, as a matter of general policy, a proposed rule change that establishes or changes a fee applicable to nonmembers must be filed under Section 19(b)(2) of the Act for full notice and comment).

⁷³ IRS Ruling, *supra* note 37.

⁷⁴ Certain transactions, such as those not involving trading, are not subject to a strict, predetermined cap. See *supra* notes 23 to 28 and accompanying text (providing a general explanation of the IRS safe harbor provisions).

is minimal when compared to information reported by T+1. Moreover, reporting a trade when the agreement occurs, rather than waiting until the transfer actually takes place, is consistent with current industry practice for other securities.

The Commission also does not believe it is necessary for members to submit a notice at a later date if a trade fails due to the unique post-trade contingencies that exist in the DPP market.⁷⁵

Ultimately, the price of a security is determined by two factors: the amount of money a buyer is willing to spend to acquire a certain amount of a particular security and the amount of money a seller is willing to accept to sell the same amount of that security. It is this information that investors value the most. The fact that a transaction fails at a later date because a general partner refuses to acknowledge the trade does not disparage the quality of the previously reported information concerning current market interest.⁷⁶

2. Implementation

The Commission believes the NASD's implementation plan adequately addresses the commenters' concerns. The NASD intends to announce the effective date of the proposed rule change in a Notice to Members within forty-five days following the date of this order. This effective date will be no later than 90 days following the publication of that Notice to Members but, in no event, will the effective date be sooner than forty-five days after the date of this order.⁷⁷ This implementation schedule should provide the NASD's members with ample time to procure any necessary equipment and enter any essential data into their computer systems.

To facilitate transaction reporting, the NASD has compiled a comprehensive list of symbols that will be utilized by members when reporting a transaction through ACT.⁷⁸ If a symbol does not

⁷⁵ Of course, members must correct inaccurate trade reports. For example, a member must correct a trade reported at \$680 if, in fact, the trade price was \$860.

⁷⁶ The Commission assumes that the parties are bargaining in good faith when they reach an agreement that is subsequently reported through ACT. Cf. NASD Rule 3310 (prohibiting members from publishing the notice of a purchase or sale of any security without having reasonable cause to believe that such transaction was a bona fide purchase or sale).

⁷⁷ Amendment No. 1, *supra* note 6.

⁷⁸ This list will automatically be incorporated into the Nasdaq Workstation's on-line symbols directory when the proposed rule change becomes effective. If members would like a copy of this list prior to the proposal's implementation, however, they simply have to contact the Nasdaq Market Operations staff in Trumbull, Connecticut, and an electronic or paper copy will be provided.

exist for a particular DPP, a member simply calls the ACT Service Desk before reporting the transaction, and a symbol will be assigned.⁷⁹

D. Amendment No. 1

The Commission finds good cause for approving Amendment No. 1 prior to the thirtieth day after the date of publication of notice thereof in the Federal Register. Amendment No. 1 simply updates the proposal's internal citations to conform with the new rule numbering system that was implemented by the NASD after it filed SR-NASD-96-08 with the Commission. Therefore, the Commission believes that granting accelerated approval to Amendment No. 1 is appropriate and consistent with Section 15A and Section 19(b)(2) of the Act.⁸⁰

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 1 to the proposed rule change. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rules change that are filed with the Commission, and all written communications relating to Amendment No. 1 between the Commission and any persons, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. § 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available at the principal office of the NASD. All submissions should refer to File No. SR-NASD-96-08 and should be submitted by February 5, 1997.

⁷⁹ The Commission believes the current six digit format is sufficient to service the DPP market. *Contra* NAPEX Letter, *supra* note 4. After polling the major market participants, the NASD represented that it anticipates approximately 2,000 DPP securities to be quoted on the OTCBB. Telephone conversation between Andrew S. Margolin, Senior Attorney, The Nasdaq Stock Market, Inc., and Anthony P. Pecora, Attorney, Division of Market Regulation, SEC (Jan. 3, 1996). Notwithstanding that the NASD intends to utilize the prefixes "xx," "yy," and "zz" to indicate DPP securities, the remaining four digits still provide ample capacity because a surplus of approximately 86,000 symbols will exist to accommodate unanticipated or new DPP securities. In addition, the Commission does not believe the expense associated with mandating an entirely new, expanded symbol format to ensure the symbols assigned clearly indicate the issuer of a particular DPP outweighs the potential benefits such a convenience would confer upon NASD members.

⁸⁰ 15 U.S.C. 70o-3, 78s(b)(2).

VI. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,⁸¹ that the proposed rule change (SR-NASD-96-08) is approved, including Amendment No. 1 on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁸²

Margaret H. McFarland,
Deputy Secretary.

[FR Doc. 97-896 Filed 1-14-97; 8:45 am]

BILLING CODE 8010-01-M

DEPARTMENT OF STATE

[Public Notice No. 2499]

Shipping Coordinating Committee Subcommittee on Safety of Life at Sea Working Group on Dangerous Goods, Solid Cargoes and Containers; Notice of Meeting

The Working Group on Dangerous Goods, Solid Cargoes and Containers (DSC) of the Subcommittee on Safety of Life at Sea (SOLAS) will conduct an open meeting at 9:30 AM on January 31, 1997, in Room 2415, at U.S. Coast Guard Headquarters, 2100 2nd Street, S.W., Washington, DC 20593-0001. The purpose of the meeting is to finalize preparations for the Second Session of the DSC Subcommittee of the International Maritime Organization (IMO) which is scheduled for February 24-28, 1997, at the IMO Headquarters in London.

The agenda items of particular interest are:

a. Amendment 29 to the International Maritime Dangerous Goods (IMDG) Code, its Annexes and Supplements including harmonization of the IMDG Code with the UN Recommendations on the Transport of Dangerous Goods.

b. Implementation of Annex III of the Marine Pollution Convention (MARPOL 73/78), as amended.

c. Development of measures complementary to the Irradiated Nuclear Fuel (INF) Code.

d. Amendments to SOLAS chapters VI and VII.

e. Bulk carrier safety: need for fitting water level alarms in cargo holds.

f. Revision of the format of the IMDG Code.

g. Loading and unloading of bulk cargoes.

h. Cargo securing manual.

i. Reports on incidents involving dangerous goods or marine pollutants in packaged form on board ships or in port areas.

⁸¹ 15 U.S.C. 78s(b)(2).

⁸² 17 CFR 200.30-3(a)(12).