

# REGISTRATION OF OIL AND GAS PROGRAMS

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**1. INTRODUCTION.** *A. Application.* 1. These guidelines apply to the registration and qualification of oil and gas programs, as defined in Section I.B.23 below, and will be applied by analogy to oil and gas programs in other forms, including but not limited to multi-tier structures. While applications not conforming to the standards contained herein shall be looked upon with disfavor, where good cause is shown certain guidelines may be modified or waived by the Administrator.

2. Where the individual characteristics of specific programs warrant modification from these standards, they will be accommodated, insofar as possible, while still being consistent with the spirit of the guidelines.

*B. Definitions.* As used in the guidelines, the following terms mean:

1. *Administrative Costs:* All customary and routine expenses incurred by the sponsor for the conduct of program administration, including: legal, finance, accounting, secretarial travel, office rent, telephone, data processing and other items of a similar nature.
2. *Administrator :* The official or agency administering the securities laws of a state.
3. *Affiliate :* An affiliate of a specified person means (a) any person directly or indirectly owning, controlling, or holding with power to vote 10 percent or more of the outstanding voting securities of such specified person; (b) any person 10 percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such specified person; (c) any person directly or indirectly controlling, controlled by, or under common control with such specified person; (d) any officer, director, trustee or partner of such specified person, and (e) if such specified person is an officer, director, trustee or partner, any person for which such person acts in any such capacity.
4. *Assessments:* Additional amounts of capital which may be mandatorily required of or paid voluntarily by a participant beyond his subscription commitment.
5. *Capital Contributions :* The total investment, including the original investment, assessments and amounts reinvested, in a program by a participant or by all participants, as the case may be.
6. *Capital Expenditures* Those costs associated with property acquisition and the drilling and completion of oil and gas wells which are generally accepted as capital expenditures pursuant to the provisions of the Internal Revenue Code.
7. *Carried Interest:* An equity interest in a program issued to a person without consideration, in the form of cash or tangible property, in an amount proportionately equivalent to that received from the participants.

8. *Cost*: When used with respect to property in Section VI, means (a) the sum of the prices paid by the seller to an unaffiliated person for such property, including bonuses; (b) title insurance or examination costs, brokers' commissions, filing fees, recording costs, transfer taxes, if any, and like charges in connection with the acquisition of such property; (c) a pro rata portion of seller's actual necessary and reasonable expenses for seismic and geophysical services; and (d) rentals and ad valorem taxes paid by the seller with respect to such property to the date of its transfer to the buyer, interest and points actually incurred on funds used to acquire or maintain such property, and such portion of the seller's reasonable, necessary and actual expenses for geological, engineering, drafting, accounting legal and other like services allocated to the property cost in conformity with generally accepted accounting principles and industry standards, except for expenses in connection with the past drilling of wells which are not producers of sufficient quantities of oil and gas to make commercially reasonable their continued operations, and provided that the expenses enumerated in this subsection (d) hereof shall have been incurred not more than 36 months prior to the purchase by the program; provided that such period may be extended, at the discretion of the Administrator, upon proper justification. When used with respect to services, "cost" means the reasonable, necessary and actual expenses incurred by the seller on behalf of the program in providing such services, determined in accordance with generally accepted accounting principles. As used elsewhere, "cost" means the price paid by the seller in an arm's-length transaction.
9. *Development Well*: A well drilled within the proved area of an oil or gas reservoir to the depth of a stratigraphic horizon known to be productive.
10. *Direct Costs*: All actual and necessary costs directly incurred for the benefit of the program and generally attributable to the goods and services provided to the program by parties other than the sponsor or its affiliates. Direct costs shall not include any cost otherwise classified as organization and offering expenses, administrative costs, or property costs. Direct costs may include the cost of services provided by the sponsor or its affiliates if such services are provided pursuant to written contracts and in compliance with Section V.B.8 of these guidelines.
11. *Exploratory Well*: A well drilled to find commercially productive hydrocarbons in an unproved area, to find a new commercially productive horizon in a field previously found to be productive of hydrocarbons at another horizon, or to significantly extend a known prospect.
12. *Farmout*: An agreement whereby the owner of the leasehold or working interest agrees to assign his interest in certain specific acreage to the assignees, retaining some interest such as an overriding royalty interest, an oil and gas payment, offset acreage or other type of interest, subject to the drilling of one or more specific wells or other performance as a condition of the assignment.
13. *Horizon* : A zone of a particular formation; that part of a formation of sufficient porosity and permeability to form a petroleum reservoir.
14. *Independent Expert*: A person with no material relationship to the sponsor who is qualified and who is in the business of rendering opinions regarding the value of oil and gas properties based upon the evaluation of all pertinent economic, financial, geologic and engineering information available to the sponsor.
15. *Landowner's Royalty Interest*: An interest in production, or the proceeds therefrom, to be received free and clear of all costs of development, operation, or maintenance, reserved by a landowner upon the creation of an oil and gas lease.

16. *Non-Capital Expenditures:* Those expenditures associated with property acquisition and the drilling and completion of oil and gas wells that under present law are generally accepted as fully deductible currently for federal income tax purposes.
17. *Operating Costs:* Expenditures made and costs incurred in producing and marketing oil or gas from completed wells, including, in addition to labor, fuel, repairs, hauling, materials, supplies, utility charges and other costs incident to or therefrom, ad valorem and severance taxes, insurance and casualty loss expense, and compensation to well operators or others for services rendered in conducting such operations.
18. *Organization and Offering Expenses:* All costs of organizing and selling the offering, including but not limited to, total underwriting and brokerage discounts and commissions (including fees of the underwriters' attorneys), expenses for printing, engraving, mailing, salaries of employees while engaged in sales activity, charges of transfer agents, registrars, trustees, escrow holders, depositaries, engineers and their experts, expenses of qualification of the sale of the securities under Federal and State law, including taxes and fees, accountants' and attorneys' fees and other front-end fees.
19. *Overriding Royalty Interest:* An interest in the oil and gas produced pursuant to a specified oil and gas lease or leases, or the proceeds from the sale thereof, carved out of the working interest, to be received free and clear of all costs of development, operation, or maintenance.
20. *Participant:* The purchaser of a unit in the oil and gas program.
21. *Person:* Any natural person, partnership, corporation, association, trust or other legal entity.
22. *Production Purchase or Income Program:* Any program whose investment objective is to directly acquire, hold, operate and/or dispose of producing oil and gas properties. Such a program may acquire any type of ownership interest in a producing property, including but not limited to, working interests, royalties, or production payments. A program which spends at least 90% of capital contributions and funds borrowed (excluding offering and organizational expenses) in the above described activities is presumed to be a production purchase or income program.
23. *Program:* One or more limited or general partnerships or other investment vehicles formed, or to be formed, for the primary purpose of exploring for oil, gas and other hydrocarbon substances or investing in or holding any property interests which permit the exploration for or production of hydrocarbons or the receipt of such production or the proceeds thereof (a prospectus may offer a series of programs with individual programs being formed in sequence).
24. *Prospect:* An area covering lands which are believed by the sponsor to contain subsurface structural or stratigraphic conditions making it susceptible to the accumulations of hydrocarbons in commercially productive quantities at one or more horizons. The area, which may be different for different horizons, shall be designated by the sponsor in writing prior to the conduct of program operations and shall be enlarged or contracted from time to time on the basis of subsequently acquired information to define the anticipated limits of the associated hydrocarbon reserves and to include all acreage encompassed therein. A "prospect" with respect to a particular horizon may be limited to the minimum

area permitted by state law or local practice, whichever is applicable, to protect against drainage from adjacent wells if the well to be drilled by the program is to a horizon containing proved reserves.

25. *Proved Reserves*: Those quantities of crude oil, natural gas, and natural gas liquids which, upon analysis of geologic and engineering data, appear with reasonable certainty to be recoverable in the future from known oil and gas reservoirs under existing economic and operating conditions. Proved reserves are limited to those quantities of oil and gas which can be expected, with little doubt, to be recoverable commercially at current prices and costs, under existing regulatory practices and with existing conventional equipment and operating methods. Depending upon their status of development, such proved reserves shall be subdivided into the following classifications:
- (a) Proved Developed Reserves. These are proved reserves which can be expected to be recovered through existing wells with existing equipment and operating methods. This classification shall include:

- (1) Proved Developed Producing Reserves. These are proved developed reserves which are expected to be produced from existing completion interval(s) now open for production in existing wells, and
- (2) Proved Developed Non-Producing Reserves. These are proved developed reserves which exist behind the casing of existing wells, or at minor depths below the present bottom of such wells, which are expected to be produced through these wells in a predictable future, where the cost of making such oil and gas available for production should be relatively small compared to the cost of a new well.

Additional oil and gas expected to be obtained through the application of fluid injection or other improved recovery techniques for supplementing the natural forces and mechanisms of primary recovery should be included as "Proved Developed Reserves" only after testing by a pilot project or after the operation of an installed program has confirmed through production response that increased recovery will be achieved.

- (b) Proved Undeveloped Reserves. These are proved reserves which are expected to be recovered from new wells on undrilled acreage, or from existing wells where a relatively major expenditure is required for recompletion. Reserves on undrilled acreage shall be limited to those drilling units offsetting productive units, which are virtually certain of production when drilled. Proved reserves for other undrilled units can be claimed only where it can be demonstrated with certainty that there is continuity of production from the existing productive formation.

Under no circumstances should estimates for proved undeveloped reserves be attributable to any acreage for which an application of fluid injection or other improved recovery technique is contemplated, unless such techniques have been proved effective by actual tests in the area and in the same reservoir. If warranted, however, a narrative discussion can be provided to point out those areas where future drilling or other operations may develop oil and gas production which at the time of filing is considered too uncertain to be expressed as numerical estimates for proved reserves.

26. *Roll-Up* : A transaction involving the acquisition, merger, conversion, or consolidation, either directly or indirectly, of the program and the issuance of securities of a roll-up entity. Such term does not include:

- (a) a transaction involving securities of the program that have been listed for at least 12 months on a national exchange or traded through the National Association of Securities Dealers Automated Quotation National Market System; or
- (b) a transaction involving the conversion to corporate, trust or association form of only the program if, as a consequence of the transaction, there will be no significant adverse change in any of the following:
  - (1) voting rights;
  - (2) the term of existence of the program;
  - (3) sponsor compensation; or
  - (4) the program's investment objectives.

- 27. *Roll-Up Entity* : A partnership, trust, corporation or other entity that would be created or survive after the successful completion of a proposed roll-up transaction.
- 28. *Sponsor*: Any person directly or indirectly instrumental in organizing, wholly or in part, a program or any person who will manage or is entitled to manage or participate in the management or control of a program. "Sponsor" includes the managing and controlling general partner(s) and any other person who actually controls or selects the person who controls 25% or more of the exploratory, developmental or producing activities of the program, or any segment thereof, even if that person has not entered into a contract at the time of formation of the program. " Sponsor" does not include wholly independent third parties such as attorneys, accountants, and underwriters whose only compensation is for professional services rendered in connection with the offering of units. Whenever the context of these guidelines so requires, the term "sponsor" shall be deemed to include its affiliates.
- 29. *Subordinate Interest*: An equity interest in a program issued to a person, without payment of full consideration, after the attainment of certain specified performance by the program.
- 30. *Working Interest*: An interest in an oil and gas leasehold which is subject to some portion of the costs of development, operation, or maintenance.

**II. REQUIREMENTS OF SPONSOR.** *A. Experience* The sponsor or its chief operating officers shall have at least three years' relevant oil and gas experience demonstrating the knowledge and experience to carry out the stated program policies and to manage the program operations. Additionally, the sponsor or any affiliate providing services to the program shall have had not less than four years' relevant experience in the kind of service being rendered, or otherwise must demonstrate sufficient knowledge and experience to perform the services proposed. If any managerial responsibility for the program is to be rendered by persons other than the sponsor, then such persons must be identified in the prospectus, their experience must be similar to that required of a sponsor and must be set out in the prospectus, and a contract setting forth the basis of their relationship with the program must be filed with and not disapproved by the Administrator.

*B. Net Worth* : 1. The financial condition of the sponsor must be commensurate with any financial obligations assumed by it in connection with the offering and the operation of the program.

- (a) For limited partnership offerings, the general partner must specifically have a minimum aggregate net worth at all times equal to 5% of participants' capital in

all existing programs organized by the general partner plus 5% of total subscriptions in the program being offered, but such minimum required net worth shall in no case be less than \$200,000 nor shall net worth in excess of \$2 million be required.

- (b) For general partnership offerings and other offerings in which investors are not provided statutory protection against unlimited liability, the managing or controlling general partner's net worth should be of a sufficient amount to adequately protect the participants against unreasonable exposure to program liabilities. Unless the Administrator establishes a different amount based upon mitigating factors, \$5 million will be considered a presumptively reasonable net worth.

2. For purposes of computing a managing or controlling general partner's net worth, 70% of the standardized measure of discounted future net cash flows relating to the proved oil and gas reserves, as determined by a qualified independent petroleum consultant, of a managing or controlling general partner may be used as an alternative to the stated value of the associated oil and gas properties on the sponsor's balance sheet. Reserves, notes and accounts receivables from all programs, interests in all programs, and all contingent liabilities will be scrutinized carefully to determine the appropriateness of their inclusion in the net worth computation. If an individual managing or controlling general partner's net worth is used in complying with the above requirements, a statement as to such net worth shall be included in the prospectus.

3. If more than one person acts or serves as managing or controlling general partner of a program, the net worth requirements may be met by aggregating the net worth of all such persons. In addition, the net worth of any guarantor of the managing or controlling general partner's obligations to or for the program may be included in the net worth computation, but only if the guarantor's liability is co-extensive with that of the managing or controlling general partner and the financial statements of the guarantor, prepared in accordance with the requirements of Section II.C of the guidelines, are furnished to the Administrator and made available to participants.

C. *Financial Statements*. 1. Managing or controlling general partners, other than individuals, shall provide to the Administrator and make available to participants, upon request, audited financial statements for the most recent fiscal year and unaudited financial statements for any interim period ending not more than 90 days prior to the date of filing the application; provided however, if the application is made in coordination with a Securities and Exchange Commission filing, the date of the financial statements may be not more than 135 days prior to the date of filing the registration application. The financial statements shall include, at a minimum, a balance sheet and a statement of operations. The statements shall be prepared in accordance with generally accepted accounting principles and the statements for the most recent fiscal year shall be accompanied by an audit report from an independent certified public accountant.

2. Individual managing or controlling general partners, whose net worth is being relied upon for purposes of demonstrating compliance with Section II.B of these guidelines, shall provide the Administrator and make available to participants a statement of financial condition as of a date not more than 90 days prior to the date of filing the application. The statement of financial condition shall be prepared in accordance with generally accepted accounting principles and accompanied by a review report from an independent certified public accountant.

D. *Additional Requirements for General Partnership and Working Interests Programs*. For offerings in which investors are not provided statutory protection against unlimited liability:

1. The sponsor shall agree to fully indemnify each participant against all program related liabilities which exceed the participant's interest in the undistributed net assets of the program. This indemnification shall be included in the program agreement.

2. Unless the Administrator establishes different terms, the sponsor shall obtain insurance coverage protecting the program and the participants against potential liabilities. The coverage should include public liability insurance with limits, including umbrella policy limits, of at least two times the program's capitalization but in no event less than \$10 million. Coverage limits in excess of \$50 million will not be required unless there are extraordinary circumstances. Other insurance policies, such as well control, environmental damage and workers compensation, should also be obtained if the program is going to engage directly in operating activities or will otherwise be exposed to potential losses in these areas. The program agreement must require the sponsor to notify the participants thirty days prior to the effective date of any adverse material change in the program's insurance coverage. If the insurance coverage is to be materially reduced, the program agreement must provide the participants a right to convert their program interests from general partnership or working interests to limited partnership interests prior to such reduction, or in the alternative, the program agreement may require the cessation of all drilling activity until the required insurance coverage can be obtained.

3. The prospectus shall disclose the terms of the indemnification agreement and shall also disclose the types and amounts of insurance coverage to be obtained for the benefit of the program and the participants along with the insurance claims history of the sponsor in the area where the program anticipates drilling wells, if such information is material. The Administrator may establish different requirements for the protection of participants based on the specific circumstances surrounding the program's proposed activities. In establishing such requirements, the Administrator may consider factors such as the net worth of the sponsor and any other person who has agreed to indemnify the participants, the insurance claims history of the sponsor and its previous programs, the availability and cost to the program of the insurance, the extent to which the drilling to be conducted by the program may include exploratory drilling, the geological and other characteristics of the formations to be developed by the program, and other procedures or policies implemented by the sponsor which may increase or decrease the potential risk of loss or liability to the program or the potential magnitude of loss or liability to the program.

E. *Tax Ruling or Opinion.* If a significant feature for federal income or excise tax purposes of a program is either deductions in excess of income from the program being available in a year to reduce income from other sources in that year or credits in excess of the tax attributable to the income from the investment being available within a year to offset taxes on income from other sources in that year, then the sponsor must receive a tax ruling from the Internal Revenue Service or an opinion of qualified tax counsel in a form acceptable to the Administrator concerning the status of the program for federal income tax purposes and an opinion of qualified tax counsel in a form acceptable to the Administrator indicating whether it is more likely than not that an investor will prevail on the merits of each material tax issue respecting which there is a reasonable possibility that the Internal Revenue Service will challenge the tax effect disclosed in the prospectus.

F. *Investment in Program.* In appropriate cases, in order to create an identity of interest with the participants, the Administrator may require that the sponsor purchase for cash up to 5.0% of the program units.

G. *Reports.* The Sponsor shall agree to file with the Administrator, if he so requests it, concurrently with their transmittal to participants, a copy of each report made pursuant to Section VIII.B of these guidelines.

H. *Fiduciary Duty* . 1. The program agreement and prospectus shall provide that the sponsor shall have a fiduciary responsibility for the safekeeping and use of all funds and assets of the program, whether or not in the sponsor's possession or control, and that the sponsor shall not employ, or permit another to employ, such funds or assets in any manner except for the exclusive benefit of the program.

2. Except as provided in Section II.H.3, neither the program agreement nor any other agreement between the sponsor and the program shall contractually limit any fiduciary duty owed to the participants by the sponsor under any applicable law.

3. The program agreement may contractually limit fiduciary duties owed to the participant by the sponsor as follows:

- (a) The program may indemnify and hold harmless the sponsor and its affiliates as provided in Section II.I
- (b) The sponsor may be required to devote only so much of its time as is necessary to manage the affairs of the program.
- (c) The sponsor and its affiliates may conduct business with the program in a capacity other than as sponsor but only in compliance with Sections V and VI of these guidelines.
- (d) Except as otherwise provided in Section VI of these guidelines, the sponsor and any of its affiliates may pursue business opportunities that are consistent with the program's investment objectives for their own account only after they have determined that such opportunity either cannot be pursued by the program because of insufficient funds or because it is not appropriate for the program under the existing circumstances.
- (e) The sponsor may manage multiple programs simultaneously.

I. *Liability and Indemnification of the Sponsor*. 1. The program shall not provide for indemnification of the sponsor, or its affiliates performing services on behalf of the program for any liability or loss suffered by the sponsor or affiliate, nor shall it provide that the sponsor or affiliate be held harmless for any loss or liability suffered by the program, unless all of the following conditions are met:

- (a) The sponsor has determined, in good faith, that the course of conduct which caused the loss of liability was in the best interests of the program, and
- (b) the sponsor or affiliate was acting on behalf of or performing services for the program, and
- (c) such liability or loss was not the result of negligence or misconduct by the sponsor or affiliate, and
- (d) payments arising from such indemnification or agreement to hold harmless are recoverable only out of the tangible net assets of the program.

2. Notwithstanding anything to the contrary contained in Section II.I.1., the sponsor, its affiliates and any person acting as a broker-dealer shall not be indemnified for any losses, liabilities or expenses arising from or out of an alleged violation of federal or state securities laws by such party unless the following conditions are met:

- (a) There has been a successful adjudication on the merits of each count involving alleged securities law violations as to the particular indemnitee, or
- (b) such claims have been dismissed with prejudice on the merits by a court of competent jurisdiction as to the particular indemnitee, or
- (c) a court of competent jurisdiction approves a settlement of the claims against a particular indemnitee and finds that indemnification of the settlement and the related costs should be made, and the court considering the request for indemnification has been advised of the position of the Securities and Exchange Commission and of the position of any state securities regulatory authority in which securities of the program were offered or sold as to indemnification for violations of securities laws; provided however, the court need only be advised of the positions of the securities regulatory authorities of those states (i) which are specifically set forth in the program agreement and (ii) in which plaintiffs claim they were offered or sold program units.

3. The program may not incur the cost of that portion of liability insurance which insures the sponsor for any liability as to which the sponsor is prohibited from being indemnified under this Section II.I; provided however, that this Section II.I.3 shall not preclude the program from purchasing and paying for such types of insurance, including extended coverage liability, casualty and workers' compensation, as is customary in the oil and gas industry.



4. The advancement of program funds to a sponsor or its affiliates for legal expenses and other costs incurred as a result of any legal action for which indemnification is being sought is permissible only if the program has adequate funds available and the following conditions are satisfied:

- (a) The legal action relates to acts or omissions with respect to the performance of duties or services on behalf of the program, and
- (b) The legal action is initiated by a third party who is not a participant, or the legal action is initiated by a participant and a court of competent jurisdiction specifically approves such advancement, and
- (c) The sponsor or its affiliates undertake to repay the advanced funds to the program, together with the applicable legal rate of interest thereon, in cases in which such party is found not to be entitled to indemnification.

J. Arbitration Provisions. The program agreement may contain provisions relating to the use of arbitration as a means of dispute resolution; provided however, it may not require arbitration for allegations involving breach of contract, negligence, violations of state and federal securities laws, breach of fiduciary duty or other misconduct by the sponsor, nor shall it provide for mandatory venue. Program agreements which contain arbitration provisions shall prominently disclose such fact on the cover page of the program agreement. Allocation of the cost of arbitration may be made a matter for determination in the proceedings. This Section II.J. should not be interpreted to prohibit separate arbitration agreements between sponsors and participants if the agreements are not a condition of making an investment in the program.

**III. SELLING OF UNITS AND SALES MATERIALS.** A. *Sales of Units* 1. Compensation to all broker-dealers shall be a cash commission. Compensation of an indeterminate nature to broker-dealers for sales of program units, or for services of any kind rendered in connection with or related to the distribution of program units, including, but not necessarily limited to, a percentage of a management fee, a profit sharing arrangement, overriding royalty interest, net profit interest, percentage of revenues, reversionary interest, working interest or other similar incentive items shall be prohibited.

2. Compensation to wholesale dealers must be a cash commission, must be reasonable and must be fully disclosed.

3. Sales commissions based on assessment of units or unfunded capital contributions are prohibited.

4. The sale of units in a program together with shares, options to purchase shares or other securities issued by the sponsor or another issuer will not be permitted unless such other securities, viewed separately, satisfy the requirements otherwise applicable to their registration.

B. *Sales Material*. 1. Supplementary materials (including prepared presentations for group meetings) must be submitted to the Administrator in advance of use, and its use must either be preceded by or accompanied with an effective prospectus.

2. *Sales Literature*. Sales literature, including without limitation, books, pamphlets, movies, slides, article reprints, and television and radio commercials, sales presentations (including prepared presentations to prospective participants at group meetings) and all other advertising used in the offer or sale of units shall conform in all applicable aspects to filing, disclosure and adequacy requirements currently imposed on the sale of corporate securities under applicable regulations. When periodic or other reports, except those required by and filed with the Securities and Exchange Commission, furnished to participants in prior programs are furnished to prospective participants in a program not yet sold, such reports will be treated as sales literature subject to the above requirements. Statements made in sales literature may not conflict with, or

significantly modify, risk factors or other statements made in the prospectus. Sales literature shall not be so excessive in size or amount as to detract from the prospectus, nor shall any sales literature be used by securities broker-dealers or agents unless such literature has been approved by the sponsor in writing and incorporates, if the Administrator so requests, disclosure of the participant suitability standards imposed by Section IV of these guidelines.

3. *Group Meetings.* All advertisements of, and oral or written invitations to "seminars" or other group meetings at which units are to be described, offered or sold shall clearly indicate that the purpose of such meeting is to offer such units for sale, the minimum purchase price thereof, the suitability standards to be employed, and the name of the person selling the units. No cash, merchandise or other items of value shall be offered as an inducement to any prospective participants to attend any such meeting. All written or prepared audio-visual presentations (including scripts prepared in advance for oral presentations) to be made at such meetings must be submitted to the Administrator within a prescribed review period. The provisions of this section shall not apply to meetings consisting only of representatives of securities broker-dealers.

4. *Prohibited Representations:*

- (a) In connection with the offering and sale of interests in a program, neither the sponsor(s) nor the underwriter(s) may, in writing or otherwise, directly or indirectly, represent or imply that an Administrator has approved the merits of the investment or any aspects thereof.
- (b) Any reference to the program's compliance with these guidelines or any provisions herein which connotes or implies such approval shall be deemed to be in noncompliance with paragraph (a) of this subsection.

**IV. SUITABILITY OF PARTICIPANTS**

A. *General Policy.*

- 1. The sponsor shall establish minimum income and net worth standards for persons who purchase program interests.
- 2. The sponsor shall propose minimum income and net worth standards which are reasonable given the type of program and the risks associated with the purchase of program interests. Programs with greater investor risk shall have minimum standards with a substantial net worth requirement. The Administrator shall evaluate the standards proposed by the sponsor when the program's application for registration is reviewed. In evaluating the proposed standards, the Administrator may consider the following:
  - (a) the program's use of leverage;
  - (b) tax implications;
  - (c) mandatory deferred payments;
  - (d) assessments;
  - (e) potential variances in cash distributions;
  - (f) potential participants;
  - (g) relationship between potential participants and the sponsor;
  - (h) liquidity of program interests;
  - (i) performance of sponsor's prior programs;
  - (j) financial condition of the sponsor;
  - (k) potential transactions between the program and the sponsor; and
  - (l) any other relevant factors.

B. *Income and Net Worth Standards.*

1. For income programs or programs that utilize at least 90% of capital contributions and funds borrowed (excluding organization and offering expenses) in providing completion financing, debt financing, or making other types of oil and gas investments, unless the Administrator determines that the risks associated with the program would require lower or higher standards, each participant shall have:
  - (a) a minimum annual gross income of \$70,000 and a minimum net worth of \$70,000; or
  - (b) a minimum net worth of \$250,000.
  
2. For drilling programs which provide the participant with statutory protection against unlimited liability, unless the Administrator determines the risks associated with the program would require lower or higher standards, each participant shall have:
  - (a) a minimum annual gross of income of \$85,000 and a minimum net worth of \$85,000; or
  - (b) a minimum net worth of \$330,000.
  
3. For drilling programs which do not provide the participant with statutory protection against unlimited liability, unless the Administrator determines that the risks associated with the program would require lower or higher standards, each participant shall have:
  - (a) a minimum net worth of \$330,000, without regard to the investment in the program, and a minimum annual gross income of \$150,000 for the current year and for the two previous years; or
  - (b) a minimum net worth in excess of \$1,000,000, inclusive of home, home furnishings and automobiles; or
  - (c) a minimum net worth of \$750,000; or
  - (d) a minimum annual gross income of \$200,000 in the current year and the two previous years.
  
4. Unless otherwise specified, net worth shall be determined exclusive of home, home furnishings, and automobiles.
  
5. In the case of sales to fiduciary accounts, these minimum standards shall be met by the beneficiary, the fiduciary account, or by the donor or grantor who directly or indirectly supplies the funds to purchase the program interests if the donor or grantor is the fiduciary.
  
6. The sponsor shall set forth in the final prospectus:
  - (a) the investment objectives of the program;
  - (b) a description of the type of person who might benefit from an investment in the program; and
  - (c) the minimum standards imposed on each participant in the program.

C. *Determination that Sale to Participant is Suitable and Appropriate.*

1. The sponsor and each person selling program interests on behalf of the sponsor or program shall make every reasonable effort to determine that the purchase of program interests is a suitable and appropriate investment for each participant.

2. In making this determination, the sponsor and each person selling program interests on behalf of the sponsor or program shall ascertain that the prospective participant:
  - (a) meets the minimum income and/or net worth standard established for the program;
  - (b) can reasonably benefit from the program based on the prospective participant's overall investment objectives and portfolio structure;
  - (c) is able to bear the economic risk of the investment based on the prospective participant's overall financial situation; and
  - (d) has apparent understanding of:
    - (1) the fundamental risks of the investment;
    - (2) the risk that the participant may lose the entire investment;
    - (3) the lack of liquidity of program interests;
    - (4) the restrictions on transferability of program interests;
    - (5) the background and qualifications of the sponsor or the persons responsible for directing and managing the program;
    - (6) the tax consequences of the investment; and
    - (7) the unlimited liability associated with working interest or general partnership offerings.
3. The sponsor or each person selling program interests on behalf of the sponsor or program will make this determination on the basis of information it has obtained from a prospective participant. Relevant information for this purpose will include at least the age, investment objectives, investment experience, income, net worth, financial situation, and other investments of the prospective participant, as well as any other pertinent factors.
4. The sponsor or each person selling program interests on behalf of the sponsor or program shall maintain records of the information used to determine that an investment in program interests is suitable and appropriate for each participant. The sponsor or each person selling program interests on behalf of the sponsor or program shall maintain these records for at least six years.
5. The sponsor shall disclose in the final prospectus the responsibility of the sponsor and each person selling program interests on behalf of the sponsor or program to make every reasonable effort to determine that the purchase of program interests is a suitable and appropriate investment for each participant, based on information provided by the participant regarding the participant's financial situation and investment objectives.

D. *Subscription Agreements.*

1. The Administrator may require that each participant complete and sign a written subscription agreement.
2. The sponsor may require that each participant make certain factual representations in the subscription agreement, including the following:
  - (a) The participant meets the minimum income and net worth standards established for the program.
  - (b) The participant is purchasing the program interests for his or her own account.
  - (c) The participant has received a copy of the prospectus.
  - (d) The participant acknowledges that the investment is not liquid.
3. The participant must separately sign or initial each representation made in the subscription agreement. Except in the case of fiduciary accounts, the participant may not grant any person a power of attorney to make such representations on his or her own behalf.

4. The sponsor and each person selling program interests on behalf of the sponsor or program shall not require a participant to make representations in the subscription agreement which are subjective or unreasonable and which:
  - (a) might cause the participant to believe that he or she has surrendered rights to which he or she is entitled under federal or state law; or
  - (b) would have the effect of shifting the duties regarding suitability, imposed by law on broker-dealers, to the participant.
  
5. Prohibited representations include, but are not limited to the following:
  - (a) The participant understands or comprehends the risks associated with an investment in the program.
  - (b) The investment is a suitable one for the participant.
  - (c) The participant has read the prospectus.
  - (d) In deciding to invest in the program, the participant has relied solely on the prospectus, and not on any other information or representations from other persons or sources.
  
6. The sponsor may place the content of the prohibited representations in the subscription agreement in the form of disclosures to the participant. The sponsor may not place these disclosures in the participant representation section of the subscription agreement.

*E. Completion of Sale.*

1. The sponsor or any person selling PROGRAM INTERESTS on behalf of the SPONSOR or PROGRAM may not complete a sale of PROGRAM INTERESTS to a PARTICIPANT until at least five business days after the date the PARTICIPANT receives a final prospectus.
  
2. The sponsor or the person designated by the sponsor shall send each participant a confirmation of his or her purchase.

*F. Minimum Investment.*

The Administrator may require a minimum initial and subsequent cash investment amount.

**V. FEES, COMPENSATION AND EXPENSES.** *A. Organization and Offering Expenses, and Management Fees.*

1. All organization and offering expenses incurred in order to sell program units shall be reasonable, and the total of those organization and offering expenses, which may be charged to the program, plus any management fee, which may be charged by the sponsor, shall not exceed 15% of the initial subscriptions.

2. Commissions payable on the sale of program units shall be paid in cash solely on the amount of initial subscriptions. Payment of commissions in the form of overriding royalties, net profit interests or other interests in production will not be approved, except that no objection will be raised to the payment of commissions in the form of interests in the program, provided the amount does not exceed that purchasable by applying the aggregate cash commission allowable to the unit offering price.

3. All items of compensation to underwriters or dealers, including, but not limited to, selling commissions, expenses, rights of first refusal, consulting fees, finders' fees and all other items of compensation of any kind or description paid by the program, directly or indirectly, shall be taken into consideration in computing the amount of allowable selling commissions.

B. *Compensation.* The participation in program revenues by the sponsor and any affiliate shall be reasonable, taking into account all relevant factors. Overriding royalty interests will be looked upon with disfavor. Subject to Section II.F.1 of these guidelines, the sponsors' interests in revenues will be considered reasonable if they meet the standards set forth below. Any other combination of fees, carried interests, or interests subordinate to pay out to the public investors, which can be demonstrated to provide participants equal or more favorable terms of participation in the program, may also be considered reasonable by the Administrator.

1. *Drilling Programs: Functional Allocation.*

- (a) Where the sponsor agrees to pay the capital expenditures of the program, but in any case at least 10% of the capital contributions to the program (including any capital contributions from the sponsor or any of its affiliates), its share of revenues will be determined by the following formula: (1) If the agreement is to pay capital expenditures but in any case a sum of not less than 10% of the capital contributions to the program (including any capital contributions from the sponsor or any of its affiliates), the sponsor will be entitled to receive 25% of program revenues; (2) the sponsor's revenue sharing may be increased in additional increments of 1% for each additional 1% increase in the percentage of capital contributions to the program (including any capital contributions from the sponsor or any of its affiliates) actually made by the sponsor up to a maximum of 50% of revenues subject to sponsor's agreement to pay in any case all capital expenditures.
- (b) The aforesaid arrangement to pay capital expenditures refers to and includes capital expenditures for the drilling and completing of wells during the life of the program, but does not include capital expenditures for facilities downstream of a wellhead. If the sponsor should enter into a farmout or other arrangements through which only the sponsor is relieved of its obligations to pay for such capital expenditures, then the sponsor's share of revenue shall be proportionately reduced, the amount to be determined on an individual basis.
- (c) In order to elect a sharing agreement as above provided, the sponsor must have a net worth of \$300,000 or 10% of the total contributions to the program by the participants, whichever is greater, and must be under a contractual obligation to pay its share of expenses as such expenses are paid by the program and to complete its minimum financial commitment to the program by the payment of cash by the end of the first fiscal year succeeding the fiscal year in which the program commenced operations. Any additional contributions made by the sponsor will be used to pay program expenses which would otherwise be charged to the participants; provided however, the sponsor may receive credit for the amount of such payments against any subsequent capital expenditure incurred by the program and allocated to the sponsor.
- (d) For the purposes of this subsection, if a well is not abandoned within 60 days following the commencement of production, then it shall be deemed to be a commercial well insofar as the program is concerned and the sponsor may not recapture its capital expenditures from the program, which otherwise would be treated as noncapital expenditures upon abandonment. As used herein, production shall refer to the commencement of the commercial marketing of oil and gas and shall not include any spot sales of oil or gas produced as a result of testing procedures. All revenues from a well abandoned under this subsection shall be allocated pro rata to those persons bearing the costs of such well.
- (e) The sharing arrangement set forth in this subsection shall not be considered presumptively reasonable: (1) in the case of sharing arrangements in which the

sponsor pays all development costs and exploratory wells are drilled on prospects which cannot reasonably be expected to require developmental drilling if the exploratory drilling is successful, or (2) in the case of sharing arrangements where the sponsor does not pay its share or category of costs on a current basis.

2. *Drilling Programs: Subordinate Interest.* As an alternative to sharing revenues on a basis related to costs paid, it will be considered reasonable for a sponsor of a drilling program to receive a promotional interest in the form of a subordinated interest in program distributions. A subordinated interest will be considered presumptively reasonable if it does not exceed 25% of program distributions after the participants have been distributed an amount equal to their capital contribution.

At such time as the sponsor is entitled to receive its promotional interest, it shall also be allocated and pay program costs in the same ratio as it participates in program revenues.

3. *Drilling Programs: Other Alternatives.* A sponsor who is allocated and pays at least 1% of all program costs as incurred (excluding organizational and offering expenses, and management fees) may receive 11% of program revenues plus an additional percentage of program revenues equal to the additional percentage of program costs which it pays in excess of 1%, up to a maximum of 50% of program revenues. The sponsor must be allocated and pay operating expenses, direct costs and administrative costs in the same ratio as they participate in program revenues.

4. *Prospect Origination Services of the Sponsor.* The sharing arrangements for drilling programs set forth in Section V.B. shall not be considered presumptively reasonable for a sponsor who does not actively participate in obtaining a significant portion of the program's prospects and who does not assume management responsibility for drilling, completing, equipping and operating a significant portion of a program's wells, unless such sponsor shall satisfactorily demonstrate that its compensation together with the costs of procuring such services for the program from third parties does not exceed the permissible compensation to the sponsor set forth in this Section V.B. For purposes of these guidelines, a sponsor shall be deemed to be actively participating in obtaining a significant portion of a program's prospects if the sponsor has in-house or under contract the technical capability of originating and/or fully evaluating the prospects to be acquired by that program. "Prospect origination" is the process of formulating a geological or geophysical concept and negotiating for the acquisition of a sufficient acreage interest in the area to warrant drilling and testing. "Prospect evaluation" is the process of determining the viability of a prospect which has been originated by a third party.

A sponsor must describe in adequate detail in the offering documents the nature of the sponsor's capability to originate and/or evaluate the prospects the sponsor intends to transfer to a program. If the capability is in-house, the "Operation" Section of the offering documents should have a full discussion of the process by which such origination and evaluation will take place and the "Management" Section of those documents should include a biographical discussion of the key personnel of the sponsor performing these activities. If the capability is to be provided by third parties under contract to the sponsor, the third parties should be identified, their qualifications described, and the contractual nature of the arrangement between the sponsor and the third party should be fully disclosed. This should include a detailed discussion of the administrative process involved in the relationship. It will be deemed presumptively unreasonable, in the latter instance,

if the contracts do not provide the program with comparable capabilities to those that would be provided if the sponsor's capability was in-house, including, among other things, availability of technical expertise and the provisions of adequate response time. Unless the sponsor can adequately demonstrate the availability of such capability, it will not be permitted to elect any of the sharing of costs and revenues described in the guidelines.

5. *Income or Production Purchase Programs.* An interest in the program will be allowed as a promotional interest provided that the amount or percentage of such interest is reasonable. Such an interest will generally be presumed reasonable if it is within the limitations expressed below:

- (a) Where the sponsor does not maintain a technical staff which has the necessary capability and experience to originate, evaluate and consummate property acquisitions without substantial third party assistance, the sponsor may take a fully participating 3% carried interest until participants have received cash distributions in an amount equal to their capital contributions after which the sponsor may take up to a fully participating 5% carried interest.
- (b) Where the sponsor maintains a technical staff which has the necessary capability and experience and will in fact originate, evaluate and consummate property acquisitions without substantial third party assistance, the sponsor may take:
  - (1) a fully participating 10% carried interest, or
  - (2) a fully participating 1% carried interest until participants have received cash distributions in an amount equal to their capital contributions after which the sponsor may take up to a fully participating 20% carried interest.

6. *Operator Services.* If the sponsor or one of its affiliates reserves the right to be designated as operator of any property acquired by the program, the prospectus must disclose the extent of the sponsor's or affiliate's operating experience and capabilities. Operator services may not be provided unless the sponsor or the affiliate has substantial operating experience. If the sponsor or an affiliate is designated as operator of any property acquired by the program, such services must be performed pursuant to a model form operating agreement issued by the American Association of Petroleum Landmen and an accounting procedure for joint operations issued by the Council of Petroleum Accountants Societies of North America, or other form of agreement acceptable to the Administrator, all in a form which is customary and usual for the geographic area in which the properties are located. In no event shall any consideration received for operator services be in excess of the competitive rate or duplicative of any consideration or reimbursements received pursuant to the program agreement. The sponsor may not benefit by interpositioning itself between the program and the actual provider of operator services.

7. *Drilling Contractor Services.* If the sponsor or one of its affiliates reserves the right to act as contractor in connection with the drilling of program wells, the prospectus must disclose the extent of the sponsor's or affiliate's contracting experience and capabilities. Contracting services may not be provided unless the sponsor or the affiliate, or their principals, has substantial contracting experience. The prospectus must disclose the material terms pursuant to which contractor services may be provided and if there is a separate contract to be utilized in connection with such services a copy of the form of such contract must accompany the registration application. Turnkey drilling contracts or other contracts with the sponsor or an affiliate of the sponsor that establish a fixed price for drilling services shall not be permitted. The sponsor or affiliate may guarantee cost estimates of subcontractors or provide indemnification against cost



overruns, provided no additional compensation is received by the sponsor or affiliate as a result of such guarantees or indemnification. The rates charged for drilling contractor services must be competitive with the rates charged by unaffiliated contractors in the same geographic region. With respect to subcontractor services provided by the sponsor or affiliate, there must be documentation, maintained for the life of the program, demonstrating compliance with Section V.B.8 below. The sponsor may not benefit by interpositioning itself between the program and the actual provider of drilling contractor services.

8. *Equipment, Supplies and Services.*

- (a) Neither the sponsor nor any affiliate shall render to the program any oil field, equipage or other services nor sell or lease to the program any equipment or supplies unless:
  - (1) such entity is engaged, independently of the program and as an ordinary and ongoing business, in the business of rendering such services or selling or leasing such equipment and supplies to a substantial extent to other persons in the industry in addition to programs in which the sponsor or its affiliates have an interest; and
  - (2) the compensation, price or rental therefore is competitive with the compensation, price or rental of other persons in the area engaged in the business of rendering comparable services or selling or leasing comparable equipment and supplies which could reasonably be made available to the program.
- (b) If such entity is not engaged in the business as required by Section V.B.8(a)(1) above, then such compensation, price or rental shall be the cost of such services, equipment or supplies to such entity, or the competitive rate which could be obtained in the area, whichever is less.

9. *Written Contracts.* All services for which the sponsor or any affiliate is to receive compensation shall be embodied in a written contract (which may be the program agreement) that specifically describes each service to be rendered and all compensation to be paid.

C. *Program Expenses.* 1. Administrative costs and other charges for goods and services must be fully supportable as to the necessity thereof and the reasonableness of the amount charged. All actual and necessary expenses incurred by the program may be paid out of capital contributions and out of program revenues.

2. Direct costs shall be billed directly to and paid by the program to the extent practicable.

3. The sponsor may be reimbursed for administrative costs, provided such costs are reasonably allocated to the program on the basis of assets, revenues, time records or other method conforming with generally accepted accounting principles. No portion of the salaries, benefits, compensation or remuneration of controlling persons shall be reimbursed as administrative costs. Controlling persons include directors, executive officers and those holding 5% or more equity interest in the sponsor or a person having power to direct or cause the direction of the sponsor, whether through the ownership of voting securities, by contract, or otherwise.

A description of the method to be used for allocating costs shall be clearly described in the prospectus and such allocations must be audited annually by the sponsor's independent certified

public accountants. The program agreement shall require the independent certified public accountants to provide written attestation annually, to be included as part of the program's annual report, that the method used to make allocations was consistent with the method described in the prospectus and that the total amount of costs allocated did not materially exceed the amounts incurred by the sponsor. If the sponsor subsequently decides to allocate expenses in a manner different from that described in the prospectus, such change must be reported to the participants together with an explanation of why such change was made and the basis used for determining the reasonableness of the new allocation method.

4. The program shall disclose in tabular form and estimate of expenses to be charged to the program showing direct costs and administrative costs separately, and the sponsor must demonstrate that it has a reasonable basis for such estimates. The estimate of direct costs and administrative costs shall be broken down into various types of services and costs. The following is the type of tabular disclosure which will be considered reasonable for disclosing estimated direct costs and administrative costs:

#### ESTIMATED PROGRAM EXPENSES

The sponsor estimates that direct costs and administrative costs allocable to the program for the first twelve months of operation will be approximately \$\_\_\_\_\_ if the minimum program capital is received (representing \_\_\_\_\_% of program capital) and approximately \$\_\_\_\_\_ if the maximum program capital is received (representing \_\_\_\_\_% of program capital). The sponsor estimates that the components of such allocable amounts will be as follows:

	Minimum Program	Maximum Program
<i>Administrative Costs:</i>		
Legal.....	\$.....	\$.....
Accounting.....	.....	.....
Geological.....	.....	.....
Secretarial.....	.....	.....
Travel.....	.....	.....
Office Rent.....	.....	.....
Telephone.....	.....	.....
Data Processing.....	.....	.....
Other (list).....	.....	.....
 <i>Direct Costs:</i>		
External Legal.....	.....	.....
Audit Fees.....	.....	.....
Independent Engineering Reports.....	.....	.....
Outside Computer Services.....	.....	.....
Other (list).....	.....	.....
<b>TOTAL.....</b>	<b>\$.....</b>	<b>\$.....</b>

The procedures followed to determine the amounts of administrative costs to be allocated to the program are enumerated as follows:

- 1.
- 2.
- 3.
4. etc.

5. The prospectus shall disclose in tabular form for each program formed in the last three years the dollar amount of direct costs and administrative costs incurred, and the percentage of subscriptions raised reflected thereby.

6. The sponsor shall bear a percentage of direct costs and administrative costs equal to its percentage of revenue participation. A subordinate interest shall bear its percentage of direct costs and administrative costs from the time that the sponsor becomes eligible to receive its subordinated interest.

## **VI. PROPERTY TRANSACTIONS WITH AFFILIATES AND OTHER RE-**

### **STRICTED ACTIVITIES. A. Sales and Purchase of Properties 1. Sales to Drilling Programs.**

Neither the sponsor nor any affiliate, including an affiliated program, shall sell, transfer or convey any property to a drilling program, directly or indirectly, except pursuant to transactions that are fair and reasonable to the participants of the program and then subject to the following conditions:

- (a) The prospectus discloses the possibility that the sponsor or an affiliate may sell, transfer or convey property to the program and whether or not the property may be sold from an existing inventory.
- (b) The property is sold, transferred or conveyed to the program at cost, unless the seller or transferor has cause to believe that cost is materially more than the fair market value of such property, in which case such sale should be made for a price not in excess of its fair market value; provided however, if the sale, transfer or conveyance is from an affiliated program that has held the property for more than two years and in which program the interest of the sponsor is substantially similar to, or less than, its interest in the subject program, the sale, transfer or conveyance may be made at fair market value.
- (c) If the sponsor or an affiliate sells, transfers or conveys any oil, gas or other mineral interests or property to the program, it must, at the same time, sell to the program an equal proportionate interest in all its other property in the same prospect.
- (d) During a period of five years from the date of formation of the program, if the sponsor or any of its affiliates proposes to acquire an interest, from an unaffiliated person, in a prospect in which the program possesses an interest or in a prospect in which the program's interest has been terminated without compensation within one year preceding such proposed acquisition, the following conditions shall apply:
  - (1) If the sponsor or the affiliate does not currently own property in the prospect separately from the program, then neither the sponsor nor the affiliate shall be permitted to purchase an interest in the prospect.
  - (2) If the sponsor or the affiliate currently own a proportionate interest in the prospect separately from the program, then the interest to be acquired shall be divided between the program and the sponsor or the affiliate in the same proportion as is the other property in the prospect; provided however, if cash or financing is not available to the program to enable it to consummate a purchase of the additional interest to which it is entitled, then neither the sponsor nor the affiliate shall be permitted to purchase any additional interest in the prospect.

- (e) If the area constituting a program's prospect is subsequently enlarged to encompass any area wherein the sponsor or an affiliate of the sponsor owns a separate property interest, such separate property interest or a portion thereof shall be sold, transferred or conveyed to the program in accordance with this Section VI.A.1 if the activities of the program were material in establishing the existence of proved undeveloped reserves which are attributable to such separate property interest.
- (f) A sale, transfer or conveyance of less than all of the ownership of the sponsor or any of its affiliates in any lease interest or property is prohibited unless the interest retained by the sponsor or affiliate is a proportionate working interest, the respective obligations of the sponsor or affiliate and the program are substantially the same after the sale of the interest by the sponsor or affiliate and its interest in revenues does not exceed the amount proportionate to its retained working interest. The sponsor or affiliate may not retain any overrides or other burden on the interest conveyed to the program.
- (g) For purposes of Section VI.A.1(c), (d), (e) and (f) above, the terms "sponsor" and "affiliate" shall not include another program in which the interest of the sponsor is substantially similar to or less than its interest in the subject program.
- (h) If the program acquires property pursuant to a farmout or joint venture from an affiliated program, the sponsor's and/or its affiliates aggregate compensation associated with the property and any direct and indirect ownership interest in the property may not exceed the lower of the compensation and ownership interest the sponsor and/or its affiliates could receive if the property were separately owned or retained by either one of the programs.

2. *Sales to Production Purchase or Income Programs.* Neither the sponsor nor the affiliate, including an affiliated program, shall sell, transfer or convey any property to a production purchase or income program, directly or indirectly, except pursuant to transactions that are fair and reasonable to the participants of the program and then subject to the following conditions:

- (a) The prospectus discloses the possibility that the sponsor or an affiliate may sell property to the program and whether the property may be sold from an existing inventory.
- (b) If the property has been held for less than two years and there have not been significant expenditures made in connection with the property, the sale, transfer or conveyance to the program from the sponsor or an affiliate, other than an affiliated program in which the interest of the sponsor is substantially similar to or less than its interest in the subject program, must be at cost as adjusted for intervening operations, unless the sponsor has cause to believe that such adjusted cost is materially more than the fair market value of such property, in which case such sale must be made at fair market value.
- (c) If the property has been held for less than six months and there have not been significant expenditures made in connection with the property, the sale, transfer or conveyance to the program from an affiliated program, in which the interest of the sponsor is substantially similar to or less than its interest in the subject program, must be at cost as adjusted for intervening operations, unless the sponsor has cause to believe that such adjusted cost is materially more than the

fair market value of such property, in which case such sale must be made at fair market value.

- (d) In all other circumstances, the sale, transfer or conveyance to the program from the sponsor or an affiliate, including an affiliated program, must be made at not more than fair market value.

3. *Purchases from All Programs.* Neither the sponsor nor any affiliate, including affiliated programs, may purchase or acquire any property from the program, directly or indirectly, except pursuant to transactions that are fair and reasonable to the participants of the program and then subject to the following conditions:

- (a) A sale, transfer or conveyance, including a farmout, of an undeveloped property from the program to the sponsor or an affiliate, other than an affiliated program, must be made at the higher of cost or fair market value.
- (b) A sale, transfer or conveyance of a developed property from the program to the sponsor or an affiliate, other than an affiliated program in which the interest of the sponsor is substantially similar to or less than its interest in the subject program, shall not be permitted except in connection with the liquidation of the program and then only at fair market value.
- (c) Except in connection with farmouts or joint ventures made in compliance with Section VI.A.1(h) above, a transfer of an undeveloped property from a program to an affiliated drilling program must be made at fair market value if the property has been held for more than two years. Otherwise, if the sponsor deems it to be in the best interest of the program, the transfer may be made at cost.
- (d) Except in connection with farmouts or joint ventures made in compliance with Section VI.A.1(h) above, a transfer of any type of property from a program to an affiliated production purchase or income program must be made at fair market value if the property has been held for more than six months or there have been significant expenditures made in connection with the property. Otherwise, if the sponsor deems it to be in the best interest of the program, the transfer may be made at cost as adjusted for intervening operations.

4. *Determination of Fair Market Value.* A determination of fair market value as required by the provisions of this Section VI must be supported by an appraisal from an independent expert. Such opinion and any associated supporting information must be maintained in the program's records for at least six years.

B. *Custody of Program Funds and Properties.* 1. Funds of a program must not be commingled with funds of any other entity and the prospectus and program agreement must clearly prohibit any such commingling. Notwithstanding the above, the sponsor may establish a master fiduciary account pursuant to which separate subtrust accounts are maintained for the benefit of affiliated programs, provided, the program's funds are protected from the claims of such other programs and their creditors. The prohibition of this Section VI.B.1 shall not apply to investments meeting the requirements of Section VI.B.4 below.

2. Advance payments to the sponsor or its affiliates are prohibited, except where necessary to secure tax benefits of prepaid drilling costs. These payments, if any, shall not include nonrefundable payments for completion costs prior to the time that a decision is made that the

well or wells warrant a completion attempt.

3. Program properties may be held in the names of nominees temporarily to facilitate the acquisition of properties and for similar valid purposes. On a permanent basis, program properties may be held in the name of a special nominee entity organized by the sponsor provided the nominee's sole purpose is the holding of record title for oil and gas properties and it engages in no other business and incurs no other liabilities. If properties are held in the name of a special nominee, either a ruling from the Internal Revenue Service or an opinion of qualified tax counsel shall be obtained to the effect that such arrangement shall not change the ownership status of the program for federal income tax purposes.

4. Program funds may not be invested in the securities of another person except in the following instances:

- (a) investments in working interests or undivided lease interests made in the ordinary course of the program's business;
- (b) temporary investments made in compliance with Section VI.B.5;
- (c) multi-tier arrangements meeting the requirements of Section VI.C.1;
- (d) investments involving less than 5% of program capital which are a necessary and incidental part of a property acquisition transaction; and
- (e) investments in entities established solely to limit the program's liabilities associated with the ownership or operation of property or equipment, provided, in such instances duplicative fees and expenses shall be prohibited.

5. Until proceeds from the public offering are invested in the program's operations, such proceeds may be temporarily invested in income producing short-term, highly liquid investments, where there is appropriate safety of principal, such as U.S. Treasury Bills. Any such income shall be allocated pro rata to the participants providing such capital contributions.

6. Any proceeds of the public offering of a drilling program not used, or committed for use, as evidenced by a written agreement, in the program's operations within one year of the closing of the offering, except for necessary operating capital, must be distributed pro rata to the participants as a return of capital, and the sponsor shall reimburse the participants for selling, management fees and offering expenses allocable to the return of capital.

7. If a production purchase program sponsor has not used, or committed for use, as evidenced by a written agreement, an amount equal to 100% of the net proceeds of the public offering for property acquisitions within two years of the closing of the offering, any excess proceeds, except for necessary operating capital and amounts reserved for identified activities, must be distributed pro rata to the participants as a return of capital, and the sponsor shall reimburse the participants for selling, management fees and offering expenses allocable to the return of capital.

C. *Other Restricted and Prohibited Activities.* 1. Programs structured to participate in other partnerships or joint ventures (multi-tier arrangements) shall be permitted provided that the terms of any such arrangements do not result in the circumvention of any of the requirements or prohibitions contained in these guidelines. In particular, all such program agreements shall accompany the prospectus and shall contain provisions which assure:

- (a) that there will be no duplication or increase in organization and offering expenses, sponsor's compensation, program expenses or other fees and costs;
  - (b) there will be no substantive alteration in the fiduciary and contractual relationship between the sponsor and the participants; and
  - (c) there will be no diminishment in the voting rights of the participants.
2. A sponsor or affiliate shall not take any action with respect to the assets or property of the program which does not primarily benefit the program, including among other things:
- (a) the utilization of program funds as compensating balances for its own benefit, and
  - (b) the commitment of future production.
3. All benefits from marketing arrangements or other relationships affecting property of the sponsor or affiliate and the program shall be fairly and equitably apportioned according to the respective interests of each
4. Any agreements or arrangements which bind the program must be fully disclosed in the prospectus.
5. Anything to the contrary notwithstanding, a sponsor or affiliate may never profit by drilling in contravention of his fiduciary obligation to the participants.
6. No loans may be made by the program to the sponsor or any affiliate of the sponsor.
7. On loans made available to the program by the sponsor or affiliate, the sponsor or affiliate may not receive interest in excess of its interest costs, nor may the sponsor or affiliate receive interest in excess of the amounts which would be charged the program (without reference to the sponsor's financial abilities or guaranties) by unrelated banks on comparable loans for the same purpose, and the sponsor or affiliate shall not receive points or other financing charges or fees, regardless of the amount.
8. No rebates or give-ups may be received by the sponsor or any affiliate nor may the sponsor or any affiliate participate in any reciprocal business arrangements which would circumvent these guidelines.

**VII. FARMOUTS, SPECIAL DISCLOSURE REQUIREMENTS.** A. The prospectus shall contain the definition of farmout and no other term shall be used to describe a farmout transaction.

B. The prospectus shall state the circumstances under which the sponsor may farmout a prospect or lease, the ability to farmout to other public programs of the sponsor or its affiliates and any limitations on the ability to farmout to such public programs.

C. The prospectus shall state that no program lease will be farmed out, sold or otherwise disposed of unless the sponsor, exercising the standard of a prudent operator, determines:

- 1. the program lacks sufficient funds to drill on the leases and cannot obtain suitable alternative financing for such drilling; or

2. the leases have been downgraded by events occurring after assignment to the program so that drilling would no longer be desirable for the program; or
3. drilling on the leases would result in an excessive concentration of program funds creating in the sponsor's opinion undue risk to the program; or
4. the best interests of the program would be served by the farmout.

D. The prospectus shall state that the decision with respect to making a farmout and the terms of a farmout to a program involve conflicts of interest, as the sponsor may benefit from cost savings and reduction of risk, and in the event of a farmout to an affiliated public program, the sponsor will represent both partnerships.

E. Except as required by Section VI.A.1, the prospectus shall state that the program shall acquire only those leases that are reasonably acquired for the stated purpose of the program and no leases shall be acquired for the purpose of subsequent sale or farmout, unless the acquisition of such leases by the program is made after a well has been drilled to a depth sufficient to indicate that such an acquisition is believed to be in the best interests of the program.

F. The prospectus shall state that the sponsor shall not farmout a lease for the primary purpose of avoiding payment of sponsor's costs relating to drilling a lease or prospect.

**VIII. RIGHTS AND OBLIGATIONS OF PARTICIPANTS.** A. *Meetings.* Meetings of the participants may be called by the sponsor or by participants holding 10% or more of the then outstanding units for any matters for which the participants may vote as set forth in the program agreement. Such call for a meeting shall be deemed to have been made upon receipt by the sponsor of a written request from holders of the requisite percentage of units stating the purposes(s) of the meeting. The sponsor shall deposit in the United States mails within 15 days after receipt of said request, written notice to all participants of the meeting and the purpose of such meeting, which shall be held on a date not less than 30 nor more than 60 days after the date of mailing of said notice, at a reasonable time and place. Provided however, that the date for notice of such a meeting may be extended for a period of up to 60 days, if in the opinion of the sponsor such additional time is necessary to permit preparation of proxy or information statements or other documents required to be delivered in connection with such meeting by the Securities and Exchange Commission or other regulatory authorities. Participants shall be granted the right to vote in person or by proxy.

B. *Annual and Periodic Reports.* The program agreement shall provide for the transmittal to each participant of an annual report within 120 days after the close of the fiscal year, and commencing with the year following investment of substantially all the program subscriptions, a report within 75 days after the end of the first six months of its fiscal year, containing, except as otherwise indicated, at least the following information:

- (a) Financial statements, including a balance sheet and statements of operations, partners' equity and cash flows prepared in accordance with generally accepted accounting principles and accompanied by a report of an independent certified public accountant stating that his audit was made in accordance with generally accepted auditing standards and that in his opinion such financial statements present fairly the financial position, results of operations, partners' equity and cash flows in accordance with generally accepted accounting principles, except that semiannual reports need not be audited.
- (b) A summary itemization, by type and/or classifications of the total fees and compensation, including any administrative cost reimbursements and operating



fees, paid by the program, or indirectly on behalf of the program, to the sponsor and affiliates of the sponsor together with the accountant's attestation as required by Section V.C of these guidelines. If compensation is paid on a subordinated interest, a reconciliation of all such payments to the conditions precedent and limitations thereto.

- (c) A description of each property in which the program owns an interest, including the cost, location, number of acres under lease and the interest owned therein by the program, except succeeding reports need contain only material changes, if any, regarding such property.
- (d) If a drilling program, a list of the wells drilled or abandoned by such program during the period of the report (indicating whether each of such wells has or has not been completed), and a statement of the cost of each well completed or abandoned. Justification shall be included for wells abandoned after production has commenced.
- (e) A description of all farmouts, farmins and joint ventures, made during the period of the report, including sponsor's justification for the arrangement and a description of the material terms.
- (f) If assessments have been made during any period covered by the report, then such report shall contain a detailed statement of such assessments and the application of the proceeds derived from such assessments.
- (g) With respect to a program which compensated the sponsor on a basis related to certain costs paid by the sponsor; (1) a schedule reflecting the total program costs, and where applicable, the costs pertaining to each prospect, the costs paid by the sponsor and the costs paid by the participants, (2) the total program revenues, the revenues received or credited to the sponsor and the revenues received or credited to the participants, and (3) a reconciliation of such expenses and revenues to the limitations prescribed.
- (h) Annually, beginning with the fiscal year succeeding the fiscal year in which the program commenced operations, a computation of the total oil and gas proved reserves of the program and dollar value thereof at then existing prices and of each participant's interest in such reserve value. The reserve computations shall be based upon engineering reports prepared by qualified independent petroleum consultants. In addition, there shall be included an estimate of the time required for the extraction of such reserves and the present worth of such reserves, with a statement that, because of the time period required to extract such reserves, the present value of revenues to be obtained in the future is less than if immediately receivable. In addition to the annual computation and estimate required, as soon as possible, and in no event more than 90 days after the occurrence of an event leading to reduction of such reserves of the program of 10% or more, excluding reduction as a result of normal production, sales of reserves or product price changes, a computation and estimate shall be sent to each participant.

2. By March 15 of each year, the general partner must furnish a report to each participant containing such information as is pertinent for tax purposes.

3. Programs which agree to make all relevant financial and engineering reports available to participants on request, will not be required to transmit to participants reports other than:

- (a) the annual reports required under subsection (1) above,

- (b) the reports for tax purposes required by subsection (2) above, and
- (c) a quarterly cash receipts and disbursements statement after the program commences its operational phase.

C. *Access to Program Records.*

1. The participants and/or their accredited representatives shall be permitted access to all records, of the program, after adequate notice, at any reasonable time and may inspect and copy any of them. The sponsor shall maintain and preserve during the term of the program and for four (4) years thereafter all accounts, books and other relevant program documents. Notwithstanding the foregoing, the sponsor may keep logs, well reports and other drilling data confidential for a reasonable period of time.
2. The limited partnership agreement, by-laws or other program agreement shall include the following provisions regarding access to the list of participants:
  - (a) An alphabetical list of the names, addresses and business telephone numbers of the participants of the program along with the number of program units held by each of them (the "participant list") shall be maintained as a part of the books and records of the program and shall be available for inspection by any participant or its designated agent at the home office of the program upon the request of the participant;
  - (b) The participant list shall be updated at least quarterly to reflect changes in the information contained therein;
  - (c) A copy of the participant list shall be mailed to any participant requesting the participant list within ten days of the request. The copy of the participant list shall be printed in alphabetical order, on white paper, and in a readily readable type size (in no event smaller than 10-point type). A reasonable charge for copy work may be charged by the program;
  - (d) The purposes for which a participant may request a copy of the participant list include, without limitation, matters relating to participant's voting rights under the program agreement and the exercise of participants' rights under federal proxy laws; and
  - (e) If the sponsor of the program neglects or refuses to exhibit, produce, or mail a copy of the participant list as requested, the sponsor shall be liable to any participant requesting the list for the costs, including attorneys' fees, incurred by that participant for compelling the production of the participant list, and for actual damages suffered by any participant by reason of such refusal or neglect. It shall be a defense that the actual purpose and reason for the request for inspection or for a copy of the participant list is to secure the list of participants or other information for the purpose of selling such list or information or copies thereof, or of using the same for a commercial purpose other than in the interest of the applicant as a participant relative to the affairs of the program. The sponsor may require the participant requesting the participant list to represent that the list is not requested for a commercial purpose unrelated to the participant's interest in the program. The remedies provided hereunder to participants requesting copies of the participant list are

in addition to, and shall not in any way limit, other remedies available to participants under federal law, or the laws of any state.

D. *Admission of Participants.* 1. Upon the original sale of program units, the participants should be admitted as unit holders not later than 15 days after the release from escrow of participants' funds to the program, and thereafter participants should be admitted into the program not later than the last day of the calendar month in which their subscriptions were accepted by the program. Subscriptions shall be accepted or rejected by the program within 30 days of their receipt; if rejected, all funds shall be returned to the subscriber immediately.

2. The program shall amend its records at least once each calendar quarter to effect the substitution of substituted participants, although the sponsor may elect to do so more frequently. In the case of assignments, where the assignee does not become a substituted participant, the program shall recognize the assignment not later than the last day of the calendar month following receipt of notice of assignment and required documentation.

Restrictions on the assignment of units or the substitution of participants are generally disfavored and will be allowed only to the extent necessary to preserve the tax status of the partnership or the classification of program income for tax purposes and any restriction must be supported by opinion of counsel as to its legal necessity.

E. *Assessability and Defaults.* 1. In appropriate cases there may be a provision for assessability; provided however, that the maximum amount for voluntary assessments shall not exceed 100% of initial subscriptions and for mandatory assessments shall not exceed 25% of initial subscriptions, and provided further, that in no case shall the total of all assessments exceed 100% of initial subscriptions. All assessments shall be made solely for the purpose of conducting subsequent operations on prospects upon which evaluation had begun during a program's initial operations, or on leases sufficiently related to such prospects as to merit, in the sponsor's judgment, additional operations to fully develop those prospects. In such cases, the aggregate offering price of the units as set forth in the application for qualification shall include and show separately the basic unit offering price and the maximum amount of the assessment.

2. In the event of a default in all or a portion of the payment of assessments, the participant's percentage interest in the program represented by his unit should not be subject to forfeiture, but may be subject to a reasonable reduction for the failure of the participant to meet his commitment. Unless the sponsor agrees to pay all defaulted assessments, the nondefaulting limited partners shall have the first option to pay any defaulted assessments. Provisions which conform to the following will be considered reasonable.

- (a) For voluntary assessments,
  - (1) A proportionate reduction of the participant's percentage interest in revenues derived from the wells drilled and/or completed with the proceeds of the assessments based on the ratio of the participant's unpaid assessment to all capital contributions and assessments used for such drilling and/or completion, or
  - (2) A subordination of the defaulting participant's right to receive revenues from the wells drilled and/or completed with the proceeds of the assessments until those nondefaulting participants who have paid the defaulting participant's assessment have received an amount of revenues from revenues of the program from such wells equal to 300% of the proportionate amount of the defaulted assessment which they paid.

- (b) For mandatory assessments,
  - (1) A proportionate reduction of the participant's percentage interest in program revenues, based on the ratio of his unpaid assessment to all capital contributions and assessments, or
  - (2) A subordination of the defaulting participant's right to receive revenues from the program until those nondefaulting participants who have paid the defaulting participant's assessment have received an amount of revenues from all revenues of the program equal to 300% of the proportionate amount of the defaulted assessment which they paid, or
  - (3) Personal liability of a participant as to the amount defaulted upon. The sponsor may enforce such personal liability through a lien on the participant's program interest, which permits the sponsor to withhold and apply all revenues attributable to the participant to the payment of any delinquent assessment. For purposes of this subsection, voluntary assessments which a participant has committed to pay will be considered mandatory assessments.
- (c) In order to make any assessment, the sponsor shall include with the call for such assessment a statement of the purpose and intended use of the proceeds from such assessment, a statement of the reduction to be imposed for failure of the participant to meet the assessment, and to the extent practicable, a summary of pertinent geological data on the relevant properties to which the assessments relate and any other information material to a participant's decision to fund the assessment.
- (d) The above alternatives, set forth in (a) and (b), are not exclusive and other provisions demonstrated to be essentially equivalent to these alternatives may be permitted by the Administrator.

F. *Voting Rights of Participants.*

- 1. To the extent the law of the state of organization is not inconsistent, the program agreement must provide that a majority in interest of the then outstanding unit holders may, without the necessity for concurrence by the sponsor, vote to:
  - (a) Amend the program agreement; provided however, any such amendment may not increase the duties or liabilities of any participant or sponsor or increase or decrease the profit or loss sharing or required capital contribution of any participant or sponsor without the approval of such participant or sponsor. Furthermore, any such amendment may not affect the classification of program income and loss for federal income tax purposes without the unanimous approval of all participants;
  - (b) Dissolve the program;
  - (c) Remove the sponsor and elect a new sponsor;
  - (d) Elect a new sponsor if the sponsor elects to withdraw from the program;
  - (e) Approve or disapprove the sale of all or substantially all of the assets of the program; and
  - (f) Cancel any contract for services with the sponsor or any affiliate without

penalty upon 60 days notice.

2. With respect to any program units owned by the sponsor, the sponsor may not vote or consent on matters submitted to the participants regarding the removal of the sponsor or regarding any transaction between the program and the sponsor. In determining the requisite percentage in interest of program units necessary to approve a matter on which the sponsor may not vote or consent, any program units owned by the sponsor shall not be included.

G. *Removal or Withdrawal of the Sponsor.* 1. In the event the sponsor is removed in accordance with subsection F above, the incoming sponsor and the removed sponsor shall, by mutual agreement, select an independent expert to value the removed sponsor's interest in the program. In determining the value of the sponsor's interest, the independent expert will take into account appropriate discount factors in light of the risk of recovery of oil and gas reserves, and, in any event, will utilize a risk factor discount no less than that utilized in the most recent offer extended pursuant to Section IX.C of these guidelines (relating to cash redemptions), if any. The incoming sponsor, or the program, shall have the option to purchase at least 20% of the interests of the removed sponsor for the value determined by the expert.

The method of payment for such interest must be fair and must protect the solvency and liquidity of the program. Where the termination is voluntary, the method of payment will be deemed presumptively fair where it provides for a non-interest bearing unsecured promissory note with principal payable, if at all, from distributions which the terminated sponsor otherwise would have received under the program agreement had the sponsor not been terminated. Where the termination is involuntary, the method of payment will be deemed presumptively fair where it provides for an interest bearing promissory note coming due in no less than five years with equal installments each year.

2. If the sponsor withdraws as sponsor and the participants elect to continue the program, the valuation procedure outlined in subsection I hereof applies. The sponsor may not voluntarily withdraw from the program prior to the program's completion of its primary drilling and/or acquisition activities, and then only after giving 120 days written notice. The sponsor may not partially withdraw its property interests held by the program unless such withdrawal is necessary to satisfy the bona fide request of its creditors or approved by a majority in interest vote of the participants. The sponsor must fully indemnify the program against any additional expenses which may result from a partial withdrawal of property interests and such withdrawal may not result in a greater amount of direct costs or administrative costs being allocated to the participants. The withdrawing sponsor shall pay all expenses incurred as a result of its withdrawal.

**IX. MISCELLANEOUS PROVISIONS.** A. *Minimum Program Capital.* The minimum amount of funds to activate a program shall be sufficient to accomplish the objectives of the program, including "spreading the risk". Any minimum less than 1,000,000 will be presumed to be inadequate to spread the risk of the public investors. In those instances where it appears unlikely that the stated objectives of the program can be achieved with the minimum subscriptions, the Administrator may require a greater amount or a reduction of the stated objectives of the program. Provision must be made for the return to public investors of one hundred percent (100%) of paid subscriptions in the event that the established minimum to activate the program is not reached. All funds received prior to activation of the program must be deposited in an interest bearing account with an independent custodian, trustee, or escrow agent

whose name and address shall be disclosed in the prospectus.

- B. *Deferred Payment.* Arrangements for deferred payments on account of the purchase price of program interests may be allowed when warranted by the investment objectives of the partnership, but in any event such arrangements shall be subject to the following conditions:
1. The period of deferred payments shall coincide with the anticipated cash needs of the program, but the full amount of the purchase price shall be paid within nine (9) months of the date on which the program commences operations.
  2. Selling commissions paid upon deferred payments are collectible when such payment is made.
  3. The program shall not sell or assign the deferred payments.
  4. Such deferred payments shall be contractually binding obligations of the buyer whether or not a promissory note is taken.
  5. In the event of a default in the payment of any deferred payment when due, the participant's percentage interests in the program shall not be subject to forfeiture but may be subject to a reasonable reduction for failure of the participant to meet his commitment. Reduction provisions will be considered reasonable if they conform to the reduction provisions provided for in Section VIII.E.2(b) of these guidelines, relating to defaults of mandatory assessments.

C. *Cash Redemptions.* 1. When cash redemption values of units are computed, such values must be supported by an appraisal of properties prepared by an independent petroleum consultant within 120 days of the commencement date of such cash redemptions. Any evaluation by company personnel must be based on such independent appraisal. Any redemption must be for cash. No redemption shall be considered effective until after cash payments have been paid to the participants.

2. Provisions in the program agreement or other documents which require a participant to sell his unit or give the program or any other person the right to repurchase such unit, irrespective of the desire of the participant to sell, will not be approved unless the participant made misrepresentations which jeopardize the legal or tax status of the program.

D. *Appraisal and Compensation*

1. In connection with a proposed roll-up; an appraisal of all program assets shall be obtained from a competent independent expert. If the appraisal will be included in a prospectus used to offer the securities of a roll-up entity, the appraisal shall be filed with the Securities and Exchange Commission and the Administrator as an Exhibit to the Registration Statement for the offering. Accordingly, an issuer using the appraisal shall be subject to liability for violation of Section 11 of the Securities Act of 1933 and comparable provisions under State law for any material misrepresentations or material omissions in the appraisal. Program assets shall be appraised on a consistent basis. The appraisal shall be based on all relevant information, including current reserve estimates prepared by an independent petroleum consultant, and shall indicate the value of the program's assets as of a date immediately prior to the announcement of the proposed roll-up transaction. The appraisal shall assume an orderly liquidation of program assets over a 12 month period. The terms of the engagement of the independent expert shall clearly state that the engagement is for the benefit of the program and its participants. A summary of the independent appraisal, indicating all material assumptions underlying the appraisal, shall be included in a report to the participants in connection with a proposed roll-up.

2. In connection with a proposed roll-up, the person sponsoring the roll-up shall offer the participants who vote "no" on the proposal the choice of:
  - (a) accepting the securities of the roll-up entity offered in the proposed roll-up;  
or
  - (b) one of the following:
    - (1) remaining as participants in the program and preserving their interests therein on the same terms and conditions as existed previously; or
    - (2) receiving cash in an amount equal to the participants' pro-rata share of the appraised value of the net assets of the program.
3. The program shall not participate in any proposed roll-up which would result in the participants having democracy rights in the roll-up entity which are less than those provided under Sections VIII.A and VIII.F of these guidelines. If the roll-up entity is a corporation, the democracy rights of participants shall correspond to the democracy rights provided for in these guidelines to greatest extent possible.
4. The program shall not participate in any proposed roll-up which includes provisions which would operate to materially impede or frustrate the accumulation of shares by any purchaser of the securities of the roll-up entity (except to the minimum extent necessary to preserve the tax status of the roll-up entity). The program shall not participate in any proposed roll-up which would limit the ability of a participant to exercise the voting rights of its securities of the roll-up entity on the basis of the number of program units held by that participant.
5. The program shall not participate in any proposed roll-up in which participants' rights of access to the records of the roll-up entity will be less than those provided for under Section VIII.C of these guidelines,
6. The program shall not participate in any proposed roll-up in which any of the costs of the transaction would be borne by the program if the roll-up is not approved by participants.

E. *Reinvestment Plans.* 1. No offering will be approved by the Administrator that includes a provision which requires that the participant reinvest his share of distributable cash distributions.

2. If permitted under applicable securities laws, a program may make available to its participants a voluntary plan for systematic reinvestments in such program or in any other program if the terms of the plan are fair and reasonable to the participants.

3. To the extent it is economically feasible, money held for reinvestment must be placed in an income-producing account which provides an appropriate safety for the principal, and must be subject to withdrawal by the participant upon not less than 10 days notice. If the funds are not reinvested within 180 days of the date of distribution, they must be distributed, with such income, if any, to the participants.

4. No sales commissions may be deducted directly or indirectly from the reinvested funds.

F. *Distribution of Revenues.* From time to time and not less often than quarterly, the sponsor must review the program's accounts to determine whether cash distributions are appropriate. The program shall distribute pro rata to the participants funds received by the program and allocated

to their accounts which the sponsor deems unnecessary to retain in the program. In no event, however, shall funds be advanced or borrowed for purposes of distributions, if the amount of such distributions would exceed the partnership's accrued and received revenues for the previous four quarters, less paid and accrued operating costs with respect to such revenues. The determination of such revenues and costs shall be made in accordance with generally accepted accounting principles, consistently applied. Cash distributions from the program to the sponsor shall only be made in conjunction with distributions to participants and only out of funds properly allocated to the sponsor's account.

G. *Distributions in Kind.* The program agreement shall provide that any in kind property distributions to the participants will be made to a liquidating trust or similar entity for the benefit of the participants, unless at the time of the distribution:

- (1) the sponsor shall offer the individual participants the election of receiving in kind property distributions and the participants accept such offer after being advised of the risks associated with such direct ownership; or
- (2) there are alternative arrangements in place which assure the participants that they will not, at any time, be responsible for the operation or disposition of program properties.

**X. PROSPECTUS DISCLOSURE.** *A. Offerings Registered with the Securities and Exchange Commission.* With respect to offerings registered with the Securities and Exchange Commission under the Securities Act of 1933, as amended, and registered or qualified with the Administrator, a prospectus which is part of a registration statement which has been declared effective by said Commission shall be deemed to comply with all requirements as to form; provided, however, the Administrator reserves the right to require additional disclosure in his discretion.

*B. Offerings Not Registered with the Securities and Exchange Commission.* 1. A prospectus which is not part of a registration statement filed with the Securities and Exchange Commission pursuant to the Securities Act of 1933 shall generally conform to the disclosure requirements which would apply if the offering was registered with the Securities and Exchange Commission. The format and information requirements of Guides Two and Four promulgated by the Securities and Exchange Commission should be followed, with appropriate adjustments made for the different business objectives of the program.

2. At the minimum and in addition to the specific disclosures required by Sections II, III, IV, V, VI, VII and VIII of these guidelines, the-following topics shall be thoroughly covered in the prospectus:

- (a) the definition of technical terms;
- (b) the suitability requirements of participants;
- (c) risk factors;
- (d) sponsor experience;
- (e) sponsor compensation;
- (f) use of proceeds;



- (g) proposed activities;
- (h) deferred payment and/or assessment policies;
- (i) property descriptions (if applicable);
- (j) prior performance information as required by Section X.C;
- (k) federal tax consequences;
- (l) plan of distribution;
- (m) legal proceedings involving the program, the sponsor or affiliates, if material;
- (n) conflicts of interest and possible transactions between the program and the sponsor or its affiliates; and
- (o) financial statements are required by Section X.B.3.

### 3. *Financial Statements.*

- (a) *The Program.* If the program is operational at the time the offering commences, the prospectus shall include complete financial statements prepared in accordance with generally accepted accounting principles and accompanied by an audit report from an independent certified public accountant. The financials shall include a balance sheet and statements of operations, partner's or shareholder's equity and cash flows. The statements must show financial results for the three most recent fiscal years (or period of existence, if less), and if the most recent fiscal year ended as of a date more than 90 days prior to the filing of the registration application, supplemental unaudited statements shall be included which show financial results for an interim period ending not more than 90 days prior to the filing of the application.
- (b) *The Sponsor.* The financial statements of the managing or controlling general partner and any guarantor, as, required by Section II.C of these guidelines, shall be included in the prospectus, except that individual managing or controlling general partners will not be required to disclose their statement of financial condition if the prospectus contains a representation of the amount of the individual's net worth and the prospectus discloses that the statement of financial condition is available for review by participants upon request.

C. *Prior Performance.* The prospectus shall contain a narrative summary of the "track record" or prior performance of programs sponsored by the sponsor and its affiliates containing at least the information set forth below.

The prior performance tables should be preceded by a narrative introduction with appropriate cross references. The narrative summary in the text should explain the significance of the track record disclosed in the tables and explain where additional information can be obtained.

Each table should be introduced by a brief narrative explaining the objective of the table and what it covers so that the investor will be able to understand the significance of the information presented. There also should be set forth with or in each table any further material information

that may be necessary to make the required tabular data, in light of the circumstances under which it is presented, not misleading. Information should be given for each prior program, public or nonpublic, with investment objectives similar to those of the program offered by the prospectus. If the sponsor has not sponsored at least five such programs, then information must be given for each prior program, public or nonpublic, even if the investment objectives for those programs are not similar to those of the program in question. In that case, programs with investment objectives that are not similar to those of the program should be grouped together according to the investment objective and information about those programs presented separately.

1. *Experience in Raising Funds.* Information presented shall include at least the following:
  - (a) the date each program commenced operations;
  - (b) the gross amount of capital raised by each program;
  - (c) the number of participants in each program; and
  - (d) the amount of the investment of the sponsor, if any.
  
2. *Experience in Investing Funds.* Information presented shall include at least the following:
  - (a) if the program is a drilling program, the drilling results of the program, including the number and classification (i.e., exploratory or development) of gross and net wells drilled and completed or abandoned;
  - (b) if the program is a production purchase program, the costs incurred in connection with the property acquisitions and the period during which the program was engaged in property acquisitions; or
  - (c) if the program has other investment objectives, then a description of the investments made or assets acquired and the period during which the program was engaged in making investments or acquiring assets.

3. *Operating Results and Prior Programs.* Information should be presented on the basis of generally accepted accounting principles. However, where information about non-public programs is included, such information may be presented on a tax basis if the program's books have not been kept in accordance with generally accepted accounting principles. If there are any significant differences between these methods in the operating results, they should be explained. This explanation should provide the reader with any additional information about the particular program presented that may be necessary to make the information contained in the table not materially misleading in light of the circumstances under which the information is given.

Information presented shall include the following:

- (a) any borrowings by the program;
- (b) total program revenues allocated;
- (c) total expenditures of the program for other than operating costs, administrative costs and direct costs;
- (d) total operating costs, administrative costs and direct costs, separately;

- (e) total cash distributed on a cumulative basis and for the last three months for which information is presented; and
- (f) the discounted present value, at a 10% discount rate, of future net cash flow associated with program reserves, if available, prepared by an independent petroleum consultant, in accordance with the Statement of Financial Accounting Standards (SFAS) Number 69, before tax, as of the latest practicable date, but in any event not more than 15 months prior to the date of the prospectus. The disclosure should also show the expected timing of revenues to be recognized from the sale of the reserves.

|D.| |sic|

E. *Demonstration of Guideline Compliance in Program Agreement.* The requirements and/or provisions of appropriate portions of the following sections shall be included in the program agreement: I.B. (Definitions); II.D., F., H., I. and J. (Sponsor Requirements); IV.F. (Participant Suitability Records); V.A.-C, (Fees, Compensation and Expenses); VI.A.-C. (Affiliated Transactions and Restricted Activities); VIII.A—G. (Rights and Obligations of Participants); IX.B., C., D., E., F. and G. (Miscellaneous Provisions).

## OIL AND GAS PROGRAMS GUIDELINES CROSS REFERENCE SHEET

Name of Applicant \_\_\_\_\_

<u>Guideline Section</u>	<u>Section Number</u> <u>Program Agreement</u>	<u>Page Number</u> <u>Prospectus</u>	<u>Endnote</u>
<b>I.B. Definitions</b>			
1. Administrative Costs	_____	_____	_____
2. Administrator	_____	_____	_____
3. Affiliate	_____	_____	_____
4. Assessments	_____	_____	_____
5. Capital Contributions	_____	_____	_____
6. Capital Expenditures	_____	_____	_____
7. Carried Interest	_____	_____	_____
8. Cost	_____	_____	_____
9. Cross Reference Sheet	_____	_____	_____
10. Development Well	_____	_____	_____
11. Direct Costs	_____	_____	_____
12. Exploratory Well	_____	_____	_____
13. Farmout	_____	_____	_____
14. Horizon	_____	_____	_____
15. Independent Expert	_____	_____	_____
16. Landowner's Royalty Interest	_____	_____	_____
17. Non-Capital Expenditures	_____	_____	_____
18. Operating Costs	_____	_____	_____
19. Organizational & Offering Expenses	_____	_____	_____
20. Overriding Royalty Interest	_____	_____	_____
21. Participant	_____	_____	_____
22. Person	_____	_____	_____
23. Production Purchase or Income Program	_____	_____	_____
24. Program	_____	_____	_____
25. Prospect	_____	_____	_____
26. Proved Reserves (a)(1) Proved Developed	_____	_____	_____

<u>Guideline Section</u>	<u>Section Number</u> <u>Program Agreement</u>	<u>Page Number</u> <u>Prospectus</u>	<u>Endnote</u>
Producing Reserves			
(a)(2) Proved Developed Non-Producing Reserves			
(b) Proved Undeveloped Reserves			
27. Roll-Up			
28. Roll-Up Entity			
29. Sponsor			
30. Subordinate Interest			
31. Working Interest			
<b>II. Requirements of Sponsor</b>			
A. Experience			
B. Net Worth			
1. (a) Limited Partnership Offerings: 5% of offering not to exceed \$2 million			
(b) General Partnership Offerings-\$5 million.			
C. Financial Statements			
D. Additional Requirements for General Partnerships and Working Interests Program			
1. Participant Indemnification			
2. Insurance Coverage			
3. Terms of indemnification agreement & insurance coverage			
E. Tax Ruling or Opinion			
F. Investment in Program			
G. Reports – Administrator			
H. Fiduciary Duty			
I. Liability &			

<u>Guideline Section</u>	<u>Section Number</u>		<u>Page Number</u>	<u>Endnote</u>
	<u>Program Agreement</u>	<u>Prospectus</u>		
Indemnification				
1.(a) course of conduct in best interest of program				
(b) services for program				
(c) not negligence or misconduct				
(d) payments only from tangible net assets				
2. Securities Law Violations if:				
(a) successful adjudication;				
(b) dismissed with prejudice				
(c) court approved and court advised of SEC and state regulatory agencies				
3. Prohibited insurance				
4. Advance of program funds for legal expenses				
(a) Performance of duties or services				
(b) Legal action initiated by third party who is not a participant				
(c) Undertake to repay if not entitled to indemnification				

**III. Selling of Units & Sales Materials**

A. Sales of Units			
B. Sales Material			

**IV. Suitability of Participants**

B. Income & Net Worth

Standards

1. Income Programs

2. Drilling Programs-  
Limited Liability

3. Drilling Programs-  
Unlimited Liability

C. Determination that Sale to  
Participant is Suitable &  
Appropriate

D. Subscription Agreements

E. Completion of Sale

F. Minimum Investment

**V. Fees, Compensation & Expenses**

A. Organizational & Offering  
Expenses, and  
Management Fees

B. Compensation

1. Drilling Programs

(a) Sponsor Payment of  
Capital Expenditures  
of 10% then 25% of  
program revenues.  
Additional 1% for  
each 1% additional  
capital expenditure  
not exceeding 50%

(b) Facilities  
Downstream &  
Farmout Reduction

(c) Sponsor Net Worth

(d) Abandoned Well

(e) Reasonableness

2. Drilling Programs-  
Subordinate Interest of  
25% of program  
distributions after

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investors receive capital contribution			
3. Drilling Programs (other alternatives)- 11% program revenues if pays 1% of all program costs. Additional 1% for each 1% of costs paid up to 50% maximum			
4. Prospect Origination Services by Sponsor			
5. Income or Production Purchase Programs			
(a) With no technical staff, 3% carried interest until 100% return, then 5%			
(b) 10% carried interest if technical staff or 1% until 100% then 20% carried interest			
6. Operator Services			
7. Drilling Contractor Services			
8. Equipment Supplies & Services			
9. Written Contract			
C. Program Expenses			
1. Administrative Costs and Other Charges			
2. Directly Paid by Program			
3. Reimbursement for administrative costs			
4.-6. Tabular Form			





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ments			
5. Drilling & Fiduciary Duty			
6. Loans to Sponsor/Affiliate			
7. Sponsor Loans to Programs			
8. Rebates/Give-ups			
<b>VII. Farmouts</b>			
A. Definition			
B. Disclosure of Circumstances/ Limitations			
C. Conditions to Farmout			
1. Insufficient Funds/ Financing			
2. Downgraded Leases			
3. Excessive Concentration of Funds			
4. Best Interest of Program			
D. Conflicts Disclosure			
E. Acquisition not for Farmout			
F. Farmout Covering Sponsor Drilling Cost			
<b>VIII. Rights &amp; Obligations</b>			
A. Meetings			
B. Annual & Periodic Reports			
C. Access to Program Records			
D. Admission of Participants			



Name: \_\_\_\_\_

Title: \_\_\_\_\_

Signature \_\_\_\_\_