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TAXATION OF LIMITED PARTNERSHIP ROLLUPS

HEARING

BEFORE THE

SUBCOMMITTEE ON
ENERGY AND AGRICULTURAL TAXATION

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

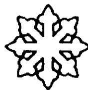
ONE HUNDRED SECOND CONGRESS

FIRST SESSION

ON

S. 1393

JULY 16, 1991



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TAXATION OF LIMITED PARTNERSHIP ROLLUPS

TUESDAY, JULY 16, 1991

U.S. SENATE,
SUBCOMMITTEE ON ENERGY AND
AGRICULTURAL TAXATION,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:00 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Tom Daschle, (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

[Press Release No H-28, July 9, 1991]

SUBCOMMITTEE TO DISCUSS TAXATION OF LIMITED PARTNERSHIP ROLLUPS; DASCHLE SEEKS PROTECTIONS FOR SMALL INVESTORS

WASHINGTON, DC—Senator Tom Daschle, Chairman of the Senate Finance Subcommittee on Energy and Agricultural Taxation, Tuesday announced a hearing on the taxation of limited partnership rollups.

The hearing will be at *10 a.m. Tuesday, July 16* in Room SD-215 of the Dirksen Senate Office Building.

Daschle (D., South Dakota) said the hearing will focus on how limited partners are affected by transactions in which general partners and others combine limited partnerships into a single entity. Adequate disclosure and dissenters' options for limited partners will be discussed in the context of S. 1393, which Daschle introduced recently.

S. 1393, which is similar to H.R. 2028 introduced by Rep. Fourtney H. (Pete) Stark, would impose a 50 percent excise tax on general partners and others who gain from a rollup in which certain limited partner protections are not provided.

"The majority of limited partners are small investors who can find their hard-earned savings cut by 50 percent or more as a result of a transaction over which they had little control. In most rollups, the limited partners have no meaningful opportunity to assess the terms of the proposed change and to exit the deal if they so choose," Daschle said.

OPENING STATEMENT OF HON. TOM DASCHLE, A U.S. SENATOR FROM SOUTH DAKOTA, CHAIRMAN OF THE SUBCOMMITTEE

Senator DASCHLE. The hearing will come to order I want to welcome everybody this morning. We are here to discuss a relatively recent phenomenon in the history of investment practices the limited partnership rollup. Literally hundreds of thousands of small investors nationwide have been drawn into these transactions, often to their great financial detriment.

We will learn more about partnership rollups today, what they are, who is harmed, and who benefits. We will hear the testimony of an investor who has been faced, not once, but twice with the prospect of losing her savings in a partnership rollup.

Most importantly, we will consider how best to provide protection in the future for millions of small investors who currently hold limited partnership interests.

One approach to protecting investors that we will discuss today is contained in Senate Bill 1393. Representative Pete Stark originally proposed this measure in the House, and I have introduced it in the Senate. S. 1393 would impose a 50-percent penalty tax on general partners and others who gain unfairly from a limited partnership rollup at the expense of limited partners.

Under the bill, cash-out or similar rights must be provided to dissenting investors. If these rights are not provided, all those who gained from the transaction, including general partners, investment advisors, managers, and others, would see their gain cut in half.

This is not the only approach to addressing partnership rollup concerns, nor is this the first hearing on the issue. But it is important that we keep this issue moving.

It is my hope that this hearing will take us a step closer to resolving the underlying concerns and protecting limited partners in the future. We have a number of witnesses to hear from, and I would like to ask that, to the extent possible, each witness limit their remarks to 5 minutes. As always, longer statements and additional comments will be submitted for the record.

With that, let me call to the table our first witness this morning from the Treasury Department, Mr. Robert Wootton, the Legislative Tax Counsel. Mr. Wootton, you are invited to come, and we are delighted you could be with us this morning.

STATEMENT OF ROBERT R. WOOTTON, TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. WOOTTON. Thank you, Mr. Chairman. I am pleased to be here today to present the views of the Treasury Department on Senate Bill 1393, which seeks to regulate partnership rollup transactions through the imposition of a 50 percent Federal excise tax on transactions that do not provide specified dissenters' rights to limited partners.

We oppose S. 1393. We believe that the Federal tax laws should not be used to attempt to regulate the terms of securities transactions on the merits.

Mr. Chairman, my written statement contains several technical comments on S. 1393 and, with your permission, I would ask that it be incorporated in the record.

Senator DASCHLE. Without objection that will be done.

[The prepared statement of Mr. Wootton appears in the appendix.]

Mr. WOOTTON. Then I will limit myself, in accordance with your request, to more general comments in testimony today.

One reason for our opposition to S. 1393 is that it would be difficult for the Internal Revenue Service to interpret and apply effectively in practice. The IRS personnel who would be asked to enforce the new excise tax would not have experience with the securities law concepts that the statute would embody.

In particular, the application of the tax would depend on whether, in connection with a partnership rollup, the limited partners have had a reasonable opportunity to dissent and dissenters' rights, concepts that are included within the bill's language.

Making these determinations would involve the examination and resolution of issues that are well outside our normal areas of experience. If S. 1393 were enacted, we might well look to applicable Federal or State laws for rules governing the form, content, and timing of disclosure and proxy solicitation, the methodology of evaluation and appraisal, and other matters which are implicated by S. 1393. This would require IRS agents to learn and interpret Federal and State securities laws, and State corporation laws, at least to some extent, in order to enforce the Federal tax law.

Alternatively, we could, through Treasury regulations, adopt a set of uniform rules governing these matters. This approach, however, would almost certainly lead to inconsistencies with applicable Federal and State laws. And, in the case of State laws, it might also raise questions of Federal preemption.

On audit, issues regarding compliance with S. 1393 would typically arise in combination with other Federal tax issues. Even in the best circumstances, agents seldom have the experience, the knowledge, or the time to raise all possible issues. Issues that require applying non-tax law, such as Federal or State securities law, may be less likely to be raised than those that are closer to the agent's usual experience.

If S. 1393 were enacted, the Internal Revenue Service would need an aggressive program of training and specialist support which inevitably would drain resources from other audit programs. Even then, agents must be mindful of revenue collection in proposing adjustments and penalties. An agent might reasonably decline to assert liability for the rollup excise tax in cases in which the liability is unclear, or potential collections appear small.

These considerations might make the new excise tax a less effective deterrent against the targeted rollup transactions, but here is the point. Deterrence is really the only justification for the tax.

The tax law—this tax law, any tax law—does not create private remedies. Accordingly, if the new excise tax were unsuccessful and did not deter a transaction, the only possible beneficiary would be the Federal fisc. The intended beneficiaries, the dissenting limited partners, would be simply out of luck.

In contrast, State dissenters' rights laws, such as those recently added to the limited partnership statutes of New York and California, do create private rights of action. Careful consideration should be given to whether the enactment of S. 1393 would inhibit the further development of appropriate responses by State legislatures and Federal or State securities regulators.

Mr. Chairman, that concludes my prepared remarks, and I would be pleased to answer questions.

Senator DASCHLE. Thank you, Mr. Wootton. We are told that about 275,000 limited partner investors have been harmed thus far. We do not know what the universe out there may be, but we are talking about a substantial number of people who have been taken in and affected detrimentally in various ways.

Yet, I notice in your testimony you do not offer any solution. You indicate that S. 1393 is not to your liking. What would you suggest we tell the 275,000 that have already been victimized, and the potential thousands more who might be? What would be the panacea, from your perspective?

Mr. WOOTTON. Well, as a tax specialist, I have tried to bring insights as to what the potential problems might be were S. 1393 to be enacted. There are other responses that are outside of my immediate area of expertise. It does appear that in the State arena, there has been movement toward creating broader and more effective dissenters' and appraisal rights for limited partners investing in limited partnerships. And, as I am sure Mr. Doty would like to talk about later on today, at the Federal level, strides have been made to ensure that limited partners learn more about the transactions and disclosures are made to them in a manner that they can fully appreciate the consequences of their votes.

Senator DASCHLE. What are those strides? I am not familiar with them.

Mr. WOOTTON. I would prefer, Mr. Chairman, to defer to Mr. Doty on that, because I am sure he will describe it more accurately than I will.

Senator DASCHLE. I am curious about the statement you made with regard to the difficulty in determining the amount of gain on which to impose the excise tax.

Obviously, these fees from rollups are required to be reported as income on tax returns. Obviously, you would have a pretty clear delineation on a return what those fees were, what the level of income was. How is it that a tax on those particular fees would be difficult to ascertain?

Mr. WOOTTON. There are some, what I would characterize as technical problems, with the measurement of fees and gain, particularly in cases where the fees to be assessed are received months, perhaps years, after the transaction takes place. But what I would really like to focus the attention on is not difficulty in measurement of the fees so much as difficulty in ascertaining whether this is a prohibited rollup transaction. In order to be such a transaction, it must fail to give the limited partners the dissenters' rights that would be required under the statute.

And that is where the interaction of Federal and State tax and securities laws could, I think, give IRS agents fits.

In particular, I would suspect that, were S. 1393 to be enacted, we would piggy-back to a greater or a lesser extent on Federal and State securities law to determine whether adequate disclosure had been made, and therefore, whether the limited partners had a reasonable opportunity to dissent.

The natural result of that is that IRS agents would be, to a greater or lesser extent, reading and trying to apply the Federal and State securities laws in deciding whether the excise tax would be applicable.

Senator DASCHLE. I do not see that as their role at all, Mr. Wootton. I interpret it differently. I see that they would be there to provide evidence. Whatever accusations, whatever investigations, whatever evidence might exist may be established through the tax forms, the tax reports. The income generated would be substantiat-

ing evidence to support the investigation, not as evidence in and of itself with which to launch an investigation.

And so, as I say, I think you have got a pretty clear indication what the revenue was, how much it was, whether it was extraordinary given whatever other evidence there may be that this was a fraudulent enterprise. It is very much in keeping with the traditions of the IRS to look at tax data when that occurs.

Let me ask you about Section 5881. The impression I have is that the greenmail tax under Section 5881 was designed, in part, to do much the same thing. We enacted it in 1987 in an effort to prevent certain corporate raiders from receiving excessive payments in hostile take-overs. Did Treasury support enactment of section 5881?

Mr. WOOTTON. My search of the records has unearthed no indication one way or the other, whether Treasury took a position, or was asked to take a position, on the greenmail tax.

Senator DASCHLE. That's sort of a stealth position. [Laughter.]

Well, in retrospect now, we are in 1991, that was 1987. You have had a few years to look at it. Do you favor taking it off the books? Do you support some kind of alteration to section 5881?

Mr. WOOTTON. I have not examined that question in detail. However, were we to be having a hearing on the greenmail tax, I suspect I would be saying things very similar to those that I am saying today on S. 1393.

Our experience with the greenmail tax is not extensive. There recently have been issued proposed regulations which do not address the substantive issues under the greenmail tax, but rather, address questions of where you file the return, how you sign it, what information it contains, and so forth.

Collections under the greenmail tax, as best as we can tell, are zero. And the reason for that is that until the proposed regulations that I referred to have been finalized, the greenmail tax is not due. When they are finalized, the greenmail tax on transactions occurring since 1987 will be due 90 days thereafter. So, I wish I could bring you more concrete evidence with way or the other on the enforcement experience with the greenmail tax. It simply is not there at this time.

Senator DASCHLE. So, in other words, the greenmail tax has not worked because the regulations have not been promulgated.

Mr. WOOTTON. We have yet to push the button which will cause the greenmail tax to be due.

Senator DASCHLE. Well, when do you think the button will be pushed?

Mr. WOOTTON. That should be relatively soon. The form has been prepared in proposed form. The proposed regulations have not been controversial. Indeed, they do not deal with controversial matters, and we anticipate that they will be finalized in the very near future.

Senator DASCHLE. So, from all you can tell, at least as far as promulgation goes, there has not been any difficulty in formulating regulations that would do what is required by law under section 5881, and to your knowledge, there has not been any controversy surrounding implementation of the provision, even though it has taken about 3 years to promulgate the regulations.

Mr. WOOTTON. In all honesty, we have not bitten off any tough questions yet. The proposed regulations simply deal with mechanical matters as to filing and have not addressed substantive issues of interpretation.

Senator DASCHLE. Well, another stealth position. Frankly, I think there is a good analogy there. I think that what you see with regard to section 5881 is just an attempt to do virtually what we are doing in S. 1393, and I think to the extent that we are able, without any harmful consequences whatsoever, to determine the impact of section 5881, we should. We should not be deterred from that simply because of the very slow approach to promulgating the regulations. But with that, I guess, Mr. Wootton, I have no further questions. Thank you.

Mr. WOOTTON. Thank you, Mr. Chairman.

Senator DASCHLE. Our next panel of witnesses includes Mr. James Doty, general counsel, Securities and Exchange Commission; Dee Harris, securities commissioner of the State of Arizona on behalf of the North American Securities Administrators Association; and Frank J. Wilson, the executive vice president of Law and Regulatory Policy and general counsel, the National Association of Securities Dealers. If those three individuals could come to the table, we will take their testimony at this time.

Mr. Doty, we are pleased you could join us. We are delighted to take your testimony, and, obviously, the entire text of your written statement will be made part of the record. I would encourage you to proceed at this time.

STATEMENT OF JAMES R. DOTY, GENERAL COUNSEL, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC

Mr. DOTY. Thank you, Chairman Daschle. We are pleased to be here to testify at this hearing concerning the important issue of partnership rollup transactions.

Several legislative measures that would impose significant restrictions on rollups are now under consideration by the Congress, including S. 1393, the bill which you have introduced and which is the subject of today's hearing, as you know.

S. 1393, as we understand it, is a proposed response to the perceived unfairness in the manner in which various rollups have proceeded.

The Securities and Exchange Commission does not, of course, set Federal tax policy, and we defer to the Treasury Department in evaluating the specifics of a proposed tax that would be imposed, such as that under S. 1393. In general, however, we do not favor the imposition of new taxes on securities transactions, particularly taxes designed to affect only a class of transactions that are not structured in a specified manner, and where the basic objective, as best we can tell, is regulatory in nature. To the degree that the perceived problems with rollup transactions have involved cases of overreaching by fiduciaries, more direct remedies, we think, may be more effective in controlling abusive practices.

Indeed, the Commission has already taken steps to require that investors obtain more clear and concise disclosure regarding proposed rollup transactions, and to allow investors to oppose such

transactions more vigorously through proxy rule reforms. We will also consider soon the NASD's proposal to abolish the practice of paying broker's fees only for obtaining affirmative or positive votes in a rollup. More active enforcement of State fiduciary standards, we also believe, would address limited partners' complaints about the actions of their fiduciaries, the general partners.

The Commission's mandate, however, is to administer and enforce the Federal securities laws, which require, as you know, full disclosure of all material information in registered securities offerings, including rollups; and in my testimony today, I will discuss the regulatory initiatives taken by the Commission to address many of the concerns that have been raised about limited partnership rollups. We believe that these measures will enhance investor protections against potentially abusive rollups, while preserving the rollup as a transaction that when properly used can enhance liquidity and afford investors an opportunity to realize value on their initial investment.

So, I would like to speak with you briefly about the rollup phenomenon and limited partnerships, and some of the regulatory aspects of the phenomenon.

For several decades, limited partnerships were an attractive investment vehicle for offering investments in commercial and residential real estate, oil and gas drilling programs, cable franchises, motion pictures and plays, and other tax-advantaged properties. For much of this time, and prior to major revisions in the Federal Tax Code beginning in 1984, investors in limited partnerships were often motivated by favorable tax treatment. The pass-through of partnership gains and losses enabled individual investors to receive substantially the same tax treatment and cash distributions that they would have received by investing directly in the property, without the attendant legal liabilities.

Many of these limited partnerships, of course, lost much of their value as a result of difficulties in the real estate and oil and gas industries—including the lingering effects on those industries of depressed fossil-fuel prices and over-built real estate markets—as well as legislation enacted between 1984 and 1987 that reduced the tax benefits accorded the investments. These developments have had a dramatic effect on the market for limited partnerships. With respect to real estate, for example, the six major syndicators of real estate partnerships saw sales decline from $6.5 billion in 1987 to $2.6 billion in 1989. During roughly the same period, all registered partnership offerings declined from $22.4 billion in 1987 to $5.3 billion in 1990.

The decline in value of these limited partnerships also highlighted the illiquid nature of the investments. Limited partnership interests are usually not traded on a national securities exchange, or quoted on the National Association of Securities Dealers Automated Quotation System, or NASDAQ.

The rollup phenomenon, accordingly, has appeared as a response to the inherent lack of liquidity in the market for limited partnership interests, as a means of creating liquidity through the combination or reorganization of one or more illiquid partnership entities. Rollups have also created considerable controversy, however, as critics have charged that general partners put their interests

above the interests of limited partners by the manner in which they structure and sell rollups.

In a typical rollup transaction, a sponsor combines a number of public or private limited partnerships into a single entity. This combination requires the consent of the requisite majority of limited partners of each predecessor entity, and typically is accomplished through a merger of existing entities into a surviving entity, which is often a corporation.

The rollup transaction, accordingly, can create liquidity where there was none before. The Commission, however, recognizes that these transactions may be abusive or unfair. We believe that the pattern of State regulation, when coupled with amplified disclosure in the area of the Federal securities laws, is an approach that will enhance investor protection and will address directly many of these abusive practices.

As we say in our written testimony, we now have published for comment a rule proposal that would address enhanced disclosures in the area of rollups directly by focusing on enhanced discussion of fairness. Whereas before, fairness and business combinations generally were addressed by our rules, this rule would focus discussion of fairness of the transaction directly on the rollup transaction, whether or not it involved a going-private transaction.

Second, we have published for comment proxy rule reform proposals that would enable investors more effectively to oppose these rollup transactions when they appear to investors to be unfair.

We would hope that that is an appropriate response to this problem, and look forward to discussing it further with you today.

[The prepared statement of Mr. Doty appears in the appendix.]

Senator DASCHLE. Thank you, Mr. Doty.

Mr. Harris.

STATEMENT OF DEE HARRIS, SECURITIES COMMISSIONER, STATE OF ARIZONA, ON BEHALF OF NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., WASHINGTON, DC

Mr. HARRIS. Mr. Chairman, good morning. I am Dee Harris, the Arizona Director of Securities. I also serve as the chairman of the Limited Partnership Rollup Task Force of the North American Securities Administrators Association (NASAA). I appreciate the opportunity to appear before you today.

I want to begin by sharing with you the grave concerns of State securities regulators across the nation about the growing number of complaints that we are hearing from both small investors and market professionals who see abusive rollups as a serious problem.

This is a particularly frustrating situation for State securities regulators who have devoted many long years to framing and using a State-level system of fair and reasonable regulation for limited partnerships. Fifteen years of concerted State efforts to police limited partnership offerings have resulted in a marketplace which is both much fairer and relatively free of fraud and abuse. We are dismayed that all of this good work on behalf of small investors is now being unraveled and undercut by the rising tide of rollups.

How does this regulatory disconnect come about, and why are State regulators out of the rollup picture? State securities laws and rules focus on risky and illiquid investments where it can be said that no efficient market exists.

That is why so much of the attention of the States falls on such instruments as penny stocks and limited partnerships. It is these instruments where there is the greatest danger of fraud and abuse.

For the Securities and Exchange Commission is reserved the role of coping with regulatory issues of a truly national and market-wide scope. This regulatory burden-sharing also explains why it is that the States, out of respect for the concept of a national market system, have adopted exemptions for securities listed on exchanges upon which almost all rollups are traded.

From a regulatory standpoint, the problem with rollups is that they embody the worst of the characteristics that normally trigger State oversight, while also managing to be national in nature. It is this "betwixt and between" way that a rollup transaction moves from the small investor focus of State regulation to the broader emphasis of Federal securities laws, which rely on far less rigorous disclosure standards.

The current Federal standards for rollups contain none of the investor protection safeguards that are the hallmarks of State regulation. What should be done to protect the small investors who now are left virtually defenseless in the rollup process?

Congress has compiled convincing evidence that the limited partnership rollup process is urgently in need of a Federal overhaul, so as to restore to limited partners the opportunity for meaningful and informed decisionmaking.

NASAA is pleased to lend strong support to the Federal reform initiatives that would go straight to the heart of the worst of the current rollup abuses, including the essential element of dissenters' rights, as embodied in S. 1393.

NASAA applauds the SEC for recognizing the abuses associated with the rollup process, and for its recent disclosure and proxy rulemaking initiatives in this area. However, we would caution that these reforms fall short of what is needed to curb rollup abuses if they are not coupled with more substantive protections for limited partners, including dissenters' rights, voting rights, limits on fees and commissions, and independent fairness opinions.

Members of this subcommittee might also be interested in learning that State securities agencies are now hard at work to determine what it is that they can do to join Congress in curbing investor abuses in limited partnership rollups.

Among the efforts now under way by State securities regulators are: amendments to the existing NASAA limited partnership guidelines, which would put in place anti-abusive rollup criteria for the regulation of new limited partnership offerings; and amendments to the existing NASAA guidelines that would spell out specific standards for the registration of rollups that do not list on national exchanges or NASDAQ, and as a result, would be subject to State registration requirements.

Mr. Chairman, reform of the rollup process is urgently needed if we are to restore integrity to, and investor confidence in, the limited partnership marketplace. No other problem facing small inves-

tors today cries out so strongly and insistently for swift action on the part of Congress. Thank you.

[The prepared statement of Mr. Harris appears in the appendix.]

Senator DASCHLE. Thank you, Mr. Harris.

Mr. Wilson.

STATEMENT OF FRANK J. WILSON, EXECUTIVE VICE PRESIDENT OF LAW AND REGULATORY POLICY AND GENERAL COUNSEL, NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., WASHINGTON, DC

Mr. WILSON. Yes, Mr. Chairman. The NASD is pleased to be here today to discuss limited partnership rollups and solutions to problems they present. We do not believe S. 1393 should be enacted, preferring the regulatory approach. Nevertheless, we are most concerned with the abuses we have seen in the area, and as a result, we have done a number of things in addressing rollup problems.

First, in the area of compensation to NASD members for soliciting "yes votes only" in rollups, we found that the payment for "yes votes only" was of the most immediate concern, and had proposed to eliminate that practice and to require the general partner proposing the rollup to pay all solicitation expenses in the event that rollup is not approved.

The result of the NASD's action is that if the general partner is facing the responsibility for paying the cost of an unsuccessful solicitation and is required to pay compensation for any votes solicited by an NASD member, a strong incentive is created for general partners to structure and propose rollup transactions that are fair to limited partners and can be endorsed by NASD members soliciting votes. We are currently awaiting SEC approval of this rule.

We have also proposed governance standards for rolled-up partnerships listed on the NASDAQ securities market. These proposed standards were recently submitted to our membership for comment. They specify requirements concerning annual and quarterly reports, independent directors, audit committees, shareholders' meetings, quorums, and so forth.

In addition, we are in the advanced stages of developing regulations on NASD members' participation in public rollup transactions.

This work is not yet complete, but matters being considered are: lack of dissenters' rights and other protections for limited partners; problems with installation of super majority voting rights; and diminution of limited partners previous rights; unfair allocations of transaction costs to limited partners; unfair changes in general partner fee structures from an operations-based to an asset-based structure; and changes from a finite to an infinite life investment.

The SEC has also acted in this area, as Mr. Doty has testified, by issuing an interpretative release on existing disclosure requirements proposing rules mandating enhanced disclosure to limited partners and proposing significant amendments to its proxy rules that would ease communications among participants in rollup transactions.

S. 1393, on the other hand, would deal with the rollup problem by imposing a 50-percent tax on certain persons receiving payments from a "prohibited rollup transaction."

A prohibited rollup transaction is defined as one where dissenting limited partners are not afforded the right to redeem their security for cash, marketable securities or promissory notes, or the right to receive securities that have substantially the same value, rights, powers, and privileges.

Our specific concern with S. 1393 is that it may be difficult to provide a financial remedy without damaging the financial viability of a partnership. While it might seem inherently fair to provide dissenters with the redemption right for compensation, the partnership may not have the resources necessary to redeem dissenters' interests, or it may force the partnership to liquidate properties at an inappropriate time.

Providing rights to dissenters should not negatively impact the majority of the limited partners.

S. 1423 and H.R. 1885, both of which are titled, "The Limited Partnership Rollup Reform Act of 1991," provide for dissenters' rights with more flexibility, in our view, at least, than S. 1393.

These bills provide dissenters with the right of an appraisal and compensation, or a security under the same terms and conditions as the original security.

They further provide that if the NASD finds such rights would be impractical, or not in the financial interest of dissenting limited partners, then other comparable rights may be offered.

Other comparable rights would be the subject of rulemaking by the NASD and may include, when the NASD deems it necessary for the protection of dissenters' rights, the use of an independent committee of persons not affiliated with the general partner or sponsor with authority to protect the interests of limited partners and act on their behalf, including retaining independent advisors.

As a general matter, considering the SEC's rulemaking, the NASD's proposed rulemaking, as well as the legislative actions pending in both the House and the Senate, we question whether S. 1393 is necessary, at least at this time.

We believe the rollup problems are regulatory in nature, and are being addressed in the regulatory proposals by the SEC and the NASD. We do not believe it is necessary to deal with this regulatory problem indirectly by amending the Tax Code.

We would, therefore, recommend that action on 1393 be deferred pending results of the regulatory proposals which are under way.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Wilson appears in the appendix.]

Senator DASCHLE. Thank you, Mr. Wilson. Mr. Harris, you have heard Mr. Doty and Mr. Wilson talk about the panacea as being more regulatory than statutory; that we can handle the problem fairly well in three ways. One, through greater regulation; two, through greater information; and three, through more emphasis at the State level in promulgating whatever additional rulemaking may be necessary. How would you respond to that? Do you take a different position? Judging from your opening remarks, I sense that you would not be satisfied with that, but I would want to clarify that, and I do not want to put words in your mouth.

Mr. HARRIS. Mr. Chairman, I think that a regulatory approach to the problem coupled with an enhanced disclosure approach to the problem can solve it. Unfortunately, I think that none of the proposals currently on the table go far enough.

Most of the Federal securities laws, as you know, limit themselves to full disclosure—except, of course, for the Investment Company Act of 1940, which does not, and which goes into substantive issues.

The SEC, without new legislative authority, does not have the tools to conduct substantive regulation in this particular arena. We would support strong Federal legislation to give the SEC new authority in that area. I think that a combination of things, including enhanced disclosure, which I know the SEC is working on; clarifying the disclosure process; some new substantive authority, including dissenters' rights, can solve the problem from a regulatory point of view. So, I am not suggesting that regulation would not solve the problem. However, the SEC needs new statutory direction from Congress in order to implement meaningful and effective regulations.

Senator DASCHLE. Mr. Doty, that was my understanding, too, that, certainly in the area of dissenters' rights, you do not have the authority. So, where in the regulatory field can you provide assurances to these investors that, indeed, through regulation alone we would be able to provide the kind of capability to address these abuses that does not exist in regulation today?

Mr. DOTY. Well, Mr. Chairman, that is an important question, and we do not want to be perceived before this subcommittee and before you as suggesting that we do not think Congress has a role to play in assuring the well-being of public investors.

As you know, for this agency, the fairness of the vote has always been the principal concern; it remains our principal concern. Our Rule, 19C-4, which was intended to assure the fairness of the voting process, was held by the Circuit Court of Appeals for the District of Columbia to be outside our statutory authority.

I think if the Commission had one area in which we thought Congress should move in order to enhance our powers to protect investors, it would clearly be in this area of the fairness of the voting process overall and to assure that votes of equity-holders generally are not abridged or diluted retroactively or retrospectively by State corporation laws that seek to provide management with the ability to represent other constituencies than equity-holders.

We do not see, in other words, the limited partnership rollup phenomenon as being an isolated one. We see the rights of equity-holders, of stockholders, as well as of limited-partnership interest holders, to affect the fortunes of their companies and their partnerships as being very important. But we see that in the context of the vote in the fairness of the voting process has been consistently what seemed to matter.

With respect to dissenters' rights, I would have to say respectfully that I think if you compared the effect that dissenters' rights under State corporate law have had on the fairness of this process, with the effect of the Federal proxy rules, it would be a pretty close call, that is, it would be a difficult thing to say that the existence of dissenters or appraisal rights for the holders of stock of business

corporations was more important than the Federal proxy rules. I think we could argue persuasively to you that the Federal proxy rules have done more to empower holders of equities than have dissenters' rights.

And, of course, what Congress would be doing here would be substantially adding to the substantive law of partnerships.

Four States now have dissenters' rights for limited partnerships. It remains to be seen whether the rest will do so, but I can imagine easily the situation in which States will come to the conclusion that appraisal rights, dissenters' rights are appropriate for limited partnerships which have so many other features now under the revised act of a business corporation.

But when Congress is legislating to protect investors generally, we would urge the Congress to see these phenomena as part of a much broader one. Rollups are a declining phenomenon at this point. They are not, in fact, a rising tide, as best we can tell.

Senator DASCHLE. I took Mr. Harris' opening remarks to say that States do not want to involve themselves with this, that they see this more as a national issue of interstate commerce; clearly one where they may not be able to address many of the particular participants because they are out of the State to begin with. If that is a fair assessment of what you said, Mr. Harris, could you—is it, by the way?

Mr. HARRIS. Yes, Mr. Chairman.

Senator DASCHLE. Is that not a pretty fair criticism of whatever argument there may be that States ought to be more involved? The fact is, they probably will not be more involved.

Mr. DOTY. We should not be perceived as saying that achieving fairness in combinations of limited partnerships lies solely in State action. I do not think that is our position here today.

But rather, what we do think should be given a chance to work are these proposed Commission rules which are designed to improve the timely dissemination of material information to the market, and to empower the holders of limited partnership interests to communicate with each other and more effectively to raise questions about the fairness of these rollups when the rollups are proposed and, indeed, to express opposition to the rollups, provided they do not solicit authority to act as proxy for other holders.

In part, Mr. Chairman, this is a process of creating through the proxy rules bargaining power. Bargained-for terms in these combinations are desirable. We want the people who are being offered the rollups to have the opportunity effectively to represent themselves and effectively to avoid overreaching and coercion by management in that process. I think that is much of what has concerned Congress, and it concerns the Commission both in rollups and in our corporate life generally.

Senator DASCHLE. I was going to ask about that. The impression I have, and my understanding of your proposed rules is that cram downs are still going to be allowed, that dissenting limited partners can still be forced to accept a transaction which was totally different from that in which they originally invested. Is that a correct interpretation of the rules as they have been proposed?

Mr. DOTY. Well, Mr. Chairman, it is true that our rules do not attempt to fix the terms of business combinations. They do not tell

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investors what is or is not a fair deal. So that if an investor group wants to trade off with a general partner in a business combination, let us say an enhanced management fee here for greater voting rights or greater distributions to limited partners there, that is a bargain which we think the parties can make.

We are very concerned, as I take it you are concerned, that the process not be really a cram down, that the process be a bargained-for, understood business transaction in which the people who are called upon to approve it perceive what their alternatives are under State law, what duties of the general partner are owed to them under State law are and what their rights will be once the transaction has occurred.

That is the focus of these proposed Commission rules; and, of course, if the disclosures are not properly made, if they are misrepresented, or if the ball is hidden from the investor, those are actionable. And that is where the disclosure rules of the SEC have literally empowered investors: by making the conduct actionable which seeks to misinform, to mislead, to lull the investor not to enforce his rights under State law, or under Federal law. I hope that is responsive.

Senator DASCHLE. Let me clarify again, just for my own edification, the position of the SEC with regard to changing the law. The impression I have from what you said earlier is that you are not necessarily adverse to changing securities law, you are adverse to changing tax law in this regard. Is that a fair assessment of your position?

Mr. DOTY. Mr. Chairman, that, I believe, is a fair general description of what the Commission's position has been over time. We have not been on the warpath about tax policy because it is not our area of expertise.

We have generally tended, as an agency, to favor a direct regulatory or legislative response to an issue that seems to involve investor fairness, because we have over time felt that that was less likely to engender inefficiencies in the securities market.

This whole statutory scheme is built on letting an efficient, unaffected market digest and use information. And we try to approach the problem that way. Parenthetically, we try not to second-guess Congress on its general tax policies.

Senator DASCHLE. Were you going to say something, Mr. Wilson?

Mr. WILSON. Yes. If I may, I would like to respond to your first basic question relative to authority in the area of substantive authority to develop rules. We believe that the NASD does have the authority to prohibit its members from participating in the distribution in rollup securities unless certain conditions or requirements are met as part of the deal, such as dissenters' rights, among others. We, as I stated in my testimony, are, in fact, working on certain provisions in that area at the present time.

Of course, all of our rules must be submitted to the SEC and approved by the SEC. Also, there are provisions relating to this in proposed bills S. 1423 and H.R. 1885 which I think, and I would concede, would make the NASD's authority in this area much more complete or certainly much more clear.

However, we believe that under the existing law with approval of the SEC we have authority in that area. Now, I say that we can

prohibit members from participating in the distribution of limited partnerships of an abusive nature pursuant to established rules when, as, and if they will be established.

I think important in that respect is that all securities dealers that are dealing with the public, hence, everybody that is distributing these securities, must, by law, be a member of the NASD. So, that rather broadly covers the waterfront.

Senator DASCHLE. What disciplinary action, if any, has NASD taken so far, given the fact that we have seen 275,000 people who have reported cases of abuse thus far? What disciplinary action——

Mr. WILSON. I think that unfortunately, like so many other areas, the specific regulations follow the abuse. The abuse has been recognized and we are in the process of developing regulations at the present time.

As I said in my testimony, one of those proposed regulations which I think will be very effective in forestalling abuses in the future is on file at the SEC, and we anticipate approval shortly, that is a prohibition on paying differential compensation in connection with soliciting proxy votes.

Senator DASCHLE. To what extent have you worked with AMEX or New York Stock Exchange in coming up with these regulations? Have they been participants?

Mr. WILSON. In connection with regulations which would regulate the distribution of the securities, no, we have not participated with them. But all of their members are the members of the NASD, as well, so they would be affected by any regulations we would develop.

Senator DASCHLE. Very well. Thank you all. I appreciate your testimony this morning. Our next panel includes Anne Petrocci of Midland, NJ; John Blake, the chairman of the American Association of Limited Partners; William Dockser, the chairman of CRI of Rockville; Michael Pollack, chairman of the Securities Law and Regulatory Affairs Committee, the Investment Program Association. If those people would come to the table, we will take their testimony at this time.

We were talking about information and the lack of ability of an investor to understand the ramifications of rollups and the consequences of whatever decisions he may make.

I committed to becoming involved with this legislation sometime last year, but in the course of my activity, I, myself, became a victim of a rollup.

This is the Damson Partnership Plan. This is the information that I was sent. I cannot get through the Congressional Record, much less this catalogue of information. I am told that the Damson officers received $10 million up front, plus consulting fees for this particular little effort, and my wife and I contributed more to Damson than we did to the church last year, I think, as a result.

Ms. Petrocci, I think we will begin with you.

STATEMENT OF ANNE PETROCCI, MIDLAND, NJ

Ms. PETROCCI. All right. I am glad to see that you were kind of victimized by this, too, because I think it gives you a perspective

that I was afraid Congress might not have; maybe they are smarter than the rest of us.

I am a 37-year-old professional architect from Midland Park, actually, New Jersey. And basically, I would classify myself as an unsophisticated but willing investor, at least until last year.

I just got through listening to what James Doty told you about how things are starting to change, and that he believed that there is a declining phenomena taking place here with rollups. And I am here, really, to debunk that myth and tell you that that is not the case, and lightening can strike twice.

In fact, I have in my hand a prospectus from Public Storage, which is called a REIT, but a rollup by any other name is still a rollup. And this is about to take place in about 2 months, and I will again be the victim of the same thing that happened to me in 1990. So, to those who say that this legislation is not necessary, that the industry will correct itself; I say never.

In October 1990, just to give you a little history of what happened to me, the Hallwood Group rolled up my limited partnership. It was one of eight that actually rolled up; 11 were asked to roll up.

In that transaction, my original $4,000 investment was downgraded to what is now $451, more or less. I lost 89 percent of my investment as a result of that rollup.

In the exchange, however, the Hallwood Group, which is now the general partner, acquired substantially all of the equity interests, including $41 million in cash, which they used, in part, to pay off the Equitec General partners in the same kind of pay out that you are talking about.

Equitec got $15 million of our $41 million for their part in this, and a lot of that was just bonus money. If you want to call it consulting fees, call it consulting fees; but it is bonus money.

In effect, Hallwood paid nothing out of their pocket, and we, the limited partners, ended up with an 89 percent loss. And as unbelievable as it sounds, that is the simple, boiled down facts in these things, and the simple, boiled down facts in my particular situation.

My story is, I do not think, different from a lot of others, and I heard this in the House of Representatives, as well. I, and a few others fearful of this very result dare to speak out, and for that, we were branded activists.

Hallwood spent nearly $10 million dollars of the investors' dollars—part of that $41 million—to craft, promote, and sell the offering, yet not $1 was spent to present the other side. This is what dissenters' rights are all about.

When I started to dig for answers myself through my own resources and communicate with fellow investors about my misgivings, I was harassed by Dean-Witter, threatened by Hallwood attorneys, and even the Securities Exchange Commission, an agency I thought was my advocate, harassed me over the telephone.

Hallwood subpoenaed me after that did not work to appear for questioning on a case which I believe I really had nothing to do with at that time, merely to pump me for information about my personal activities in this "no rollup coalition" which was starting to form. The SEC suggested that they might press charges against

me for violating SEC laws. Collectively, their harassment cost me more than $1,000 in legal fees, phone calls, and other expenses; a considerable sum of money for somebody who is a small investor, and I do not think it is something that we limited partners/small investors should have to do.

I now understand that the SEC has published some proposed regulations dealing with abusive rollup practices. I understand that these proposals may address the readability of documents as they are sent to the investors, however, they do not address the principal issue as I see it, which is dissenters' rights, and relief for those who would dissent from these transactions.

Investors need that protection, including dissenters' rights, something that leaves the limited partner with the basic terms and conditions of his original agreement, at least for those who do not want to roll up.

After all, the only agreed upon agreement that I got into was the one that said the general partner and the limited partner would stay together for life—i.e., the life of the limited partnership agreement. I believe that S. 1393 could go far in helping to rectify some of these problems, because it is going to hit the general partners where it hurts—in their pocketbook. That is the way I see it; basically bottom line. Giving a fair deal to limited partners is the only deal that I believe should be given to a limited partner. The general partner is supposed to be fiduciary agent, and as a fiduciary agent, limited partners have to be held with some regard and given equal time.

My experience with Equitec rollup, as I said, were pretty awful. But, as if that was not bad enough, as I said in the beginning, I recently received a prospectus in the mail announcing, you guessed it, another one of these reorganizations, so lightening has struck twice.

Public Storage has just announced what they call a new "opportunity" for the partnership. Opportunity, by "Webster's Dictionary," is a well-chosen, favorable, well-timed situation.

These restructurings are neither well-chosen, favorable, or well-timed for the limited partner. My first instinct, of course, was to ban the mailman from bringing anything further to my door. But on second thought, rather than banning the bearer of bad messages, I think we should ban rollups altogether.

And principally, that is what I am here to tell you today, because the faith of millions of people in this country, or hundreds of thousands of people, at least, in financial institutions in this country, on Wall Street, the SEC, and their brokers, is being compromised, and we feel cheated and let down by the system. And we look to Congress to rectify those problems, at least in part.

In my entire life, I never expected to be presented with another (rollup REIT prospectus), and unless there is some relief now, and some retroactive relief as well, I do not think that the limited partner is going to be able to fare this storm.

I hope that this legislation and legislation that comes out of Congress as a whole will address restructurings of other types, including this one which is a REIT, because a rollup by any other name is still a rollup, and that is what a REIT is, as well.

Simply, when a general partner wants to change, the limited partner should have the option of keeping the original deal. Short of that, I think that we should ban rollups altogether.

Basically, there is nothing in these restructurings, as you probably know from reading your own, that deals with the assets, managements, rentals, and valuation of the property. The cake is the cake. It is the same that they are going to cut up later.

What happens in these restructurings, as I understand them now after a year of constant study on this and quite a lengthy involvement, is that when these deals are put forth, what is happening is that the relationship between the fiduciary and the limited partners is changing.

And there is a cake that is the same cake as you started with, but instead, now the general partners have the cake and the knife, and they are not going to cut that cake fairly.

[The prepared statement of Ms. Petrocci appears in the appendix.]

Senator DASCHLE. Thank you, Ms. Petrocci.

Mr. Dockser.

STATEMENT OF WILLIAM B. DOCKSER, CHAIRMAN, CRI, INC., ROCKVILLE, MD

Mr. DOCKSER. Yes. My name is William Dockser. I am chairman of CRI in Rockville, MD. As an investment fiduciary that oversees a $4.5 billion real estate portfolio on behalf of 60,000 investors, I, too, want to protect investors from abusive rollup practices.

I am concerned about the descriptions we have heard presented today, yet I question whether a bill reforming rollups is needed now. And I submit to the Congress and those still backing an anti-rollup bill could better serve public investors if, instead, they took action to alleviate the real destroyer of value in many partnership investments today; the depression in real estate.

Unlike many, I have had an opportunity to see the structuring of an investor-friendly rollup from the inside. My company, CRI, Inc., in 1989 merged two partnerships and one REIT managed by CRI.

That rollup—or as we prefer to call it, the CRI merger—stands out because it provided dissenters' rights, a key feature promoted by the legislation before this subcommittee. The CRI merger gave the investors the right to choose either a new, perpetual-life company, or, if they dissented, a new, finite-life, liquidating company much like their original investment.

In the aftermarket trading on the New York Stock Exchange, the shares of both new companies have defied the typical downward spiral of rollup stocks. Both shares trade within cents of their original offering price.

Despite the positive experience of CRI's investors, I oppose the passage of a law that requires dissenters' rights in all partnership restructurings. The marketplace can safeguard investor interests, and should be left to do so without Congress mandating the method.

The process of restructuring investments should, as a matter of course, be open to investor input. At CRI, we reached the decision

to provide dissenters' rights after give and take meetings with brokers whose clients held interest in the original entities.

However, even when sponsors have failed to do this, the news media, activist brokers, and others, have given investors a voice in the process. I do not suggest that all rollups are good for investors. Some are; some are not. And recent experience indicates that investors, when they oppose a rollup, can vote down a proposal.

However, I do submit that the generalized attacks on rollups have gone overboard. Those attacks have poisoned the air against any form of partnership restructuring, even necessary proposals that pass the two basic tests: first, do they treat investors fairly, and second, do they have a good chance of improving or salvaging the real estate investments?

Rollups—or as I prefer to describe them, partnerships restructuring—can be designed to pass both tests if responsible fiduciaries choose to do so. But few fiduciaries would dare propose a restructuring in today's anti rollup climate.

The risks of failure, even for investor friendly transactions, are too great. SEC Commissioner Edward Fleischman recently suggested the damage from abusive rollups is, unfortunately, already done.

Making reforms today is like trying to divert water already running under the bridge. Why? Because the rollup—as a potentially abusive transaction—is dead. What remains, however, is a bigger, more fundamental problem.

A significant portion of this country's wealth—maybe even half—has been invested in real estate. A lot of those investments are not performing. The resulting loss of wealth impacts a vast constituency in this country today.

It impacts pension fund investors; taxpayers bailing out the savings and loan industry; insurance policyholders; taxpayers, again, when they have to refinance the FDIC for the banks; and limited partners and general partners in real estate investment programs.

Owners of troubled real estate today need an infusion of two things: capital and active management, in order to ride out the hard times, recoup their original value, and re-position their investments to participate in any rebound.

Restructuring real estate securities, when done right, represents a micro-solution to the problem. What is needed is a macro-solution.

Many serious analysts agree that the biggest single cause triggering today's real estate depression was the Tax Reform Act of 1986. By eliminating the tax benefits on existing investments, the bill abruptly destroyed investment values. To recover some of this loss, new legislation is needed.

As a result, I urge Congress to consider providing incentives, such as tax credits, so that new money is invested in distressed real estate, and so the properties receive needed improvements and qualified management when acquired.

Today's hearings are obviously not the place for outlining a full tax incentive program for the recovery of real estate, but action is seriously needed. I urge Congress to begin.

In sum, I believe that those seeking to prevent abusive rollup practices have already succeeded. There is tightened regulatory oversight, and heightened awareness in the marketplace to prevent

future abuses. Congress now should begin the process of reversing the devastating impact on real estate values caused by the 1986 Tax Act.

Today's troubled real estate assets, in one way or another, belong to all Americans.

[The prepared statement of Mr. Dockser appears in the appendix.]

Senator DASCHLE. Thank you, Mr. Dockser. I would only remind you that this Damson rollup had little to do, at least directly, with real estate—it was oil—and it occurred within the last couple of months.

Mr. Blake.

STATEMENT OF JOHN FREEMAN BLAKE, CHAIRMAN, AMERICAN ASSOCIATION OF LIMITED PARTNERS, WASHINGTON, DC

Mr. BLAKE. Good morning, Mr. Chairman. My name is John Blake. I am an attorney in private practice in Washington, and I am the chairman of the American Association of Limited Partners. AALP is a grass-roots membership organization, representing the 8 million individual investors who have invested in limited partnerships. I appreciate the opportunity to appear here today.

Abusive rollups represent an immediate, direct, and catastrophic threat to America's limited partners. Tens of thousands of investors in the 1980's placed their funds in limited partnerships, investing in real estate, oil, and gas, equipment leasing arrangements, and other programs.

Today, those investors are faced with a threat that was never anticipated when the investments were made, and they faced that threat irrespective of the performance of their own particular partnership. The threat that I am referring to is the reorganization of limited partnerships, commonly known as rollups.

Our information documenting the 13 major rollups to date shows that on average, the limited partner stands to lose 63 percent of the stated value of the rolled-up security. To date, limited partners have lost a total of $1.4 billion in the value of their investments as a result of being entangled in a rollup transaction.

In exchange for the opportunity to be rolled over by a rollup, limited partners see their investments further diluted by excessive fees and commissions, which are paid to sponsors and underwriters of the rollups. In some cases, it is astonishing how close the fees charged equals cash available in partnerships that are being rolled up.

All of this takes place on the basis of a complicated and misleading prospectus, coupled with a cover letter from the general partner extolling the value of the proposed transaction.

Unfortunately, frustrated, confused, and angry investors often vote yes to the rollup without any real understanding of what their vote means, and often relying upon the advice of a broker, who, unbeknownst to the investor, will be paid for every "yes" vote, but will not be paid a red cent for obtaining a "no" vote. Worst of all, the very notion of a "no" vote to a proposed rollup is a cruel illusion. A limited partner who votes "no" to a rollup has no way of truly opting out of the deal. Instead, if a bare majority of limited

partners vote "yes," those who voted "no" will have the transaction crammed down their throats.

I submit to you, Mr. Chairman, that it is only by putting an end to the vicious financial game of cramming rollups down the throats of investors that the abuse in abusive rollups will end.

The only way to end cram downs is to provide the investor with a meaningful right to dissent to the transaction. Dissenters rights means either cash or the ability to keep the deal that they originally entered into, thereby, opting out of the thing that is being offered in the rollup.

Mr. Chairman, the AALP is pleased to give its strong support to the measure before you today. Your bill would discourage the most flagrant abuse in limited partnership rollups.

Your bill would extract an appropriate price for the fun of cramming a bad deal down onto defenseless limited partners. I am sure that you will be told today that the provisions of S. 1393 are unfair and excessive. As the head of the only organization which is dedicated to the protection of small investors, I must tell you that these pleas should fall on deaf ears. What is unfair is to take the life savings of an individual investor and cause it to be rolled over by a transaction that an investor voted against.

You have been told today that the use of the Tax Code to correct this problem is inappropriate. This charge is ludicrous. The use of the Tax Code to shape social policy has been an important element of tax policy since the beginning of the Federal income tax system.

Consumption taxes encourage savings; progressive tax rates redistribute wealth from the rich to the poor; Social Security taxes redistribute wealth from younger generations to older generations.

All of these are examples of the intended use of the Tax Code to accomplish specific social policy goals.

In fact, it is the Tax Code itself, that by favoring one type investment over another, caused many limited partners to make these fateful investments to begin with.

The use of the Tax Code to redress unfairness is neither unusual, nor is it unfair, especially when the result would be so effective so quickly.

Mr. Chairman, individual investors need the protection that your bill will provide. I ask you to stand with the small investor, and assure that they will no longer be taken advantage of by larger interests with greater clout. Ultimately, your legislation is about fairness; the long overdue fairness which limited partners deserve.

Thank you very much.

[The prepared statement of Mr. Blake appears in the appendix.]

Senator DASCHLE. Thank you, Mr. Blake.

Mr. Pollack.

STATEMENT OF MICHAEL B. POLLACK, PARTNER, REED, SMITH, SHAW & McCLAY AND CHAIRMAN, SECURITIES LAW AND REGULATORY AFFAIRS COMMITTEE, INVESTMENT PROGRAM ASSOCIATION, ON BEHALF OF THE INVESTMENT PROGRAM ASSOCIATION, WASHINGTON, DC

Mr. POLLACK. Mr. Chairman, good morning. My name is Michael Pollack. I am a partner with the law firm of Reed, Smith, Shaw &

McClay, and chairman of the Investment Program Association, Securities Law and Regulatory Affairs Committee.

I appreciate the opportunity to appear before you this morning to speak about limited partnership reorganizations generally, and Senate Bill 1393, specifically.

The IPA recognizes the need to protect the interests of limited partners in rollup transactions, and has been working with governmental and self-regulatory agencies, Federal and State legislative committees, and the stock exchanges, to help fashion appropriate reform in the area of partnership reorganization.

We hope that this activity will help ensure clear and concise disclosure, a fair voting process, and, where appropriate, specific rights for limited partners who do not wish to participate in a given transaction.

Throughout this process, the IPA has expressed the view that the partnership should be able to retain adequate flexibility to transact business in a way that will enable general partners to maximize the value of assets for the limited partners.

As you have heard this morning, much progress has been made in this area. The NASD has issued proposed rules for prohibiting its members from participating in transactions that pay only for "yes" votes, or only if the transaction is approved.

One month ago, the SEC issued a series of releases and proposed rules which will help make both rollup and partnership offering prospectuses more understandable to investors, and will make it easier for those who object to a partnership rollup to communicate their views to other partners.

The Limited Partnership Rollup Reform Act introduced in both the Senate and House, requires partnerships to provide dissenters' rights to objecting partners. The IPA has continued to participate in the development of these various proposals, and will remain actively involved in this process. Significant progress has been made, and is continuing. The current proposal addressed all the concerns raised by rollup opponents. Introducing new initiatives in the process at this time is unlikely to be helpful, and may divert attention from the progress being made.

Because Senate Bill 1393 focuses primarily on dissenters' rights, I want to take a moment to address that important issue specifically.

There has been an abundance of published information relating to the evils of rollups and the manner in which they diminish the value of limited partnership interests.

Any loss in partnership value is simple to calculate once a rollup has been completed. It is not nearly as easy to determine the reason for this loss of value. Logic would certainly suggest that to the extent these partnerships have invested in real estate, the current condition of the United States real estate market certainly would have played some role in this loss of value.

I raise this point only to stress the fact that rollups are not necessarily bad, and that a rollup certainly may be an appropriate transaction in some circumstances. If legislation were to be enacted that would either prevent or make it very difficult to complete a rollup transaction, limited partners would be locked into under-performing assets, and would ultimately be the victims.

In designing a dissenters' rights plan for limited partners, you must recognize that in many cases the assets involved in a rollup are distressed. There may not be cash available to cash out dissenters, and partnerships may not have sufficient cash flow to pay interest on notes.

Furthermore, the assets the partnerships own may make it impossible to create a security with substantially the same rights and the same assets. It is therefore essential that any legislation providing dissenters' rights to limited partners retain some flexibility for the partnership.

I would also like to take this opportunity to point out to the committee that the IPA has been active in one other area for the benefit of limited partners. That is the area of tax simplification.

Legislation has been introduced in both Houses which would greatly simply the tax reporting requirements for limited partners in widely held limited partnerships. By enacting these simplification measures, Congress could greatly reduce the cost of tax compliance for limited partners. The tax reporting system currently required of partnership investors is so grossly complex, that some investors will gladly support a partnership rollup if it means an end to the current K-1 nightmare.

The IPA believes that the most helpful action the Senate Finance Committee could take would be to pass Senate Bill 1394, the Tax Simplification Act of 1991, and achieve its enactment before the end of this year.

Thank you again for this opportunity to appear before you this morning.

[The prepared statement of Mr. Pollack appears in the appendix.]

Senator DASCHLE. Thank you, Mr. Pollack. I note that IPA has changed its position from what I understand was earlier testimony, whereby IPA initially presented as their position support for disclosure, but not for any dissenters' rights.

Now I understand with your testimony today that dissenters' rights are something that your organization would support, is that correct?

Mr. POLLACK. Well, we feel can support the dissenters' rights in situations where it is possible to provide dissenters' rights. It is not possible to provide dissenters' rights in all situations. And, as I think you heard this morning from the NASD, there has to be some regulatory oversight that has some flexibility to recognize these different situations.

Senator DASCHLE. It is not possible to provide for dissenters' rights in certain cases?

Mr. POLLACK. No. Because, as I said, there may not be cash available to pay off limited partners to buy their interest back. There may not be cash flow to pay notes.

Mr. Dockser was able to do a rollup that did provide dissenters' rights, and he should be applauded for it. But he had a particular type of asset that lended itself to setting up an entity that retained the same rights for the limited partners. That is not always possible.

Senator DASCHLE. What about that, Mr. Blake, it is not possible?

Mr. BLAKE. Mr. Dockser's transaction is also one that would not have been covered by your legislation, because he was combining

several already publicly traded entities. That meant that people against the transaction had the opportunity to sell their security as soon as they heard about it. So, I think while Mr. Dockser is to be applauded for having done the only dissenters' rights rollup that we are aware of, it is not a good example of what normally happens.

I think that dissenters' rights has to be a notion which can be flexible to meet the specifics of the transaction, but to say that there was any transaction as to which no dissenters' rights could be given, I think, is a gross overstatement.

Mr. POLLACK. Now, if I could, first of all, I think that the point here is that the appropriate analysis of that should be in a regulatory body that has the flexibility to deal with these on a case by case basis. So, I think that is the importance there.

Secondly, I think it is important to remember that dissenters' rights merely allocate assets between the majority of the limited partners and the minority of the limited partners who vote against the transaction.

Mr. BLAKE. I deny that entirely. Dissenters' rights allocates money from the general partner, the sponsor and underwriter, to the limited partner.

Mr. POLLACK. That is not necessarily so. A partnership has a certain pool of assets. That pool of assets is going to be divided in a certain way, and if the assets that are going to be used to pay dissenters comes out of that partners' pool, the limited partners who remain in that pool will be diminished by the amount paid out to the limited partners.

Senator DASCHLE. Well, I would think that would be a good thing, in some cases. I have to tell you, when I found out that the Damson folks got $10 million up front, and then we were told our investment we had there was cut by more than 50 percent as a result of this, that kind of distribution is exactly the kind of thing we are talking about in dissenters' rights. Why can you not tell these guys, "No up front fees. Hey, we are all in this together."

Mr. POLLACK. Well, no up front fees is different from providing dissenters' rights. You could say there should be no up front fees.

Senator DASCHLE. Why does it have to be separate? I am not sure I understand.

Mr. POLLACK. Well, because if you say no up front fees, that means you left a pool of funds in the partnership.

Senator DASCHLE. Exactly.

Mr. POLLACK. Now the question is, once you have done that, how do you allocate that corpus? How much do you give to the majority, and how much do you give to the minority who dissent? And that is the point of dissenters' rights is that dissenters' rights gives a certain percent to those who choose to opt out.

And allocating those rights is not necessarily an easy thing to do, especially in the real estate area where you do not have liquid assets that can be made available to pay out dissenters.

Mr. BLAKE. I would like to suggest then, Mr. Daschle, that if your bill passed, they would find it much easier to make that allocation.

Mr. DOCKSER. Mr. Chairman, if I could just comment.

Senator DASCHLE. Mr Dockser.

Mr. DOCKSER. The points you raised are obviously very legitimate and very real. One of the ways that you could address them very effectively is to go back through whoever sold you that transaction originally, make your feelings well-known, and I would not be surprised if you did not get some very positive response. Most of the broker/dealer community has been extremely responsive to investor concerns over the past year, year and a half. They have formed committees, they have actively negotiated and involved themselves in proposed rollup transactions. Those transactions have been renegotiated, they have been opposed.

And the broker/dealer community, on behalf of the limited partners, has been quite effective in getting a number of the terms and conditions changed. I am not saying all, by any means, but they do have a conscience, because they want your business in the future and they do not want you to sue them, so they are going to actively represent your interests.

Senator DASCHLE. Well, Mr. Dockser, I have to say I have some really grave doubts about that. I think there are cases where that is exactly the truth and that happens, and I applaud those brokers who are willing to take it upon themselves to rectify the situation.

But I have to tell you I think there are—and they might for a U.S. Senator or a Congressman—I wonder if they do for Mr. Smidlap sitting in Pierre, SD, who has made this whole transaction by phone; who sends his money through the mail; who does not know this guy from Adam; and is now trying to somehow get some kind of remuneration for being victimized. Frankly, I just do not think that happens very often. What were you saying, Mr. Blake, $1.6 billion, is that——

Mr. BLAKE. $1.4 billion.

Senator DASCHLE. $1.4 billion.

Mr. BLAKE. I am not aware on any active proposed rollup where that is not happening. Virtually every single instance I can think of the broker/dealer communities have done their analysis, they have sent out pieces, they have talked to their clients.

In a recent one, two were defeated; two were passed after a very open and public discussion about the issues. I think the broker/dealers, maybe a year ago they were not that sensitive, but today they are very, very sensitive to the issues.

Senator DASCHLE. Well, let me give you your first example, this one, because I have not been contacted by my broker/dealer yet. Ms. Petrocci.

Ms. PETROCCI. Yes. I have got to agree with you (pointing to Senator Daschle) and disagree with you (pointing to Mr. Docker). I am sorry, but broker/dealers, even the ones that have been friendly, do not have the power to effectively "save" the limited parnter—being involved in a coalition of sorts, which was very loose, that was trying to get some information out and get some information in about this Equitec investment rollup that took place, I dealt firsthand with a lot of brokers. And yes, there were some brokers who were against this thing. There were other brokers who were not. But there were no brokers who put their tush on the line to see that this thing did not go through. All right. And even the ones who tried to make some inroads found themselves being contacted

by various people, including the SEC, being told not to do it—so, I do not think that brokers have the power to make a difference.

And with regard to the issue of dissenters' rights, I think dissenters' rights are far more than just what you end up with in the end. If there is $10 million, like on the part of Equitec to spend in promoting this thing, there has got to be some money so the dissenters have a chance to get this thing defeated. I cannot believe that if there is $10 million to promote it, there is not a dime to fight it.

Senator DASCHLE. That is a good point. Any other comments? I am curious as to why, when a new partnership enters the market, there is a dramatic drop in value almost every time right after it begins to be traded. Is that a correct perception of what happens? You have got a price, it is offered, it goes onto the market and just the next day plummets. Yes, Mr. Blake.

Mr. BLAKE. Senator, our information is that on average you will lose 44 percent of the stated value of your security on the first day.

Senator DASCHLE. Forty-four percent?

Mr. BLAKE. Forty-four percent on the first day, and then over the next succeeding months, you will end up losing 63 percent of the value. That is, the value at which the security was stated to you in the prospectus that you had before you.

Now, many of these rollups have involved real estate, but not all of them have involved real estate. And if you isolate only the real estate rollups, you find a very interesting statistic.

During the 1980's, the index for REIT's have shown that the value of real estate in those vehicles has gone up 84 percent during the 1980's, and the value of the real estate that is owned by rolled-up limited partnership entities has gone done by, astonishingly, 84 percent. What is happening here?

What is happening here is not that there is a bad real estate market. What is happening is that there is differential compensation. You are getting a security that has been bled of all its cash to pay exorbitant fees to those who are promoting it, which are packed with super majority provisions entrenching management, which the market looks upon very poorly, and which are now in a position where their own cash flow cannot support their operations. That is the reason why the market ignores those securities when they arrive on the market.

Senator DASCHLE. That is pretty devastating, Mr. Pollack, Mr. Dockser. How in the world do you justify that?

Mr. DOCKSER. Well, there is such a large number of misstatements in the previous statement that I cannot tick them all off.

Senator DASCHLE. We have got plenty of time. Why not go ahead and try.

Mr. DOCKSER. Fundamentally, you have a large number of people who are in a real estate transaction. That real estate transaction has not been actively traded and has had an illiquid market. When you go to what I call a far more active, and probably a fairer marketplace, the New York Stock Exchange and the American Stock Exchange, you do have a legitimate rush to liquidity that will inevitably, in virtually every single instance, bring down the price of the shares.

In order for any company—whether it is a real estate company or whether it is an industrial company—to support its shares, it

has to have institutional following. Most of these transactions will not have institutional followings for years. It will take years before people will become comfortable.

There is a serious liquidity crisis in real estate today; it is totally true. And the shares, to a great extent, reflect that.

The valuation process that is being described frequently is a pricing of the shares solely for exchange value, solely for the purpose of treating one class of investors fairly with another class of investors in a different partnership. So the number being used may or may not reflect the real estate marketplace.

Historically it does not. With very few exceptions, the shares do trade down. Our transaction was an exception. There will probably be a few other exceptions, but they are going to have to be well-presented, well-engineered, and people are going to have to pay attention to the institutional market.

Senator DASCHLE. Mr. Pollack, do you have any comment?

Mr. POLLACK. Well, I agree with what Mr. Do:kser just said. I think, again, the question is what are you really measuring here? Are you are measuring against a number that is used to allocate among partnerships, as opposed to try and ascertain the true value.

As I pointed out in my written testimony, it is another problem with creating dissenters' rights, and that is, how do you really value the assets in the partnership.

Many of these people who try to sell these partnership interests before they ever get to the market also find that they cannot sell them for prices that are stated in the prospectus at the number that is allocating among partnerships.

And most prospectuses that I have seen, at least, state quite clearly that the exchange value is being used solely to allocate among partnerships and should not be taken as an indication of the price at which it will sell.

Senator DASCHLE. Well, I have got to tell you, I think it is nothing more than a license to steal in some of these cases, because these limited partners simply do not have the information. They are not given the kind of adequate opportunities to evaluate the decision prior to the time they make it. They are probably being encouraged by someone to go ahead and make it and trust somebody else, and ultimately they end up the big losers.

Mr. POLLACK. Well, I think that is what the SEC, at least, has tried to prevent. And I can tell you in my other capacity as an attorney, I spent this entire weekend with a new offering document trying to comply with the SEC's new rules on using plain English, trying to make things very clear and simple. And I think they have done a very good job in improving the disclosure process and I think that will be reflected if these transactions continue——

Senator DASCHLE. But you still do not have dissenters' rights, in spite of all the regulation. So, what do you do in a case like that?

Mr. POLLACK. Well, the dissenters' rights question is being addressed in other ways, and I think that there are attempts being made to address the dissenters' rights problem. I do not know if it can be done in a way that makes it fair to all partners, and that is what we are trying to do.

Senator DASCHLE. Yes, Ms. Petrocci.

Ms. PETROCCI. Can I just say something? I am not a stock broker, and I cannot even begin to talk like these guys talk, but it seems to me that if there is a serious problem with liquidity at this time, then why put yourself in the position where that is the net result?

Most people that got into these limited partnerships knew they were getting in for a specific amount of time, but they did not expect to get out of it tomorrow. I got in mine, and mine had a duration of 2009.

Now, are you going to tell me that for the next 20 years the real estate situation is not going to change? If it does not, the whole country will be bankrupt.

So, like anything else, there are ups and downs in the real estate business. If they left the damn thing alone, to put it mildly, maybe by 2009 things would be better, but at least they would not be where they are, which is that I had a $4,000 investment which is now worth $451. All right.

So, the perception on the part of the industry—if that is what it is—that people want liquidity in these things is incorrect. We did not expect liquidity. All we expected is that we got into a deal, we made an agreement, and at the end of that deal, at the end of that time of the agreement that there would be a certain division of whatever was left, and that they had to react to the market and act in a responsible fashion along the way to manage our investment.

Now, it would be one thing if I lost my money honestly, which is what you are talking about. I mean, if by 2010 there was nothing left in my partnership and they could not give me a penny back, that is all right. I made that investment, and I made that investment with my eyes open. All right.

I may not have understood it—and I tell you right now I did not—but I made that investment. Had I lost my money honestly, that would be one thing. To have it outright stolen from me—which is the way I feel now—is not all right. And I think that is what we are talking about here. All right.

I mean, there has to be some fairness for the limited partner and the way this—a rollup—is structured right now, there is not.

Senator DASCHLE. Thank you. If there are no further comments, I want to thank each of the panel members. Mr. Blake.

Mr. BLAKE. Could I make just one closing remark?

Senator DASCHLE. Yes.

Mr. BLAKE. In a normal merger acquisition on a securities market, an investor has an opportunity to vote "no" prior to the transaction taking place by simply selling their shares on the open market. That opportunity does not exist for the limited partner that is caught in a rollup.

The opportunity to walk with your feet happens only after it has been put on the market, and before you have had time to blink, you have lost 44 percent of your value.

Ms. PETROCCI. Ninety, in my case.

Mr. BLAKE. Also, there have been many remarks today about the fact that this problem is on the wing, and it is being solved, that regulations are working, that everyone is happy with the outcome of the pressure that has gone on this issue so far.

I think AALP gets a little of the credit for having put up that pressure, but it is the passage of laws such as yours and the ones that are now before the House and the Senate, also in other arenas, which are keeping the wolves at bay. And if these bills disappear, we are going to be back in the kind of Draconian rollup world that started this problem to begin with. Thank you.

Senator DASCHLE. With that, this panel is excused. Thank you.

Our final panel is comprised of Robert Stanger of Robert A. Stanger & Co.; and Richard Wollack, of Liquidity Fund Management, Incorporated.

Mr. Stanger, Mr. Wollack, you have had the opportunity to hear testimony of all stripes and colors as it has preceded you. I welcome each of you and thank you for coming.

I would invite you to comment on anything you may have heard, in addition to whatever formal remarks you would like to make to the committee at this time. As I have indicated, the entire text of your statements will be made a part of the record. I invite you to proceed. We will begin with Mr. Stanger.

STATEMENT OF ROBERT A. STANGER, CHAIRMAN, ROBERT A. STANGER & CO., SHREWSBURY, NJ

Mr. STANGER. Mr. Chairman, thank you for inviting me. It is a pleasure to be here.

As in all things, when you hear testimony from a variety of sources, you find things that you accept as reality, and things that you do not accept as reality.

Just briefly on that point, there are secondary trading markets in partnership securities. They are not very good, which the testimony I will give will demonstrate.

Many of the securities that have been subject to a rollup have traded in the secondary market prior to the rollup. We did a study, I believe we submitted to the House when it was deliberating the Marke Bill, to try to compare the prices in the secondary market with the values of the resulting securities in the rollup, and there was not a lot of difference between the two.

Now, the confusion stems from the testimony of the previous panel that there is a number in the prospectus that looks like it is value, or liquidation value, or somebody's prediction of value, but it is not.

And also, often when securities trade publicly, which gives you the ability to liquidate them at will, when they are asset-backed securities like real estate securities, they almost never sell at or above appraised value; they almost always sell at a reasonable discount from appraised value. But that is the trade-off from the standpoint of liquidity.

Senator DASCHLE. Why is that always precipitated as soon as it enters the market, though? I mean, why would that not have been reflected prior to the time it entered the market as a new product?

Mr. STANGER. Well, it is; that is what I am trying to tell you. The prices in the secondary market have not varied a lot from the prices that the rollup securities have sold.

Senator DASCHLE. Well, I do not follow that.

Mr. STANGER. So, it is reflected.

Senator DASCHLE. On X day, you have got security valued at $100. After the rollup, it enters the market, and all of a sudden, according to the testimony we just received, it is now valued at about $66; a 44-percent discount.

Mr. STANGER. Let me try it this way. Say an investor put $1,000 in partnership unit, and it trades before the rollup at $400. And probably, if you had to pick a relationship for real estate partnerships today, that is about it, if you average them all.

In other words, a very substantial loss is represented by the trading value of those securities before the rollup. Now, what I am saying is after the rollup, the securities you have received in the rollup do not sell at a greatly different price than $400. You could have an appraised value of the real estate of $800.

So, to say that the day the rollup occurs the stocks go down 50 percent is not accurate. Stocks were already trading at prices to reflect what the values were. Now, those markets are not significant, and there is not a lot of volume.

Senator DASCHLE. I would like to get into that, but why do we not take your statements, and then we will talk more about that.

Mr. STANGER. Here is the guy who knows about that, his firm is a big factor in that market.

Senator DASCHLE. I will give him the chance to address that question, too.

Mr. STANGER. All right. We have tracked the partnership industry from a financial analytical point of view since 1979. We have provided data to the Senate Finance Committee, the Joint Committee on Taxation, and House Ways and Means over the past seven or 8 years.

The opinions I am about to express are made with a certain amount of bias. My company serves in a financial advisory capacity to syndication companies generally, several of whom are currently contemplating reorganizations or mergers.

A second source of bias is my belief that securities regulatory and self-regulatory processes, rather than using tax legislation to cure perceived ills in business deals, is the best approach.

The financial world and the fortunes of investors consist of a series of delicate balances which tax legislations can easily upset. In deliberations concerning the 1986 Act, I suggested to the Committee on Finance that creation of the passive loss rules would, by the stroke of a pen, reduce the value of all income-producing real estate by reducing tax benefits of ownership. The combination of over-building made possible by over-lending, plus the negative impact of the Tax Act on real estate have definitely had a significant impact in creating the savings and loan and commercial banking messes with which we are now trying to deal.

In this case, the ideal of tax justice for individual taxpayers has inadvertently helped create an enormous financial and fiscal problem for us all.

I would relate this separate issue to the consideration of this bill with the following logic: If you retroactively make partnerships harder to merge, reorganize, or combine, than other classes of securities, three results will occur.

One, you will reduce capital formation; two, you will permanently lessen the value of all partnership securities outstanding, and

three, you will force investors to live with the very poor existing secondary market for partnership securities.

First, let us look at capital formation. During the decade of the 1980's, more capital was raised through the initial public offering of partnership securities than the initial public offering of common stocks. Gradually, through changes in the tax law, some of the attractiveness of partnerships has been removed at a time when the economic results of partnership investing has been poor or mediocre.

A combination of these two factors has cut SEC initial public offering filings of partnership securities from $13 billion in 1983 to less than $2 billion, according to our estimate for 1991. Capital formation is an issue which policymakers such as you need to address because there is a national need for it, but the issue has no voter constituency.

By restricting the flexibility to merge, consolidate or restructure, you make the partnership form of organization and, hence, partnership securities, less valuable. In our view, many general partners are not adequately capitalized, are not managing assets under their control well, and in my view, market forces would naturally bring about some rationalization of the situation through friendly or hostile mergers, tenders, or reorganizations. Legal impediments will reduce such activity, I feel, to the long-term detriment of partnership investors.

To the extent the legislation forces partnerships to remain as single entities, you will also force partnership investors to operate in the so-called secondary market if they want liquidity. Let me give you a snap shot of that market. Of the 3,500 partnerships currently filing 10K's and 10Q's with the SEC, we estimate that about 400-500 trade in any 1 year. Many do not even trade once in a calendar quarter.

The total volume of trading annually is about $250 million, whereas outstanding publicly registered partnership securities at original cost represent an investment of roughly $82 billion.

The turnover in the so-called secondary market for partnership securities is about one-third of 1 percent a year, which contrasts to a turnover 100 times greater for securities traded on the New York Stock Exchange.

Our sense as analysts is that about one-third of partnership securities involved in real estate are in good shape; about one-third are in bad shape, defined as paying no cash to investors, and probably not likely to.

The bell curve distribution of investment performance, by the way, is about the same in partnerships as you will find looking at mutual funds. Twenty to 30 percent of mutual funds keep up with the 500, 20 or 30 lag way behind, and the rest are right about in the middle.

I believe that assets should be grouped in larger entities then individual partnerships, and that investors are best served if the process is allowed to take its natural course. The rollup is not the cause of the loss that existed prior to the transaction, nor the most pressing problem, but can be the solution in many cases.

Senator DASCHLE. Thank you, Mr. Stanger.

Mr. Wollack.

STATEMENT OF RICHARD G. WOLLACK, CHAIRMAN, LIQUIDITY FUND MANAGEMENT, INC., EMERYVILLE, CA

Mr. WOLLACK. Mr. Chairman, I am Richard Wollack, chairman of Liquidity Fund, a registered investment advisor, dealer in the secondary market, limited partnerships, and I appreciate the opportunity to be here today.

As you have heard, limited partnerships are a serious problem, I believe, the single greatest preventable threat today to the financial well-being of small investors in the United States. And you have heard of the $1.4 billion that has been lost.

I might point out that in the analysis of those same transactions, while the investors lost $1.4 billion, the general partners, the investment bankers, and the various people involved with creating that transaction made in excess of $200 million in fees.

Mr. Chairman, rather than simply hacking at the branches of this serious problem, your reform proposal, S. 1393, strikes at its root. That is, the fundamental problem of cram downs, whereby small investors are denied a real choice about participating in a rollup. Under your bill, general partners would have the incentive to structure their deals in a fair manner, and provide dissenters' rights to limited partners who choose to vote "no" in a rollup.

Keep in mind, that is all we are talking about here today—making sure that investors who do not want in can stay out of a rollup. We are not talking about banning rollups. We are simply talking about discouraging unfair and abusive rollups.

Even though the issue is more complicated than this, you have already heard the battery of arguments against rollups, and I am going to address a few of them here today in my prepared remarks.

But I have taken notes, and I am prepared, based on your introductory comment, to respond to a number of the other things that I would call myths. Things like the first assertion that you hear, as you have heard, is that the rollup problem has gone away. That is a bunch of nonsense. It is simply not the case.

The truth is, a number of rollup reorganizations of single partnerships are proceeding and increasing. The multiple partnership rollups have gotten much press, so general partners now just do them individually, restructuring single partnerships. The same kind of abuses are inherent in single partnership rollups, as Ms. Petrocci already mentioned.

As to the recent decline in the multiple partnership rollups, I suggest that that is something that you have probably seen many times, Mr. Chairman, and that is what I call the spotlight phenomenon under which an industry that has attracted the attention of Congress lies low until the light is turned off.

If your reform proposal is not adopted—a bill that would have the effect of keeping that spotlight burning forever—abusive rollups will be back in earnest.

The second assertion we hear is the SEC is taking care of the problem, as was stated earlier. I find this ironic when the Chairman of the SEC, in promulgating those rules, himself stated that the reforms are no panacea.

Still, it would be naive and intellectually dishonest for me to argue that the SEC's steps may not have a salutary effect in some rollup situations.

All the same, what the Commission proposes by way of disclosure and proxy changes absolutely would not address the fundamental rollup abuses arising from the absence of dissenters' rights, as you have pointed out. The SEC proposals are no substitute for the measures of your bill.

The third assertion is that rollups really are not as bad as you have heard or read. I might be willing to concede that if the general partners can find limited partners who have been in rollups who agree with them.

The reality is, as you have already heard in our study of the 13 major rollups, every single one of the transactions, the investors lost money. One hundred percent lost money, and the investors saw their equity erode, as has been already testified to.

The fourth, and final assertion, is that it is not appropriate to use the Tax Code to correct this problem, and here, as you pointed out in your comments, Mr. Chairman, your bill is really in the same category as how Congress saw fit to fix the Green Mail abuses by using a tax penalty.

I see nothing inappropriate about taking the reasonable and focused steps set out under your bill to discourage the systematic looting of hundreds of thousands of limited partners. It is important to remember that it is the abuse that may be termed excessive, not your proposed reforms.

In summation, I would underscore that no one is proposing that rollups be banned, at least I am not. All that is being encouraged under S. 1393 is fairness in the structuring of such financial transactions. How can anyone argue against that? Thank you.

Senator DASCHLE. Thank you, Mr. Wollack. Let me go back to the initial discussion that Mr. Stanger and I had with regard to value. It appeared that you had some thoughts about that as we were talking, and I would like to invite you at this time to respond to that particular discussion.

Is it not true that values do dramatically decline as these rollup products enter the market, and is not the fact that they are a new product part of the reason why you see a decline in value?

Mr. STANGER. It is simply inappropriate to describe as a loss the difference between the trading value of securities and their appraised value. By the same reasoning, every real estate security represents a loss for the investor, because it is selling below appraised value.

Senator DASCHLE. Well, what is wrong with that, Mr. Wollack?

Mr. WOLLACK. It isn't fair to compare the fact that existing real estate securities, like REIT's which are created originally to be a traded security, and say that they trade at a discount—as Mr. Stanger just alluded to—and then say well, what is so bad, we put a rollup onto the market, and it falls roughly the same amount as one of those securities.

It is something like having your money stolen and then being told, do not worry, you are no worse off than the guys who had less money to begin with. It is still a taking, and it happens.

I always ask the question, if these general partners are so smart and they know that this is going to happen, because they have experts like Bob, a good friend, telling them it is going to happen, why do they do it? Are they not a fiduciary? Are they not empowered with doing good for the limited partnership? That is what I thought a fiduciary is all about.

Senator DASCHLE. That is a pretty reasonable question, Mr. Stanger.

Mr. STANGER. In the case—and take the lady investor in the Hallwood-Equitec deal. She ended up with a security, that while it paid a dividend, it was not earning the dividend, or paid a cash distribution that was not earned.

Now, either in that case where the distribution is not earned, or in the case of a real estate security that does not pay any cash currently, on average, they sell in the market at an 85-percent discount from appraised value. In other words, the world does not like real estate securities that do not earn cash.

Senator DASCHLE. Well, I will bet you that 95 percent of the people who make that investment have absolutely no idea that that is the case.

Mr. STANGER. Well, they made the investment with an anticipation of receiving cash, but the real estate markets in the intervening time have not allowed that to happen.

Senator DASCHLE. Do they ever regain their value?

Mr. STANGER. Sure.

Senator DASCHLE. They do?

Mr. STANGER. Sure. Mr. Blake outlined—I think it was Mr. Blake—the performance of REIT securities in the decade of the 1980's.

Mr. WOLLACK. But not rollup securities. He pointed out that the average rollup fell 84 percent that was created in the 1980's, while REIT's were going up. I have got some more recent data on REIT's versus rollups that I think might be informative.

Beginning November 1, as Bob knows, as he has reported in some of his periodicals that he publishes, REIT's have begun a significant run-up in value, because the marketplace believed that these real estate securities were too low. They were being hit too hard.

So, investors started bidding up the price. And the average REIT in the last 8 months—November 1 through June 30—has risen in value 24.62 percent, based on the National Association of Real Estate Investment Trust Equity Index that they publish.

Do you know what the average real estate rollup has done? Same period; it declined 2.3 percent. It is not the assets underneath that is the problem. It is the structure of the deal.

Now, what causes the decline—getting back to your first question, Mr. Chairman—big fees up front that take equity out. Now, it is important to note that these fees are sometimes characterized as 2 percent or 3 percent of assets. In a leveraged program, that can be 5 or 10 percent of equity. And then when you look at the share of the cash, as Mr. Blake alluded to, it can be 50, 75 percent, or all the cash.

You create a junk security. You merge good assets with bad assets, which is exactly what happened in Ms. Petrocci's case, the

fact that they put good assets with bad assets. You create a junk security that no one wants to own.

You create super majority voting, no one wants a management that is entrenched. No one is going to invest in that. That is why these securities perform poorly.

But I think, getting to the other point that is important to respond to is this secondary market issue. It is something that has been talked around the edges, and I am glad we have an opportunity to talk about it here.

First of all, I think it is important to say that the issue is not the secondary market. The issue seems to me to be all about rollups. But as long as it raised, let us discuss it. First of all, Bob's data in terms of the performance of the secondary market and the pricing in the secondary market versus where rollups trade, again, I say, why force a rollup on an investor? And that is the important point. In the secondary market, nothing is mandatory. An investor knows exactly what price they are being offered to the penny. And guess what? Hardly anyone accepts this. He already pointed out there is very little—very few people, when they know what is going to happen to them, when they know what price they can get, who want the liquidity at that price.

Another important point is that Bob's data, I think, is inaccurate at some level. He says there is not much difference between the secondary market and where rollups trade.

I have had some differences with the SEC over some of this policy, although, as I mentioned, I applaud the SEC for taking some steps in disclosure and proxy reform.

But there is one thing I agree with the SEC, is they published some data that shows that they took all the rollups, even during a period of time when the secondary mark-up was not well-advanced, it was very small, and there was not a lot of competition that has had some benefit of raising prices. But throughout all the rollups that they studied, they showed that the secondary market, on average, performed about 20 to 25 percent better than the first day trading price of rollups. So, even where there was a very small market it performed 20 to 25 percent better.

Our own analysis of the more recent rollups, the real estate rollups where we have some real good data, showed that the secondary market performed 70 percent better than the first day of trading at rollups.

Senator DASCHLE. Let me just ask you to comment on an observation that may or may not be valid. But, if I hear anything as I hear witnesses time and again, it is you guys are giving us too much paperwork, there is too much regulation, too much frustration in trying to comply with laws. You pass a law, and pretty soon there are just volumes of regulation that follow.

Now I have got everybody today coming to tell me, "Look, we want regulation. We have got to have regulation, because that is the only way we are going to correct the abuse."

Would it not be cleaner—and I guess I direct this more to you, Mr. Stanger, because I think I may know Mr. Wollack's answer—but would it not be cleaner to say we are going to try to address the motivation.

Can't we say to general partners and others, "It is just not going to be profitable for you to do this in the future. You are going to get penalized tax-wise for doing this." Rather than go through this elaborate regulatory framework within which we are going to require this person to take several steps to prove that he is not doing anything wrong, why not just do it in a clean approach, as we are proposing in this bill, by saying, "Look, we know a good one from a bad one. If this is a bad one, you are out of there. You are going to pay heavily in taxes."

Mr. STANGER. I think I would choose to respond in two ways. Even the bill as proposed requires the Secretary—which I presume is the Secretary of the SEC—to write regulations to implement a portion of it.

And secondly, you are regulating in the bill because securities have to be outstanding for 3 years in order to make the acquirer an eligible acquirer. And I would just wonder between 2.9 years and 3.0 years if one company really is much better than the other.

Number two, by doing so, you prohibit conversions from partnership to REIT's, which is a very sensible thing to do, and it would be very difficult to do it under the terms of your bill. And then when you talk about giving debt, somebody is going to have to write regulations with respect to making that debt fair.

For instance, is there a zero coupon bond that was due 100 years from now probably would not be considered fair, but somebody is going to have to sit down and write regulations anyway. I do not know if that is responsive.

Senator DASCHLE. Well, I think it is responsive, and it is a good answer. I think it is a matter of degree. In the proposal we are making, trying to set out the criteria by which you will be taxed is one thing, but to set out the regulatory framework within which you must maneuver in order to accomplish an end result is something which I would view as a lot more complex, and a lot more difficult to enforce.

Mr. STANGER. Well, the witness from Treasury, I think, made a good point. In many cases, the general partner receives an interest in the rolled-up security which reflects either the interest he had in the original partnership, or his entitlement to fees in the original partnership. But that is not going to be taxable income to him at the time of the transaction; only when he receives distributions from the rolled-up entity.

So, I agree with the Treasury Department's technical view that this is going to be something that is difficult for them to do. If a guy receives a fee in dollars, cash, that is easy. But if he receives a fee—which is common in these transactions—that is an interest in the resulting rollup, then it is going to be very difficult to do.

Senator DASCHLE. Why? It is delineated, right?

Mr. STANGER. Yes, but what is it worth? Is it worth what the stock trades at? Is it worth the appraised value? It is not a taxable exchange, it is a tax-free exchange.

Senator DASCHLE. But it is only a piece of information, the entire investigation is not laid out in your tax form. This is a piece of information that I would think would be useful in order to make the case either in a prosecutorial sense, or a defensive sense that they were doing the right thing, that this is not extraordinary, that this

is not something out of line with other transactions similar in nature, that it really tells part of the story. It does not tell it all, but it would be a pretty clear way of indicating, I would think, the propriety of the payment under the circumstances that would have to be provided under different sources of information.

Mr. STANGER. If it is a cash payment, I agree with you completely.

Mr. WOLLACK. Senator, I think that this bill will not be difficult to administer at all, because, as you know, to create these documents—you have one up there, I have one here, also—very talented securities and tax professionals that are retained by the general partners to do these transactions.

And the motivation in your bill is not to be taxed. Not to go ahead and do one of these and, oh, give me a 50 percent penalty tax on top of the regular tax; that does not make sense.

So, what they are going to do is use their sophisticated counsel to structure a deal that meets the test within your bill, and we will not have to worry about all the administrative hassles, we will have fair rollups, which is all we are asking for.

Mr. STANGER. Yes, I agree with that, which is what makes it very important to think clearly through, either if you legislate it and put it in the bill, or if the Secretary does write regulations as to exactly what securities can be exchanged. Because that is a very important step so that you do not stifle a transaction that has merit.

Senator DASCHLE. I find it somewhat ironic that those who oppose the administrability of a tax provision are the ones who support what I have got in my hand. I mean, what could be less administrable from an investor's point of view than the ballast that I am holding in my left hand here.

Mr. STANGER. Is that the Damson, Parker, and Parsley transaction?

Senator DASCHLE. It is. That is right.

Mr. STANGER. Again, just to show how things are confused sometimes, Parker and Parsley securities which were exchanged as well as Damson limited partnership interests, sold at $28 a share before the transaction. I think they were listed on the New York Stock Exchange, but it might have been NASDAQ. There was a two for one split. The stock now sells at $22, or the equivalent of $44.

Now, I do not know the figures with respect to the Damson partnerships, but the Parker and Parsley folks that combined, had their stock effectively go from $28 to $44 following the rollup. And that is because they——

Mr. WOLLACK. That is because they benefitted from the Damson assets——

Senator DASCHLE. No, that was it. I was a Damson partner, unfortunately.

Mr. STANGER. I understand. But I will bet you that——

Senator DASCHLE. And I paid for that value. That is the way I see it. Paid substantially.

Mr. STANGER. There were trading markets in the Damson securities, too.

Senator DASCHLE. That is right.

Mr. STANGER. I do not know, because I have not done the math, but I will do it and write you a letter. I will bet the prices represented by your ownership interest in the merged entity are a higher value for you than the trading prices of the securities before the exchange.

Senator DASCHLE. I cannot wait for your analysis.

Mr. STANGER. All right.

Senator DASCHLE. If there are no further comments or questions, I appreciate both witnesses and your excellent comments and the discussion. Your contribution has been very helpful to us. I thank all of our panel members, and, with that, the hearing stands adjourned.

[Whereupon, the hearing was adjourned at 12:00 noon.]

APPENDIX

Additional Material Submitted

Prepared Statement of John Freeman Blake

I. INTRODUCTION

Chairman Daschle and members of the Subcommittee: My name is John Freeman Blake. I am an attorney in private practice in Washington, D.C. I specialize in taxes and financial planning. I appear before you today in my role as chairman of the American Association of Limited Partners ("AALP") a not-for-profit, mass-membership organization formed to represent the interests of the eight million small investors in the United States who own limited partnerships.

On behalf of the AALP, I appreciate the opportunity to appear before you today. The issue being addressed this morning—limited partnership reorganizations, or, "roll-ups"—is the *single most pressing concern* of this nation's eight million limited partners. Tens of thousands of small investors in the 1980s placed their funds in limited partnership vehicles investing in oil and gas, real estate and other programs. When many of these limited partnerships faltered, their sponsors sought to combine and reorganize them into entirely new investments, commonly referred to as "roll-ups." The experience to date for investors in roll-ups has been nothing short of disastrous. More than 275,000 limited partnership investors nationwide have suffered through roll-ups, losing 44 percent of the value of their original investment on the *very first day* of trading and 63 percent during the following weeks and months. So far, limited partners have lost a total of $1.4 billion in the value of their investments. Adding insult to injury, limited partners also have been saddled with excessive fees and commissions for the sponsors of the roll-up, misleading information and the loss of their voting rights.

As chairman of AALP, I have listened to limited partners express their outrage that general partners, who are charged with the fiduciary obligation of putting the interests of the limited partners above their own interests, are able to violate those obligations so blatantly in the structuring and operation of the typical roll-up transaction.

What is abundantly clear from the devastating stories told by limited partners caught in roll-ups is that the process is not working to adequately protect the rights and interests of small investors. Rather than meeting their obligations as fiduciaries, general partners have found in the roll-up transaction a void between state and federal law in which they may act with impunity and with little or no regard to the interests of small investors.

The current roll-up process works almost exclusively to the benefit of general partners and their associates who help put together these deals. What limited partners urgently need is a level playing field upon which fair transactions can take place without undue advantage to one party.

Mr. Chairman and Members of the Subcommittee, I commend your efforts to explore the abuses that currently occur in many roll-up transactions and to move toward corrective federal legislation. Traditionally, Federal securities laws have operated on the premise that full disclosure is a sufficient remedy against abuse—that investors, having all relevant information before them, are capable of making informed decisions. However, Federal reliance on disclosure normally is coupled with substantive state laws that give more scrutiny to the fairness of proposed transactions. When the limited partnerships that are now the target of roll-ups were originally being formed, state securities regulators forced syndicators to structure the deals in a manner that promoted fairness for small investors: simple majority voting, subordination of general partners' interests to those of limited partners, and

other similar measures. The problem with roll-ups is that they operate beyond the reach of state authorities. Ironically, many of the abusive practices being crammed down the throats of limited partners are precisely the practices that state securities regulators had earlier worked so hard to eliminate.

There can be no doubt that the exclusive reliance of Federal law on disclosure is not sufficient to remedy the gross imbalance that exists between general and limited partners in a typical roll-up transaction. Reform must contemplate new substantive rules, including dissenters' rights, to protect the small investor.

II. INVESTOR CRISIS

Hundreds of thousands of limited partners are now at risk of losing in a roll-up their hard-earned money. If steps are not taken to overhaul the process, these limited partners will join the ranks of more than 275,000 limited partnership investors who have been skewered in the 13 major roll-ups of non-traded public partnerships conducted before and during 1990. AALP estimates that another **300,000 small investors in over 110 non-traded public limited partnerships—valued at $2.7 billion—may be confronted with a roll-up proposal during 1991.** I use the term "skewered" because of the dismal performance of roll-ups trading on public markets. On the very *first day of trading*, the average new roll-up loses 44 percent of its value; eventually, small investors find that their investments have lost an astonishing 63 percent of their pre-roll-up value.

Who has been victimized in these deals? The data assembled by AALP shows that the typical limited partnership investor was between ages 50 and 60 when the limited partnership investment was made. The average limited partnership investment was $10,000. The limited partner was told that the investment had a finite life, that it would end in seven to 12 years (depending upon market conditions), at which time the properties would be sold and the proceeds of the sale would be distributed to investors on a prorata basis.

Mr. Chairman, and Members of this Subcommittee, I submit to you that this profile is not that of a "high roller." Limited partners are secretaries, clerks, laborers, middle level executives, teachers—in short, limited partners are the backbone of the middle class who live—and vote—in each of your states.

The dollars at stake in roll-up transactions are not disposable dollars for the limited partners. These dollars may represent savings for an elderly person's retirement nest egg, a family's fund for the college education of their children, or a young person's down payment toward a home.

When investors make decisions about how to allocate their savings among competing investments, a number of considerations are carefully weighed. Often, the decisions are made with the advice of a competent financial planner. Typically, a number of investment characteristics are factored into the decision: the size of the investor's portfolio, the need for diversification, the time it will take for an investment to reach its potential, its liquidity, and the specific risk factors. All these elements need to be properly blended to the individual's needs and age.

A conservative investor might only want a conservative real estate partnership investment; one that purchases its properties with cash, without leverage, with a finite life of seven to 12 years. And herein lies the problem. A roll-up discards all the previous planning efforts of the investor and the adviser. Those investors who were well advised and had purchased an interest in a partnership that was performing well, suddenly find their careful investing wiped out by forces that are too strong for small investors to fight. Properties that perform well are combined with properties that perform poorly, and the new entity is thrust out onto public markets which make their judgments about the relative value of competing securities in a particularly swift and decisive manner.

When confronted with a proxy solicitation document, limited partners do not have at their disposal a battery of attorneys, accountants and investment bankers to assist in making a decision concerning the proposed roll-up. Instead, they are left on their own to decipher the massive and complicated documents announcing the proposed roll-up. Many vote "yes" simply because they believe the representations made to them in the cover letter prepared by the general partner. Others vote "yes" on the "advice" of their broker, who, it turns out, is being paid to deliver a "yes" vote, but not for "no" votes!

After the roll-up is completed, limited partners receive one of the biggest surprises in their lives. The public market on which the new roll-up entity trades swiftly eradicates the difference between the appraised value of the properties in the partnership, and the true fair market value of the security.

Despite the fact that 100 percent of the 13 major roll-ups to date have lost money for limited partners, there is no way an investor would know this from the materials he or she receives in the proxy process.

What is obvious is that investors in limited partnerships need additional protection. There must be reforms in the process itself that provide safeguards from those who would use roll-ups to enrich themselves at the expense of small investors.

Ample evidence has been presented to demonstrate the gross imbalance that exists between general partners and limited partners in roll-up transactions. Congress has been presented with example after example of the losses that investors have experienced. The numbers are staggering. Limited partners have lost over $1.4 billion in equity as a direct result of abusive roll-ups. In contrast, general partners have generated for themselves, their investment bankers, their accountants and (I am sorry to say) their attorneys, some $190 million in fees and other costs. Under current law, a roll-up is the financial equivalent of an armed robbery, and this circumstance must be stopped.

It has been said by some industry participants that these astonishing investor losses can be explained away by the current economic slump in real estate. If this were true, we would be able to point to other, similar losses in real estate securities. However, during the same period in which roll-ups have been depleting the savings of small investors, the index maintained by the National Association of Real Estate Investment Trusts showed REIT shares *growing* in value, at an average rate of 8.25 percent per year (1980–1989). Public securities markets have shown a particular dislike to roll-ups that cannot be explained away by reference to general economic conditions.

III. PROTECTING DISSENTERS' RIGHTS: A CRITICAL ELEMENT OF ROLL-UP REFORM

Mr. Chairman, the legislation you have introduced, S. 1393, appropriately targets dissenters' rights as the critical reform necessary to provide basic protections for limited partners facing a roll-up, including the right to preserve their original investment and the restoration of their ability to make truly meaningful and informed decisions about their financial destiny. In short, a strong dissenters' rights provision should be the lynch pin of any roll-up reform legislation.

I am appalled by what appears to be a blatant disregard by general partners of their responsibilities as fiduciaries. A general partner has an affirmative duty to act as a fiduciary for investors. That responsibility applies to all investors, including those who do not want to participate in a proposed roll-up. A continuing duty is owed to all investors.

State corporate laws provide shareholders with a variety of protections when faced with a proposed reorganization. For example, independent counsel is generally engaged to represent the interests of shareholders facing a takeover. State statutes also guarantee shareholder rights to dissent to a proposed reorganization and receive the fair market value of their shares in lieu of stock in the reorganized entity. Moreover, since the shares of the corporation's stocks are already traded on an open market before the reorganization, shareholders also can "vote with their feet" by selling their shares.

While the concept of dissenters' rights is well established in corporate law, it is virtually nonexistent in limited partnership roll-ups and other similar restructurings. Limited partners need to have similar types of protection in a proposed roll-up transaction. Today, these rights do not exist at either the state or federal level. Instead, the limited partner must accept the statements of the general partner and its underwriter that the transaction is fair; the limited partner is not offered an opportunity to cash out; and, if the limited partner wants to sell his or her shares, he or she must wait until the markets have wrecked their havoc on their value before being able to walk away from the rolled-up entity.

Under current law, if an investor objects to a proposed roll-up, the deal can be "crammed down" the dissenter's throat, if even a bare majority of limited partners vote in favor of the deal. As a result, even those investors who have determined that it is not a good deal for them are forced to accept the transaction if just 51 percent of their colleagues go along with the roll-up. As an example of how it is that dissenting investors can be taken advantage of during a roll-up to which objections have been raised, I commend to you the letter I recently received from a limited partner describing her experience in two roll-up transactions to which she had objected. This investor is college educated, works as a receptionist and lives in what she describes as a "third-ring" suburb of Minneapolis, Minnesota. In relevant part, the letter details this limited partner's experience:

". . . On the advice of FSA Planners of Edina, MN, I . . . invested $5,000 in Equitec XVI on 2/24/86 and $15,000 in I.R.E. Real Estate Income Fund Ltd. on 5/7/86. Together, they represented about 1/3 of my investment portfolio. They were advertised as vehicles for capital growth, with some tax-sheltering advantages. In both instances, they were presented as investments with a *finite* life of 7 to 9 years, at the end of which time all the properties would have been sold and the distribution made to the limited partners.

Performance of Equitec: During the life of the investment, I received quarterly dividends and payouts for properties sold of $499.77. In the Fall of 1990, Equitec began soliciting votes for a 'roll-up' into Hallwood Realty Partners . . . A roll-up severely devalues the original investment and becomes an *open-ended* investment—just the opposite of what I originally purchased. Despite my 'no' vote, the roll-up proceeded and I sold my Hallwood shares to get whatever I could. The Hallwood shares netted me $485.76—for a total return of 985.53 out of the original $5,000 investment. Tax-sheltering benefits were negligible . . .

When I made both of these investments, it was with the understanding that the trusts were of a *finite* nature. Now, after the individual investor, like myself, has relinquished control of his or her money, they have changed the game rules and we have an *infinite* investment . . . something I would never have chosen for myself. I did, indeed, agree to assume the risks of investing in the real estate market, *but I did not sign up to be mugged—and that is exactly what this has become.*" (emphasis added)

The point here is simple: A limited partner should be able to vote "no" on a roll-up proxy and have that vote count for something. *AALP strongly supports dissenters' rights, as provided for under S. 1393.* Mr. Chairman and Members of the Subcommittee, AALP respectfully suggests that, for the following reasons, strong dissenters' rights remain the cornerstone of any roll-up reform legislation:

Uniqueness Requires Protection. It is precisely because of the unique aspects of limited partnerships and roll-ups that dissenters must be protected. It cannot be emphasized enough that these transactions are not like typical proxy votes that are cast in corporate reorganizations. Perhaps the most important distinctions between roll-ups and other corporate restructurings are: (a) limited partnerships have no independent board or directors to negotiate with the general partner; (b) there is no ability for investors to "vote with their feet;" and (c) there are no large individual or institutional investors who could mount a proxy fight in opposition. To not recognize the uniqueness of the limited partnership transaction is to assume that limited partnerships are just like corporations. Yet, even shareholders in corporations have forms of dissenters' rights under state law. It is time for specially-tailored dissenters' rights to be established for limited partnership investors.

Investment Not Intended to Roll-up. It may be instructive to compare the relative positions of corporate shareholders and limited partners. When buying shares of a public corporation, investors commit to put their funds in a traded vehicle; they fully recognize that they will be in an infinite life transaction. Corporate shareholders recognize that they have the ability to sell their shares in the open market if they are not satisfied with the course the corporation is taking or if they are dissatisfied with any proposals made by the corporation. Further, receiving a proxy to vote on a merger or acquisition is not totally unexpected. Corporate shareholders understand that such events may occur in the normal course of business. (Further, although a merger may be a significant change for the corporation, it is far simpler than the extraordinary complexity of the roll-up of multiple limited partnerships.) And, again, in a traditional corporate merger of public companies, if the investors do not like the proposed transaction, they may sell their shares immediately in the open market. Corporate shareholders *never* have a "cram-down" forced upon them. *Unfortunately, the same is not true for limited partners.*

Protects All Partners. Some roll-up advocates have claimed that dissenters' rights would work to "disadvantage the majority of limited partners." In fact, it is just the reverse: *dissenters' rights would strongly benefit the majority.* Specifically, mandating dissenters' rights in roll-up transactions would establish a critical investor counterbalance now available in corporate transactions (such as independent directors and the presence of large, sophisticated investors), but absent in limited partnership roll-ups where no one protects the limited partners' interests during the creation, structuring and offering process. By providing for dissenters' rights, general partners will be encouraged to structure a transaction that is fairer to limited partners so that the deal will attract a large majority of "yes" votes. Without dissenters' rights, limited partners opposed to the deal will continue to have roll-ups

"crammed-down" their throats, and both the minority and majority will suffer the loss of equity because no safeguards are built into the process.

Roll-ups Not Remotely Contemplated. Unlike corporate transactions, *limited partners never bargained for a fundamental change in the objectives of their investment.* The typical roll-up is an extraordinary departure from the fixed life, self-liquidating nature of the original limited partnership. Certainly, it must be recognized that, to "cram down" a change of this magnitude which would transform the investment into an infinite life deal with new fees and completely different objectives, sends a clear message to small investors who own limited partnerships that they have no control over their financial destiny—they are at the absolute mercy of the general partners. It is true that almost every limited partnership called for a "50 percent plus one vote" majority to make changes to the limited partnership agreement, but the concept of such a fundamental change in the investment objectives through a roll-up transaction was *neither contemplated nor disclosed* in any of the original documents provided to investors. Clearly, investors never would have invested in a limited partnership if they knew at the time they put their funds in such an investment that the terms of the deal could be radically altered even if they disapproved. Limited partners invested in a non-traded entity with a fixed life; they made an investment choice with which they were satisfied. They understood the risk of the capital markets. They did not expect to be "rolled-over" in a roll-up. To not give them a choice to avoid a "cram-down" is to abrogate the clear intent of the original investment contract.

Mr. Chairman and Members of the Subcommittee, AALP is not persuaded that there is any merit to the arguments made against dissenters' rights by general partners and their associates who stand to make huge profits off of these deals while small investors lose their life savings.

IV. CONCLUSION

Mr. Chairman and Members of this Subcommittee, limited partnerships are an important vehicle for capital formation in this country. Investor confidence in limited partnerships is eroding because of the flaws and loopholes that now riddle the roll-up process. Adoption of S. 1393 would be an important step forward in the effort to stem the unfair losses and abuses to which hundreds of thousands of limited partnership investors have been subjected. AALP does not believe consumers should have to continue to lose sleep at night because of the fear that their number will be the next to come up in a roll-up deal. It is for this reason that AALP is actively supporting federal legislative initiatives—including S. 1423 introduced by Senator Chris Dodd and a bipartisan group of his colleagues on the Senate Banking Committee; H.R. 1885, introduced by Congressmen John Dingell, Ed Markey and Matthew Rinaldo and approved last month by the House Telecommunications and Finance Subcommittee; and legislation similar to S. 1393 introduced by Congressman Pete Stark.

While the limited disclosure and proxy reforms recently proposed by the Securities and Exchange Commission (SEC) are laudable, they nonetheless fall far short of what is needed to protect America's eight million limited partners from unfair abuses that now threaten their investment equity. Left entirely unaddressed by the SEC is, among others, the critical issue of dissenters' rights. It now is appropriate that the Congress use its authority to underscore the need for additional protections for limited partners. While the Commission deserves credit for recognizing the severity of the roll-up problem, it must be recognized that more disclosure in and of itself is no panacea. Meaningful decision-making for limited partnership investors must be restored if we are serious about repairing the damaged investor confidence in these markets.

Industry organizations and associations, state securities regulators and federal officials all have recognized that the current system is flawed and in urgent need of an overhaul. It is time to move forward with reform legislation. Action is needed now to avoid additional injuries to limited partners. On behalf of this nation's eight million limited partners, the AALP commends this Subcommittee for your attention and commitment to strengthening investor protections in the roll-up process.

[SUBMITTED BY SENATOR TOM DASCHLE]

Description of S. 1393 Relating to the Treatment of Partnership Rollup Transactions

[Prepared by the Staff of the JOINT COMMITTEE ON TAXATION, July 10, 1991, JCX-12-91]

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of S. 1393 (relating to the treatment of certain partnership rollups). S. 1393 (introduced by Senator Daschle on June 26, 1991) is scheduled for a hearing on July 16, 1991, before the Subcommittee on Energy and Agricultural Taxation of the Senate Committee on Finance.

Part I of the document discusses present law. Part II describes the provisions of S. 1393. Part III discusses certain issues relating to the bill.

I. PRESENT LAW AND BACKGROUND

A partnership rollup generally is a transaction in which two or more partnerships are combined and "rolled up" into a single surviving entity (such as a partnership, corporation or real estate investment trust). The original partnerships' property generally is transferred to the surviving entity, and holders of interests in the original partnerships generally receive interests in the surviving entity in exchange for their interests in the original partnerships.

Under present Federal tax law, the transfer of property to the surviving entity may be tax-free to the transferor partnerships and to the surviving entity, and the exchange of interests in the original partnerships for interests in the surviving entity may also be tax-free to she holders, depending on the form of the transaction.[2]

Present Federal tax law imposes no penalty tax or excise tax on payments received or accrued by persons performing services or relinquishing rights in connection with a partnership rollup transaction. Present Federal tax law does, however, impose excise taxes intended to discourage certain types of transactions. A 50-percent excise tax is imposed under present law on any person who receives "greenmail." Greenmail is any consideration transferred by a corporation to acquire its own stock from a shareholder in certain attempted corporate takeover transactions. Excise taxes are also imposed on a variety of transactions involving pension plans, 8ublic charities, private foundations, and certain trusts.[3]

II. DESCRIPTION OF S. 1393 [4]

Explanation of Provisions

In general

Under the bill, in the case of a partnership rollup that does not provide cash-out or similar rights to dissenting investors, a 50-percent excise tax would be imposed on certain persons providing services (such as promoters, general partners, and others) on certain gain or other income realized in connection with the rollup.

Prohibited rollup transaction

Under the bill, the excise tax would apply to payments received in connection with a prohibited rollup transaction. A prohibited rollup transaction is a transaction

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of S. 1393 Relating to the Treatment of Partnership Rollup Transactions* (JCX-12-91), July 10, 1991.

[2] If the surviving entity is a partnership, present law provides that no gain or loss is recognized to the partnership or to the contributing partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. If the surviving entity is a corporation, present law provides that no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in the corporation, and immediately after the exchange such person or persons are in control of the corporation. For this purpose, control means ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. Notwithstanding these rules providing for tax-free transfers, recapture of depreciation or amortization is required with respect to personal property and with respect to certain amortization deductions for real property, in the event of certain transfers of the property.

[3] See Chapters 41, 42, 43, 44, 46, and 47 of the Internal Revenue Code.

[4] S. 1393 was introduced by Senator Daschle on June 26, 1991.

that converts certain types of limited partnership interests into interests with different rights, but only if the following two requirements are met: (1) specified dissenters' rights are not provided; and (2) in connection with the rollup, there is a securities offering that must be registered with the SEC or comparable State or local government agency, or there is a request for a proxy or vote. The type of limited partnership interest converted by the rollup must be one in which the holder is entitled to receive a share of all net proceeds from all sales or refinancings of partnership assets which occur on or after a specified date.

Dissenters' rights

In order to avoid the excise tax under the bill, each limited partner must have a reasonable opportunity to dissent to the rollup. In addition, each partner who dissents must have the right to require the redemption of his interest for an amount equal to his share of the net value of the partnership's assets immediately before the rollup. Such value cannot be less than the amount represented in any document filed with the SEC or any other governmental authority as the value of the partnership's assets. The partner's interest must be redeemed for (1) cash, (2) marketable securities that have traded for at least three years on a national exchange, (3) negotiable promissory notes issued by the entity resulting from the rollup (with terms to be specified in regulations), or (4) securities that have substantially the same value, rights, powers and privileges as the limited partnership interest exchanged in the rollup.

Disqualified rollup-related payment

The excise tax would apply to the receipt of a disqualified rollup-related payment by a disqualified person. Such payment is any payment, fee or other consideration received (1) on account of services rendered in connection with a prohibited rollup transaction, (2) in exchange for an interest in a limited partnership which is a party to the rollup, or for the relinquishment of any right arising under an agreement with any such entity, or (3) on account of services rendered to any entity resulting from the rollup or on account of holding any interest in such entity. A disqualified rollup-related payment would not include any amount received by the disqualified person for services to the extent the payment does not exceed the amount the disqualified person would have been entitled to receive for such services from a limited partnership had such entity not entered into the rollup.

Disqualified person

Under the bill, the excise tax would apply only to the receipt of payments by a disqualified person. A disqualified person is (1) any person who, immediately before or after a rollup, was or is a general partner, manager or investment adviser with respect to a limited partnership which is a party to the rollup, (2) any person performing services as a broker, dealer, underwriter, promoter, investment banker or appraiser in connection with the rollup, or (3) any person related to any of the persons described above.

Effective Date

The excise tax under the bill would apply to rollups occurring after April 23, 1991, unless the converted limited partnership interest was traded on a national securities exchange before April 23, 1991.

III. ISSUES

Arguments in favor of the bill

1. Limited partnership investments are sufficiently similar to investments in corporate stock that the same protections afforded under State corporate law to minority shareholders should be afforded to minority investors in limited partnerships.

2. If Congress determines that certain investor rights and protections should be provided in partnership rollups, an excise tax imposed on failure to provide such rights and protections could be as effective as a direct requirement imposed under State business law. Congress has imposed excise taxes on other types of transactions it determines should be controlled or discouraged.

3. Limited partnership investors may be unsophisticated or may have inadequate information to reach an informed decision whether to approve a rollup transaction. Allowing dissenters to cash out of their limited partnership interests would reduce promoters' incentives to over-value the rolled-up entity.

4. Imposing additional conditions on rollup transactions will not significantly affect the liquidity of existing limited partners, because secondary markets already exist for limited partnership interests.

Arguments against the bill

1. Federal tax sanctions are an inappropriate and inefficient means of providing investor protection and specifying investor rights. If necessary, such protection and rights should be created directly by State or Federal business and securities legislation and enforced by the appropriate business and securities regulatory agencies or by private cause of action.

2. Imposing an additional cost on partnership rollups interferes with the operation of the free market. Requiring that investors be provided with cash-out or similar rights in a rollup is inappropriate if the original price of the limited partnership interests took into account the lack of liquidity and other risks associated with the investment.

3. Limited partners should be deemed to have known the terms of the partnership agreement they have executed, particularly with respect to provisions regarding transfers of partnership property and dissenters' rights. If investors in limited partnerships are not sufficiently sophisticated to understand the terms of the partnership agreement, then limitations should be placed on who can invest initially, not on the terms of subsequent rollup transactions.

4. Rollup transactions do not, by themselves, reduce the value of a partner's investment. Rather, low trading values for interests in the rolled-up entities reflect the low value of the underlying partnership assets and a payment for the benefit of increased liquidity (i.e., the ability to trade interests on a securities exchange).

PREPARED STATEMENT OF WILLIAM B. DOCKSER

As an investment fiduciary who oversees a four-and-a-half billion dollar real estate portfolio on behalf of sixty-thousand investors, I *too* want to protect partnership investors from abusive roll-up practices.

Yet:

—I question whether a bill reforming roll-ups is needed now.
—And I submit that Congress and those still backing an anti-roll-up bill could *better* serve public investors if—instead—they took action to alleviate the *real* destroyer of value in many partnership investments today—the depression in real estate.

Unlike many, I've had an opportunity to see the structuring of an *investor-friendly* roll-up from the inside.

My company, CRI, Inc., in 1989, merged two partnerships and one REIT managed by CRI. That roll-up, or as we prefer to call it, the CRI merger, stands out because it provided *dissenters' rights*, a key feature promoted by the legislation before this Subcommittee.

The CRI merger gave investors the right to choose either:

—A new, perpetual-life company, or if they dissented,
—A new, finite-life, liquidating company, much like their original investment.

In aftermarket trading on the New York Stock Exchange, the shares of both new companies have defied the typical downward spiral of roll-up stocks.

—The stock of the liquidating company trades *above* its original share price.
—The stock of the perpetual life company—CRIIMI MAE—trades quite actively—just a few cents below its original price.

Despite the positive experience of CRI's investors, I *oppose* the passage of a law that *requires* dissenters's rights in *all* partnership restructurings. The marketplace *can* safeguard investor interests, and should be left to do so without Congress mandating the method.

The process of restructuring investments *should* as a matter of course—be open to investor input. At CRI, we reached the decision to provide dissenters' rights after give-and-take meetings with brokers whose clients held interests in the original entities. However, even when sponsors have failed to do this, the news media, activist brokers, and others have given investors a voice in the process.

I do not suggest that all roll-ups are good for investors. Some are; some are not. And recent experience indicates that investors, when they oppose a roll-up, can *vote down* a proposal.

However, I do submit that the generalized attacks on roll-ups may have gone overboard. These attacks have poisoned the air against any form of partnership restructuring—even *necessary* proposals that pass two basic tests:

—First, do they treat investors fairly?
—And, second, do they have a good chance of improving or salvaging real estate investments?

Roll-ups, or as I prefer to describe them, partnership restructurings *can* be designed to pass both tests—if a responsible fiduciary chooses to do so. But few fiduciaries would dare propose a restructuring in today's anti-roll-up climate. The risks of failure—even for an investor-friendly transaction—are too great.

SEC Commissioner Edward Fleischman recently suggested that the damage from abusive roll-ups is, unfortunately, already done. Making reforms today is like trying to divert water already under the bridge.

Why?

Because the roll-up—as a potentially abusive transaction—is dead. What remains, however, is a bigger, more fundamental problem.

A significant portion of this country's wealth—maybe half—has been invested in real estate. A lot of those investments are not performing. And the resulting loss of wealth impacts a vast constituency in the country today. It impacts:

—Pension fund investors;
—Tax-payers bailing out the savings and loans;
—Insurance-policy holders;
—Tax-payers, again, when they have to refinance the FDIC fund for banks, and
—Limited partners and general partners in real estate investment programs.

Owners of troubled real estate today need an infusion of two things—capital and active management—in order to ride out the hard times, recoup their original value, and re-position their investment to participate in any rebound.

Restructuring real estate securities, when done right, represents a *micro-solution* to the problem.

What is needed is a *macro-solution*.

Many serious analysts agree that the biggest single cause triggering today's real estate depression was the Tax Reform Act of 1986. By eliminating the tax benefits on existing investments, the bill abruptly destroyed investment values. To recover some of this loss, new legislation is needed.

As a result, I urge Congress to consider providing incentives, such as tax credits, so that new money is invested in distressed real estate, and so that properties receive needed improvements and qualified management when acquired.

Today's hearings are obviously not the place for outlining a full tax incentive program for the recovery of real estate. But action is seriously needed, and I urge Congress to begin.

In sum, I believe that those seeking to prevent abusive roll-up practices have already succeeded. There is tightened regulatory oversight and heightened awareness in the marketplace to prevent future abuses. Congress now should begin the process of reversing the devastating impact on real estate values of the 1986 Tax Act.

Today's troubled real estate assets, in one way or another, belong to all Americans.

Prepared Statement of James R. Doty

Chairman Daschle and Members of the Subcommittee:

I am pleased to testify at this hearing concerning limited partnership roll-ups. Several legislative measures that would impose significant restrictions on roll-ups are now under consideration by Congress, including S. 1393, the bill introduced by Chairman Daschle, which is the subject of today's hearing.[1]

S. 1393 is a proposed response to the perceived unfairness in the manner in which various roll-ups have proceeded. The Securities and Exchange Commission does not, of course, set federal tax policy, and we defer to the Treasury Department in evaluating the specifics of the proposed tax that would be imposed under S. 1393. In general, however, we do not favor the imposition of new taxes on securities transactions—particularly taxes designed to affect only a class of transactions that are not structured in a specified manner and where the basic objective is regulatory in

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[1] S. 1393 would impose a 50 percent excise tax on payments made to general partners, managers, investment advisers, or others who provide financial services in connection with the roll-up of limited partnerships, unless investors are able to obtain in exchange for their partnership interests cash, marketable securities or negotiable promissory notes having a value equal to an investor's proportionate share of liquidation value.

nature. New taxes on securities transactions risk shaping market behavior in an artificial or unforeseeable manner. In addition, new costs for recordkeeping and compliance may be incurred, just to avoid application of a new tax, often in situations not involving regulatory abuse.

To the degree that the perceived problems with roll-up transactions have involved cases of overreaching by fiduciaries, more direct remedies may be more effective in controlling abusive practices. Indeed, the Commission has already taken steps to require that investors obtain more clear and concise disclosure regarding proposed roll-up transactions, and to allow investors to oppose such transactions more vigorously through proxy rule reforms. We will also consider soon the NASD's proposal to abolish the practice of paying brokers fees only for obtaining positive votes in a roll-up. More active enforcement of state fiduciary standards by the judiciary would also address limited partners' complaints about the actions of their fiduciaries, the general partners.

The Commission's mandate is to administer and enforce the federal securities laws, which require full disclosure of all material information in registered securities offerings, including roll-ups; and in my testimony today, I will discuss the regulatory initiatives taken by the Commission to address many of the concerns about limited partnership roll-ups. We believe that these measures will enhance investor protections against potentially abusive roll-ups, while preserving the roll-up as a transaction that when properly used can enhance liquidity and afford investors an opportunity to realize value on their initial investment. I would, however, first draw the Subcommittee's attention to some critical legal aspects of these regulatory initiatives.

I. BACKGROUND ON LIMITED PARTNERSHIP OFFERINGS AND ROLL-UPS

For several decades, limited partnerships were an attractive investment vehicle for offering investments in commercial and residential real estate, oil and gas drilling programs, cable franchises, motion pictures and plays, and other tax-advantaged properties.[2] For much of this time, and prior to major revisions in the federal tax code beginning in 1984, investors in limited partnerships were often motivated by favorable tax treatment. The pass-through of partnership gains and losses enabled individual investors to receive substantially the same tax treatment and cash distributions that they would have received by investing directly in the property and without the attendant legal liabilities.

During the 1970's, the limited partnership offering was principally a vehicle for privately negotiated transactions among institutional investors and entrepreneurs, although there also was a fairly widespread use of private offerings of limited partnership interests through securities firms acting as placement agents. Commencing in the early 1980's, offerings of limited partnership vehicles were no longer confined to the private placement market, with $8.6 billion of partnership interests being registered for public sale in 1982. Registered offerings of limited partnerships were over $10 billion in every year thereafter through 1986, achieving a record $26.6 billion in 1986. During the 1980's, almost $150 billion worth of limited partnerships were registered for sale to the public, with tens of billions more sold in private placements.

Many of these limited partnerships lost much of their value as a result of difficulties in the real estate and oil and gas industries—including the lingering effects on these industries of depressed fossil-fuel prices and overbuilt real estate markets —as well as legislation enacted between 1984 and 1987 that significantly reduced the tax benefits accorded to such investments. These developments have had a dramatic effect on the market for limited partnerships. With respect to real estate, for example, the six major syndicators of real estate partnerships saw sales decline from $6.5 billion in 1987 to $2.6 billion in 1989. During roughly the same period, all *registered* offerings declined from $22.4 billion in 1987 to $5.3 billion in 1990.[3]

The decline in value of many limited partnerships has also highlighted the illiquid nature of these investments. Limited partnership interests usually are not traded on a national securities exchange or quoted on the National Association of

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[2] Testimony of Richard C. Breeden, Chairman, United States Securities and Exchange Commission, "Concerning Roll-Ups," before the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, United States Senate, February 27, 1991, at 4 et seq., hereinafter cited as "Breeden Testimony."

[3] Breeden Testimony at 9. The sales information on real estate syndication is found in an article by Keith R. Guericke in *Pension World*, July 1991, at 16.

Securities Dealers Automated Quotation System ("NASDAQ").[4] The secondary markets for limited partnership interests are characterized by many small holders, extremely low trading volume and relative illiquidity; and few types of partnership securities are followed by financial analysts or investment banking firms. Between 15 and 20 small investment firms buy and sell partnership units, either for their own accounts or for resale to new investors.

The Commission recognizes that the illiquidity of the secondary market for limited partnership interests, as well as the risks inherent in the small asset base and the types of properties involved in a typical limited partnership, may make such partnerships a considerably more speculative investment for individual investors than more traditional corporate equity securities or mutual funds. With that in mind, the disclosure documents required to be filed with the Commission in connection with registered limited partnership offerings are reviewed carefully by the Commission's staff. A key focus of the staff's review and comment is to highlight the risks inherent in a limited partnership investment, including the lack of liquidity, the discretion and compensation of the general partners, and the restrictions on voting rights of the limited partners.

II. THE ROLL-UP PHENOMENON

A. Description of Roll-Ups

The roll-up phenomenon has appeared as a response to the inherent lack of liquidity in the market for limited partnership interests, as a means of creating liquidity through the combination or reorganization of one or more illiquid partnership entities. Roll-ups have created considerable controversy, however, as critics have charged that general partners put their interests above the interests of limited partners by the manner in which they structure and sell roll-ups.

In a typical roll-up transaction, a sponsor combines a number of public or private limited partnerships into a single entity. This combination requires the consent of the requisite majority of the limited partners of each predecessor entity, and typically is accomplished through a merger of existing entities into a surviving entity, which is often a corporation. Investors in the predecessor entities receive an interest in the new entity. The interest is usually an equity security, but in some instances it is a debt security or some combination of debt, equity and cash. Whereas the securities of the predecessor entities for the most part are not traded in the secondary markets, the securities of the new entity often are listed on the New York Stock Exchange ("NYSE") or the American Stock Exchange ("AMEX") or quoted on NASDAQ.[5]

Thus, a roll-up transaction can create the benefit of greater liquidity for the investor limited partners, even where the partnership business has suffered, its assets have declined in value and the partnership interests have lost a significant part of their value. In such circumstances, depending on market conditions and other factors that affect the performance of limited partnerships, participation in a roll-up could offer investors the opportunity to obtain the highest realizable value on their initial investment.

Based on its experience in this area, however, the Commission recognizes that roll-up transactions may be abusive or unfair. For example, although investors who acquire partnership interests in a registered offering have an expectation that the general partner's fees will not exceed the amount disclosed, roll-ups may result in attempts to extract additional fees. In addition, while state laws limit the participation of limited partners in the partnership's affairs, a roll-up may further reduce the limited partners' voting control over the disposition of partnership assets. Finally, investors who had expected the partnerships to be dissolved and the assets distributed after a "finite life" may find their interests converted into investments of unlimited duration.

Both the rights and responsibilities of participants in limited partnerships are governed by state partnership law, which generally limits the participation of limited partners in the partnership's affairs. A limited partner has neither any direct role in management of the entity, nor any general liability for the partnership's

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[4] The trading that does occur usually consists of relatively isolated "accommodation" transactions handled privately by the broker-dealer that originally sold the limited partnership interest to the investor.

[5] Based on the disclosures contained in roll-up filings made with the Commission since January 1, 1985, it appears that approximately 65% of the surviving entities are, or are intended to be, traded publicly—51% of these surviving entities on AMEX, 29% on the NYSE, and 20% on the NASD's National Market System.

debts. As with the stockholder of a business corporation, the liability of a limited partner is limited to the risk of his or her investment in the partnership interest. Also, as with the relationship between corporate directors and managers and the shareholders they serve, state law generally imposes fiduciary duties on the general partners to the limited partners.

Before sponsors may proceed with a roll-up, the requisite number of limited partners in each limited partnership, most often a majority of the outstanding limited partnership interests, generally must vote to approve the transaction. The actual vote required to approve the transaction is fixed by the terms of the limited partnership agreement in accordance with state partnership law.

The federal securities laws mandate that disclosure documents that are used to solicit the vote or exchange of securities by the limited partners must be filed with the Commission and are subject to staff review and comment regarding compliance with the Commission's rules and regulations governing disclosure. Because most roll-ups involve the solicitation of limited partners' proxy votes and the issuance of new securities, these documents usually take the form of a combined proxy statement, which is used to solicit proxies, and a registration statement, including a prospectus, which is used to register the new securities.[6] Staff review and comment usually result in repeated revisions by roll-up sponsors in response to requests from the staff for enhanced disclosure.

B. Trends in Roll-Up Activity

From January 1, 1985 to July 3, 1991, 69 typical roll-up transactions involving approximately 1800 entities valued at approximately $7.1 billion have been registered with the Commission. By contrast, during approximately the same period, filings were made with the Commission for more than $343 billion worth of corporate mergers and acquisitions.[7]

It appears that the pace of roll-up activity is on the decline. Nine roll-ups involving more than one partnership were filed in the first two quarters of 1990, but only one such roll-up filing was made with the Commission during the first two quarters of 1991.[8]

III. THE LEGAL FRAMEWORK FOR PROTECTION OF INVESTORS

The protection of investors in a corporation or partnership generally includes at least four elements:

1. *Adequate Information.* To enable investors to understand the consequences of an investment decision or proposed transaction, investors need to receive full disclosure of all material information regarding the security or the transaction in the documents required to be delivered, such as proxy statements and prospectuses. This, of course, is the province of the federal securities laws and the Commission's rules thereunder. The Commission vigorously enforces these laws and rules.

2. *Fiduciary Duties.* State law imposes strict fiduciary duties on officers and directors, general partners and other insiders towards investors. These duties impose on general partners the duty of observing the utmost candor and fair dealing in transactions with their limited partners.

3. *Effective Voting Rights.* State law generally provides a fundamental protection for all investors in establishing the right to vote to replace directors or general partners and to approve extraordinary transactions. Most roll-ups cannot proceed without an affirmative vote of a majority of the limited partner interests in each limited partnership involved. One very troubling aspect of some roll-ups, however, is that they restrict significantly the ability of investors in the rolled-up entity to vote out the general partner.

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[6] Although the structure of a particular roll-up will determine the specific Commission disclosure requirements that apply, these requirements are substantially similar. For purposes of the present statement, therefore, it is unnecessary to distinguish among the various Commission rules that may apply.

[7] These filings on Forms S-4 and F-4 were made between October 1, 1984, and May 31, 1991, the only period for which such data were available.

[8] Two other roll-up filings were made with the Commission during the second quarter of 1991 to register, under the Securities Exchange Act of 1934, securities issued in roll-ups that were exempt from registration under the Securities Act of 1933. Such registration was done on a Form 10.

4. *Recourse to the Courts.* Investors need to be able to enforce their other rights in the courts. Limited partners have, in some cases, sued general partners to challenge the fairness and other aspects of proposed roll-ups.[9]

Of these four protections, the Commission is responsible under current federal law for administering the rules requiring full disclosure of all material information in proxy statements, prospectuses and other regulated disclosure documents. Under Congress's guiding principle of full and fair disclosure, Commission rules and regulations are designed to make certain that investors receive all material information bearing on the merits of roll-ups, including the economic and other interests of the general partner therein, the resulting change in investor rights, and the business prospects and risks of the new entity. Similar information also is required to be disclosed pursuant to Commission rules when an investor first acquires a limited partnership interest in a public offering.

The basic standards governing the *fairness* of transactions are found in state partnership and corporate laws, and the decisions of the courts that apply those laws. A few states also regulate the compensation of, and transactions with, affiliates in connection with their review of proposed securities offerings. By contrast, the federal securities laws focus on full disclosure of the information necessary to provide investors the ability to assess the merits of the transaction and the performance of the fiduciary.

Indeed, where the Commission has sought to protect the fairness of the voting process through a regulation—Rule 19c-4—designed to prevent the unfair abridgement of voting rights, a federal court has held that the Commission lacked the requisite authority under its statutes.[10] Thus, it is the investor, or the state courts that apply state law—not the Commission—who must decide whether a proposed transaction is fundamentally fair or unfair.

The Commission's mandate under the federal securities laws, although generally limited to disclosure, is nonetheless extremely important. While the Commission cannot *require fairness* in business combination transactions, it can and does provide investors with the factual basis on which to make investment decisions about fairness, to evaluate the detriments and benefits in the exercise of the franchise, and to bring suit when fiduciaries have breached the fiduciary duties owed to the limited partners or misrepresented the reasons for or the fairness of proposed roll-up transactions.

For almost sixty years the Commission has, through its enforcement of the disclosure statutes, made possible the effective enforcement by investors of fiduciary duties and protection of voting rights through recourse to the courts.

In addition to Commission enforcement action, individual investors have remedies under both state and federal law. Limited partners may sue the general partner under state law, alleging breach of contract (based on specific terms of the partnership agreement) or breach of fiduciary duty, or may sue both the general partner and the issuer for fraud. Such actions could be based on the terms of the roll-up and the general partner's role in negotiating or accepting those terms.

Moreover, investors may bring suit against the same parties, alleging fraudulent disclosure, under federal securities law antifraud provisions such as Securities Exchange Act Sections 10(b), 13(e) and 14(a), and Commission Rules 10b-5, 13e-3(b)(1), and 14a-9 thereunder.[11] Courts have not taken a mechanistic view of disclosure requirements in such suits, but have given the disclosure requirements the expansive application they deserve in order to effectuate their purpose. Quite recently, for example, the Supreme Court held that false statements in a proxy solicitation characterizing management's reasons and beliefs, may be actionable even though conclusory in form.[12] In so doing, the Court endorsed a position advanced by the Commission, which had participated as amicus curiae in the case.

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[9] Although we are aware of few reported decisions regarding roll-ups, we would not assume that the courts are not enforcing the rights of limited partners. *See, Schick* v. *Ernst & Whinney,* [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,764 (S.D.N.Y. 1991); *American Insured Mortgage Investors* v. *CRI. Inc.,* [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,730 (S.D.N.Y. 1990).

[10] *Business Roundtable* v. *Securities and Exchange Commission,* 905 F.2d 406 (D.C. Cir. 1990).

[11] In addition, because roll-up transactions are generally registered under the Securities Act, investors can in some cases invoke the express private rights of action provided by that Act. If an issuer improperly fails to register the securities issued in a roll-up, investors can bring suit under Section 12(1) of the Securities Act, alleging violation of the registration requirements of Section 5 of the Securities Act. If a limited partner believes the registration statement and prospectus used in connection with the roll-up were misleading, that investor can seek damages under Section 11(a) and 12(2) of the Securities Act.

[12] *Virginia Bankshares, Inc.* v. *Sandberg,* [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,036 (U.S. June 27, 1991).

IV. COMMISSION REMAKING INITIATIVES

Because of specific concerns about roll-up transactions, the Commission has undertaken several initiatives designed to improve the quality of disclosures made to investors and the procedures utilized in roll-ups. As discussed below, some of these are directed solely at roll-ups; others relate more broadly to the Commission's proxy rules as they apply not only to roll-ups, but also to a wide variety of other transactions by limited partnerships and corporations. These initiatives will ensure that limited partners receive the information they need to make informed decisions about roll-up transactions.

First, the Commission has been actively working to improve the quality and readability of the information in roll-up disclosure documents. The Division of Corporation Finance has incorporated into its review and comment process a number of disclosure suggestions made by commenters and participants in these transactions. Such changes include:

- clearer disclosure about the material effects to investors that will result if the transaction is approved;
- clearer and more concise information regarding how a roll-up would affect the general partner's compensation;
- comparative disclosure of the material-differences in legal rights, obligations, and duties of the parties to a roll-up and the impact of the changes in investment objectives on limited partners; and
- prominent disclosure of differential or contingent compensation arrangements,[13] as well as the potential conflicts of interest inherent in that fee structure.[14]

Second, the Commission has issued a release [15] setting forth its views of existing disclosure requirements applicable to limited partnership roll-up transactions and initial public offerings of limited partnership units and other similar securities. The interpretations require:

- clear, concise and understandable disclosure concerning the material elements and terms of the transaction;
- complete information regarding the issuer, the security being offered, the offering transaction and the risks of the investment;
- an emphasis on the complexities and uncertainties involved in combining a number of different entities; and
- an emphasis on the disclosure of the risks of investing in a limited partnership and the restrictions that state partnership laws and limited partnership agreements place on investor rights.

Third, the Commission has proposed amendments [16] to its rules to enhance the clarity, as well as the substance, of the disclosures provided to investors in connection with roll-ups. These amendments would, among other things:

- improve the quality and readability of information provided to investors, particularly with regard to information contained on the cover page and in the summary section, in connection with limited partnership roll-up transactions;
- require that separate individual partnership supplements be delivered to the investors of each entity participating in a roll-up;

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[13] The NASD is amending its rules to prohibit member brokers and investment advisers from receiving differential or contingent compensation in connection with roll-up transactions. See Securities Exchange Act Release No. 29228 (May 23, 1991), 56 FR 24436 (May 30, 1991). The comment period on this proposal ended June 14, 1991.

[14] Recommendations by broker-dealers to their customers in connection with securities to be issued in roll-up transactions also have raised concerns involving customer suitability. The receipt of fees tied to the number of "yes" votes obtained may conflict with the duty of broker-dealers, in recommending to customers the purchase, sale or exchange of securities, to have a reasonable basis to believe that the recommendation is suitable for each customer based on his or her security holdings and financial situation and needs. See NASD Rules of Fair Practice, Art. III, Section 2, NASD Manual (CCH) ¶2152. Moreover, a broker-dealer's failure specifically to disclose to customers the existence of this conflict may violate the general antifraud provisions of the federal securities laws, particularly where the firm has a preexisting customer relationship with the investors it solicits.

[15] Securities Act Release No. 6900 (June 17, 1991), 56 FR 28979 (June 25, 1991).

[16] Securities Act Release No. 6899 (June 17, 1991), 56 FR 28962 (June 25, 1991). The comment period on the proposed rules ends August 9, 1991.

• heighten the disclosure requirements with respect to conflicts of interest and the fairness of a proposed roll-up transaction, similar to those governing going private transactions;
• provide enhanced disclosure regarding the reasons for proposing the roll-up, alternatives considered by the general partner, valuation methods and pro forma financial information; and
• set a minimum solicitation or tender period for any roll-up transaction.

The Commission also is engaged in a broad review of its proxy rules under Section 14(a) of the Securities Exchange Act. Under that section, any person who seeks to obtain, or influence the transfer of, the power to vote from the holder of the voting right must comply with Commission rules regarding solicitation of proxies. The proxy rules apply to a wide variety of limited partnership and corporate transactions, including roll-ups. To address concerns raised by limited partners and corporate shareholders, the Commission recently proposed several amendments [17] to its proxy rules. These amendments would facilitate communication among investors in order to promote informed proxy voting, and would reduce the costs of compliance with the proxy rules for persons engaged in soliciting proxies. Specifically, the proposals would:

• ease regulatory restrictions ordinarily applicable to communications with and among security holders by exempting from all proxy rules (other than the antifraud provisions) solicitations by any "disinterested" person not involving the delivery of a proxy;
• limit the types of proxy soliciting material required to be filed in preliminary form to the proxy statement and form of proxy;
• provide that all proxy material, whether in preliminary or definitive form, would be public upon filing; and
• improve securityholder access to mailing lists of other securityholders.[18]

Along with these initiatives, the Commission's antifraud enforcement program continues to focus on both initial limited partnership offerings and roll-ups of limited partnerships to assure that the requirements of the federal securities laws are satisfied. The Commission will take appropriate enforcement action whenever it discovers violations of federal securities laws.

V. CONCLUSION

The Commission appreciates the interest of this Subcommittee in the important issues raised by limited partnership roll-ups. Although we recognize that some roll-up transactions may have been unfairly structured and unfairly promoted in the past, heightened awareness of the problems of previous transactions may have contributed to the virtual disappearance of roll-up combinations. Because of specific concerns about roll-ups, the Commission has already undertaken several initiatives to improve the quality and clarity of information provided to limited partners, and to enhance investor protection in roll-ups. The Commission intends to move as rapidly as possible on its rulemaking proposals, to avoid any recurrence of the past problems in this area.

PREPARED STATEMENT OF DEE HARRIS

Mr. Chairman and Members of the Subcommittee: Good morning. My name is Dee Harris. I am director of the Arizona Corporation Commission's Division of Securities and chairman of the Limited Partnership Roll-Up Task Force of the North American Securities Administrators Association (NASAA). In the U.S., NASAA is the national voice of the 50 state agencies responsible for small investor protection and the efficient and fair functioning of the capital markets at the grassroots level. On behalf of NASAA, I appreciate the opportunity to appear before you today to testify on the issue of limited partnership roll-ups.

Mr. Chairman and Members of the Subcommittee, you are to be commended for conducting a review of the extremely serious investor protection issues that arise in connection with public limited partnership reorganizations—commonly referred to

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[17] Securities Exchange Release' No. 29315 (June 17, 1991), 56 FR 28987 (June 25, 1991). The comment period on the proposed rules ends September 23, 1991.

[18] Under current rules, the registrant may choose whether to mail solicitation materials to other shareholders on behalf of the requesting shareholder, or to provide the requesting shareholder with a list of other shareholders. The proposed amendments would shift the right to choose from the registrant to the requesting shareholder.

as "roll-ups" [1]—and for introducing legislation that would provide for additional investor safeguards in this area.

State securities regulators around the country are receiving a rising number of complaints about roll-ups not only from limited partners, but also from market professionals who are expressing the strong view that their clients—the partnership investors—have not been well-served in these deals. Along with my fellow state securities regulators, I am gravely concerned that the roll-up process deprives small investors of the many and important protections afforded to them under state regulation of limited partnerships.

Federal securities laws and rules as they currently are applied to roll-ups in no way compensate for the stripping away of these state-level protections and, as a result, are in need of reform to address this very serious problem for a growing number of small investors.

STATE SECURITIES REGULATION: EMPHASIS AND FOCUS

Mr. Chairman and Members of the Subcommittee, overseeing the multi-trillion dollar investment marketplace in the United States is an enormous task that directly affects the financial well-being of millions of Americans and requires the close attention of the federal and 50 state governments. While the Securities and Exchange Commission (SEC) rightfully commits its resources to broad, market-wide regulatory activities, state securities agencies devote the bulk of their efforts to those regulatory and enforcement issues which most directly affect small investors.

State securities (or "blue sky") [2] laws provide for the protection of small investors through: the registration of securities offerings; the licensing of broker dealers and their agents; and a wide range of enforcement efforts, including criminal prosecution. Since these state laws date back eight decades, they have been described quite accurately as the United States' "first consumer protection statutes." [3] For example, the substantive state registration requirements act as an effective and proven "trip wire" for the early exposing of the conduct of abusive and fraudulent investment promoters.

The primary focus of state securities registration requirements is on those risky and illiquid investments, such as limited partnerships and penny stocks, where there is not even a semblance of an "efficient market" [4] and, as a result, abuses against small investors are most likely to occur. Among the serious problems that arise in thinly- or non-traded instruments are: a dearth of publicly available information; undue influence by the promoters and other insiders; and arbitrary pricing. It is important to note that these registration issues of critical importance to small investors, with the exception of mutual funds, are not dealt with on a substantive basis under federal securities laws.

STATE REGULATION OF LIMITED PARTNERSHIPS

Limited partnerships are among the riskiest and most illiquid of all instruments in the investment marketplace.[5] In addition to the absence of a trading market, limited partnerships are distinguished by the fact that they are almost exclusively designed for, and sold to, small investors, many of whom have relatively limited financial sophistication. Since the protection of such individuals from fraud and abuse is the primary focus of state securities regulation, NASAA has adopted a comprehensive set of limited partnership registration guidelines for real estate programs, oil and gas programs, equipment leasing programs, cattle feeding, real estate invest-

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[1] "Roll-ups" generally involve transactions in which a number of limited partnerships are combined into a single entity that will trade publicly.

[2] The securities laws of most states are based on the Uniform Securities Act, which was approved in 1956 by the National Conference of Commissioners on Uniform State Laws (NCCUSL). The states have periodically amended the Act since that time.

[3] Joseph C. Long, *Blue Sky Law,* Volume 12, 1985, page 1-3.

[4] While many experts argue that there are no truly "efficient markets," the term is used in relation to markets in which actively traded securities with a strong national or regional following generally have all or most publicly-available information incorporated into the price of a particular security. That is, the price of a specific security reflects all its risks and rewards, as determined by numerous and sophisticated market figures, such as independent securities analysts.

[5] In a syndicated limited partnership, investors turn over their funds to a general partner (or sponsor) who are to manage the partnership's business. Limited partners do not participate in the management and the operation of the partnership's business, nor do they assume any liability, except, of course, for the capital they have contributed to the enterprise. The investments are for a specified duration, after which the partnership's assets will be sold and the partnership dissolved.

ment trusts, and commodity pool programs. These Guidelines are widely used by the sponsors of limited partnerships as they structure their deals and also form the basis for state securities agency review of partnership registration filings.

While the Guidelines are custom-tailored to reflect the unique nature of each type of partnership, they do share substantive provisions intended to guide the conduct of program sponsors, including:

- Specific net worth and experience requirements of sponsors;
- Limitations on sponsors' compensation in amount and form;
- Prohibitions on certain sponsor transactions and other dealings which involve conflicts of interest;
- Requirements for limited partners' democracy rights; and
- Requirements for specific reporting to limited partners.

For broker dealers, the NASAA Guidelines set out customer suitability standards and limits on overall organization and offering expenses. (Each NASAA Guideline contains specific minimum suitability criteria which a potential investor must meet before purchasing an interest in a limited partnership.) The Guidelines have been revisited and updated periodically in response to changing market and economic considerations.

The NASAA Guidelines for public limited partnerships are used by the professional examiners of state securities agencies across the U.S. (For example, 40 states report that they use some or all of the Real Estate Guidelines.) Once a Uniform Application to Register Securities (Form U-1) is filed with a state, the process of reviewing the limited partnership begins. In a real estate limited partnership, the following elements of "Limited Partner Rights and Protection Provisions" come into play:

- **Limited partners' voting rights.** Specific limited partner voting rights must be observed, including those related to partnership dissolution, amendment of the partnership agreements, sale of substantially all assets and general partner removal. These rights may be exercised by a simple majority vote of the limited partners. Rights comparable to those guaranteed under stockholder corporate democracy also must be granted, including the right to call special meetings, demand a vote and obtain lists of names and addresses of all limited partners.
- **Suitability.** Specific standards for customers are enumerated in the Guidelines, with variations accounted for in the differences in the programs and markets.
- **Conflicts of interest.** In order to prevent self-dealing on the part of the general partners, compensation standards have been developed in the event that the general partners provide goods and services to the partnership. Compensation for such must be competitive with that which would be charged by an unaffiliated third party. Also prohibited are loans of partnership funds to the general partners.
- **Commingling of partnership funds.** Such practices are prohibited. However, a general partner may establish a master account for the benefit of various affiliated partnerships provided that the funds of one partnership are protected from the claims on the other partnerships.
- **Fiduciary duty.** The general partners have a fiduciary responsibility for the safekeeping and use of all funds and assets of the partnership and are prohibited from using such funds or assets in any manner except for the exclusive benefit of the partnership.
- **Financial statements and periodic reports.** In order to protect the limited partners' rights, the NASAA Guidelines require that small investors be provided with audited financial information of the partnership and other periodic and annual reports. Also mandated are periodic financial disclosures relating to self-dealing and transactions with affiliates.
- **Sponsor's net worth, experience and financial statements.** Thresholds related to the general partner's net worth and experience must be satisfied. Financial statements included in offering materials must conform to specific standards.
- **Exchange, transfer and redemption of limited partnership interests.** The Guidelines prescribe the conditions for the admission of the original and substitute limited partners and prohibit mandatory redemptions, with limited exceptions. Also included are provisions governing the transferability of limited partnership interests and limitations on deferred payments.
- **Termination of the general partner.** Allows limited partners the right to remove the general partner upon majority vote and sets out provisions related thereto. Any termination of the general partner must be done on terms reasonable to the partnership.

• **Sponsor Indemnification.** The Guidelines specify the specific and narrow circumstances under which the general partner may tap partnership funds in the event that he or she is sued.

The states routinely work through NASAA to update and modernize the Guidelines. The Real Estate Limited Partnership Guidelines, adopted by NASAA in 1980, have been amended annually since 1983, with the most recent changes being put in place on January 1, 1990. The NASAA Real Estate Committee [6] has convened study groups (which include industry representatives) to examine a wide range of concerns and possible revisions. For example, the Oil and Gas Guidelines, since their adoption in September 1976, have been amended in 1977, 1979, 1983, 1984, and 1987. The dynamic nature of the Guidelines reflects a clear interest on the part of the states to keep abreast of emerging promoter tactics and to harmonize regulatory requirements, where it is possible and in the best interests of small investors.

NASAA also has undertaken additional efforts to preserve the small investor protections at the heart of the various Guidelines. On October 12, 1988, the Association adopted a resolution in support of restrictions on the use of the words "insured" and "guaranteed" as part of the name of a program or in related sales literature. The concern of Association members was that the terms were being used to describe provisions which did not constitute guarantees or insurances, as those terms are commonly understood by small investors. We are pleased that the SEC recently reached the same conclusion, as evidenced in its public announcement earlier this year.

THE REGULATION OF ROLL-UPS

While most state statutes provide for the registration of securities to be "offered" or "sold" to the residents of that jurisdiction, several exemptions from these registration requirements have been put in place, as is also the case under federal securities law. Most notable among the state registration exemptions is that which is provided for "any security listed or approved for listing upon notice of issuance" on the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and in most states, certain regional exchanges and the National Market System (NMS) of the National Association of Securities Dealers Automated Quotation (NASDAQ) system.

The "exchange exemption," which dates back roughly 70 years in state securities statutes, is a recognition that certain securities required to meet the qualitative and quantitative standards of the exchanges do not require the additional oversight of state securities regulation. The widespread adoption of exchange exemptions reflected a responsible effort on the part of state securities regulators to relieve such securities in the national marketplace of state registration requirements. In more recent years, state securities regulators have moved to statutory recognition of the NASDAQ/National Market System (NMS) as the functional equivalent of a qualified stock exchange for the purposes of the registration exemption, in response to Congressional and other calls for a truly national market system.

Until the 1980s, the nearly singular effect of the exchange exemptions was to remove from the purview of state securities regulation the trading of listed common stock and bonds of nationally known companies. However, recent years have seen the exchanges list certain initial public offerings (IPOs) and roll-ups that were not contemplated when the states originally adopted exchange exemptions. The states' exemptions for exchange-listed securities were predicated on the existence and application by the exchanges of published listing criteria. It is unclear to NASAA members exactly what standards are being used today by the exchanges to qualify roll-ups for listing.

Today, almost all roll-ups of public limited partnerships are exchange-listed or approved for exchange listing and, therefore, such offerings sidestep substantive review by the states. The net effect of this process is that individual limited partnerships that had been screened through state investor protection standards are converted literally overnight into investment instruments outside of the gambit of state regulation. In this way, limited partners are effectively stripped of the many and important safeguards required under the NASAA Guidelines.

While roll-ups are subject to federal oversight by the SEC, the Commission is not currently authorized to employ in its regulation of them the substantive approach used by the states to regulate the initial limited partnerships. Under federal securities laws, there must simply be full disclosure of the factors relevant to the invest-

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[6] In 1990, the NASAA committees responsible for limited partnership guidelines were combined into the Direct Participation Programs Committee. This structural change has in no way lessened the ongoing work in the various partnership areas.

ment in the public limited partnerships. The Commission's rules do not impose any suitability standards for particular investments by customers. Nor do the SEC rules prohibit conflicts of interest by insiders or contain any limitation on the amounts of commissions and compensation payable to the various parties of a partnership transaction.

Most importantly, SEC rules do not prevent the roll-up sponsors from entrenching themselves in almost absolute control of the new entity. In the end, the safeguards used to protect limited partners at the state level are erased in the roll-up process and are not in any way compensated for by the current minimal federal regulation of roll-ups.

NASAA commends the Commission for recognizing the abuses associated with the roll-up process and for its recent rulemaking initiatives in this area.[7] While the Association has not yet reviewed the rules in detail, we certainly would agree with the intent of the proposals—that is, more useful and understandable disclosure to limited partners and reform of the proxy rules. However, we would caution that these reforms will fall far short of what is needed to curb roll-up abuses if they are not coupled with more substantive protections for limited partners, including dissenters' rights, voting rights, limits on fees and commissions and independent fairness opinions.

THE NEED FOR FEDERAL REFORMS

Mr. Chairman and Members of the Subcommittee, due to the promulgation of the NASAA limited partnership guidelines, the Association's members have had more than 15 years experience in working together to protect the interests of limited partners. While we are proud of our accomplishments in his regard, we are dismayed and deeply concerned that the often abusive roll-up process has substantially undermined the important safeguards upon which limited partners have come to depend. Those of us at the state level continue to be strongly committed to using substantive standards to police and make as efficient and fair as possible the initial marketplace for limited partnerships. However, it is beyond our authority to also shoulder the job of protecting limited partners who get caught in the cross-fire of the roll-up process. As was demonstrated in our work with Congress on the virulent epidemic of penny stock fraud, NASAA and its members do not hesitate to call for a more effective state and federal sharing of the response to a truly national problem. Today, we are faced with another such problem. The wisdom of securities regulation in the United States is that it provides an active and important role for those of us at the grass-roots level to oversee risky and iliquid investments that otherwise would serve as the vehicle for the systematic abuse of small investors. For the federal government is largely reserved the role of coping with truly national and marketwide problems, including insider trading and mergers and acquisitions. To this list of national marketplace issues has been added the current roll-up crisis. No other problem area today in investing cries out so strongly and insistently for swift action on the part of Congress.

It should by now be evident that existing federal securities laws and regulations are unsuited to, and insufficient in the face of, the unique circumstances of roll-up contests. In attempting to apply rules and regulations governing corporate restructurings to limited partnership roll-ups, the SEC has been faced with the classic case of "trying to make a square peg fit in a round hole." No matter how many different ways one tries, and no matter how long one spends trying, eventually one learns that a square peg simply does not fit in a round hole. The current roll-up regulatory process was framed with traditional corporate restructurings in mind, where such factors as pre-existing securities, independent boards representing shareholders, the presence of institutional investors and the presumed existence of an efficient market, work to maintain a level-playing field between all parties involved. Clearly, limited partners facing a roll-up enjoy the benefit of no such circumstances. Therefore, it is both appropriate and essential that Congress direct the SEC to make the necessary adjustments to the federal rules and regulations governing the process.

Mr. Chairman and Members of the Subcommittee, NASAA is pleased to support the concept of dissenters' rights embodied in S. 1393. While the expertise of NASAA members is in the area of securities regulation and not tax policy, we fully agree with your statement upon introduction of the bill that "abusive partnership rollups continue because the core of the problem—dissenters' rights—has not been addressed."[8] If adopted, this reform will be a giant step in the direction of remedying

[7] See Securities and Exchange Commission Release Numbers 33-6899; 34-29313; 34-29315; 33-6900; and 34-29314.

[8] Statement of Senator Thomas Daschle, Congressional Record, June 26, 1991, p. S8751.

the pervasive investor abuses now present in the roll-up process and will help restore the eroded investor confidence in these markets.

CONCLUSION

Mr. Chairman and Members of the Subcommittee, it is NASAA's position that limited partners opposed to a roll-up should be afforded a reasonable opportunity to preserve or liquidate their original investment. "Cram-downs" in the wake of the slimmest majorities of "yes" votes in a roll-up have emerged as a major and often devastating abuse of small investors and should be prohibited or otherwise restricted, as provided for under S. 1393. Congress has compiled abundant documentation as to the abuses suffered by limited partners caught in the rising number of roll-ups. No other problem area today in investing cries out so strongly and insistently for swift action on the part of Congress.

Members of this Subcommittee might also be interested in learning that state securities agencies from around the country are now hard at work doing what they can to curb investor abuses in limited partnership roll-ups. Among the efforts now underway by state securities regulators are:

- Amendments to the existing NASAA limited partnership Guidelines which would for the registration of new limited partnership offerings put in place specific criteria, including dissenters' rights, in the event the partnership is rolled-up in the future; and
- Amendments to the existing NASAA Guidelines that would spell out specific criteria, based on the reforms considered by this Subcommittee and other Congressional panels, for the registration of roll-ups that do not list on national exchanges or NASDAQ and therefore are subject to state registration requirements.

While no one state acting on its own would be able to stop an abusive roll-up seeking registration, the states intend to use the successful multistate coordination model now in place for the registration of limited partnership offerings. Under such an approach, the states would band together to coordinate comments so that, acting in concert, abusive roll-ups would not be granted registration at the state level.

NASAA and its members do not hesitate to call for a more effective state and federal sharing of the response to a truly national problem. Today, we are faced with another such problem in roll-ups. Make no mistake about it: The roll-up problem has not gone away. It may have gone under cover, but as long as there are eight million partners who are a source of potential new revenue for general partners, and as long as there are no substantive protections for investors, there is a tremendous opportunity for fraud and abuse in the roll-up process.

State securities agencies are willing to do their part in working with the Congress, the SEC and the self-regulatory organizations, to end the current abuses. Such "teamwork," under which all the oars will be pulling together, represents the best hope for bringing an end to this systematic attack on small investors. In fact, it is fair to say that no other problem area today in investing cries out so strongly and insistently for action on the part of Congress. Accordingly, NASAA respectfully urges the swift adoption of federal roll-up reforms, including a strong package of dissenters' rights.

PREPARED STATEMENT OF ANNE PETROCCI

My name is Anne Petrocci. I am a 37 year old professional Architect from Midland Park, New Jersey, *and* basically an unsophisticated but willing investor. S. 1393 is important legislation which could go far to protect the potential victims of these partnership restructurings. Investors need Congress to help protect them from abusive practices. And to those who say the problem has been resolved, I am here to debunk the myth that lightening can not strike twice in the same spot. I was a victim of a recent roll-up (October, 1990) and may be again.

In October, 1990, The Hallwood Group rolled up my limited partnership in Equitec Capital Appreciation Fund (Fund 18) along with 7 other Equitec Partnerships into one Master Limited Partnership. This transaction resulted in huge gains for Hallwood and Equitec with equally huge losses to the limited partners. As an example, my original $4,000 investment was recently trading at $5.38/share for a net value of $451.92—an 89% loss. In the exchange, the Hallwood Group acquired substantially all of the equity interests in the consenting partnerships and indirect ownership by paying Equitec nearly 15 million dollars from our (the partnerships) *cash funds*. In effect Hallwood paid nothing out of their pocket and we, the limited partners, end up with an 89% loss. As unbelievable as this sounds, these are the

simple boiled down facts in this transaction. I and a few others fearful of this very result dared to speak out.

Branded an "activist" I was in fact only an investor attempting to find some answers. Hallwood spent nearly 10 million dollars of the investors' monies to craft, promote and sell the offering, yet not one dollar was spent to present the other side. When I started to dig for answers and communicate with fellow investors about my misgivings I was harassed by Dean Witter, threatened by Hallwood attorneys and even the Securities and Exchange Commission, an agency I thought was *my* advocate. Hallwood subpoenaed me to appear for questioning on a case I had nothing to do with so they could pump me for information about my personal activities and resistance to the roll-up. The S.E.C. suggested that they might press charges against me for violation of some S.E.C. laws. Collectively, their harassment cost me more than a thousand dollars in legal fees, phone calls, and other expenses—a considerable sum of money for a small investor like me.

I now understand that the S.E.C. has published some proposed regulations dealing with abusive roll-up practices. I understand these proposals address proxy reform and the readability of the documents that general partners send to their investors. While these efforts are on the right track, the train has stopped short of the station. Dissenting investors still can have the roll-up crammed down their throats without relief. Investors need protection that includes dissenters rights—something that leaves the limited partner with the basic terms and conditions of the original deal. After all that is the only agreed upon "agreement" that exists between the general partner and the limited partner.

S. 1393 addresses the issue by calling for a special surtax on general partners' fees if such a dissenters rights' provision is not in the roll-up agreement. Giving a fair deal to the limited partner is the only deal that should be given to a limited partner. The general partner is supposed to be a fiduciary agent. S. 1393 puts some teeth behind what is considered to be equitable treatment of investors.

My experiences with the Equitec roll-up were bad enough. Now in the last week I received another prospectus in the mail announcing, you guessed it, another reorganization of one of my limited partnerships. Lightening strikes again. Public Storage has just sent out notices announcing a new "opportunity." My first instinct is to ban the mailman from bringing anything that resembles a telephone book (the dreaded prospectus) to my address. My second thought, rather than banning the bearer of the message, is to ban roll-ups altogether.

I have heard it said that the marketplace will take care of abusive practices. Well, abuses go on. But, the harassment I endured is only a small part of the big picture. Hundreds of thousands of small investors are losing and losing big. Not only in their pockets, but more poignantly, in their loss of faith—faith in the financial institutions of this country, Wall Street, the S.E.C., and our brokers and advisors. So often we feel cheated and let down by the System. Many have told me they will never invest again. For them, this is the ultimate failure in the morality of the financial world . . . From the S&Ls to Milikens and now this, the small investor is disgusted and discouraged. Something has to be done to restore the small investors' faith in the System, to protect us from these aggressive, all powerful companies.

In my entire life I never expected that this July I would be revisited by another prospectus like I received last July. Potential abuses loom ahead for all limited partnership investors until federal legislation is passed that specifically prohibits the egregious behavior. The message has to be that a good deal for the general partner is not good enough. It has to be as good a deal for the limited partner.

I hope that S. 1393 addresses the type of restructuring that Public Storage has proposed, a conversion from a limited partnership into a real estate investment trust. Simply when a general partner wants to change the deal, the limited partner should have the option of keeping the original deal. If other limited partners in the group wish to change the terms than let them, but not require them for everybody. Seniors should not have their assets wrenched from them—taking a finite life investment in which they never see the assets sold and the profits returned to them. People should not get investments crammed down their throat, such as turning an all cash deal into a high leverage, high risk investment strategy as some roll-ups have done. It is not right and it should be stopped. S. 1393 works to correct the problem.

I urge that this legislation be moved quickly and make it retroactive. In fact investors should have the opportunity to vote on the life of the investment on a separate vote. Let me remind the general partners after all, it is the investors' money. Thank you for this opportunity to testify.

PREPARED STATEMENT OF MICHAEL B. POLLACK

The Investment Program Association ("IPA") is pleased to participate in this hearing on partnership reorganization reform. As we have stated at previous hearings on this topic, there are ways to improve the reorganization of partnerships while at the same time provide sufficient flexibility both for investors who support a reorganization and general partners who strive to preserve the value of the assets owned by the partnership. The IPA represents the sponsors and distributors of partnerships and other investments and is in a unique position to present the views of those organizations with the responsibility for operating these investments. Additionally, the IPA can offer its expertise on how legislation is likely to affect these investments and investors. The IPA welcomes this hearing as an opportunity to discuss the appropriate scope of Federal legislation in the rollup area.

The IPA and its members share the concerns of members of Congress, the SEC, the NASD, investors and others regarding specific abuses surrounding partnership rollup transactions and is anxious to see those abusive practices stopped. At the same time, the IPA is concerned that in many respects, the proposed legislation (S. 1393) is an inappropriate response to the real concerns which need to be addressed in connection with these transactions: the fairness of the solicitation process and the ability of the majority of investors in any partnership to direct the future course of the enterprise.

The debate surrounding rollups has been filled with the rhetoric normally associated with economic issues. Unfortunately, this rhetoric has obscured some of the facts and has created an environment for reform that no longer relates to the real problems affecting investors in rollups. One common misconception about rollups is that the rollup process itself causes a diminution in the value of a partnership. Some proponents of rollup legislation offer data on the reduction in the price of shares after the first day of trading of a rolled up entity as evidence of this diminution of value. These proponents then conclude that it was the rollup that caused this diminution in value without offering any direct evidence of the cause and effect. The fact is that in many cases there has not been a diminution in value because of the rollup; the diminution in value has been caused by an erosion in the value of the assets held by the partnerships over the period of time prior to the rollup. The rollup has not caused the erosion, it has only caused a recognition of its extent. The real estate market is suffering from a severe depression and property values have plummeted across the country. This depression has been caused in part by the over building encouraged by the tax laws of the early 1980's. For partnerships which own real estate, it is almost certain that the value of their equity has decreased and in some cases their equity has vanished. The owners of real estate assets have, in some cases, seen the value of their investments wiped out not necessarily because of rollup transactions but because of this real estate depression.

The "Exchange Value" disclosed in the prospectus is often used as the basis for determining the extent of the "losses" caused by the rollup. As the prospectus for a rollup transaction indicates, the "Exchange Value" is used not to determine the market value of an investor's interest in the partnership, but as a method for allocating shares of the new entity among the limited partners of the combined entities. In fact, many investors, some of whom have been the most active supporters of the rollup legislation, purchased their interests in these partnerships at prices significantly below the "Exchange Value" in recognition of the fact that the value of the assets had deteriorated. It is clear that to the extent value has been lost, it was usually lost prior to the rollup.

Since last October when the first rollup hearing was conducted, Congress has provided a service to investors and the partnership industry by raising the public awareness of the problems connected with rollups. As a result, the NASD has proposed rules regarding differential compensation in connection with the solicitation of consents and has proposed NASDAQ listing standards for partnerships. Additionally, the SEC has proposed new disclosure requirements for rollup transactions and has issued an Interpretative Release relating to the disclosure in the original partnership offering documents of the risks associated with potential rollup transactions and the rights of investors in such transactions. The SEC has also proposed new rules relating to the proxy process that would make the process fairer for those who might oppose a rollup. In addition, the IPA has been working with the national securities exchanges to obtain specific listing standards for entities that result from rollup transactions.

The IPA has maintained throughout the rollup debate that legislation should not make these transactions impossible and that any legislation or regulation should not disadvantage the majority of limited partners who approve a transaction. If the

majority of limited partners in any limited partnership is to be relied upon to determine the future course of a limited partnership, Federal legislation must ensure that the majority was not created through the use of coercive solicitation tactics. It is essential that there be no economic incentive to influence the outcome of a partnership vote.

Therefore, the IPA supports the provision of H.R. 1885 and S. 1423, The Limited Partnership Rollup Reform Act and the NASD's proposed rule regarding the prohibition on the payment of differential compensation to member firms that solicit votes in rollup transactions. The IPA also supports the requirement that rollup disclosure be clear, concise and readable by limited partners. When limited partners have a document they understand and their registered representatives or financial planners no longer have incentives to influence their votes, limited partners will be in a position to make an informed decision and select the course of action they believe is in their best interests.

Another element of proposed legislation relating to rollups is the prevention of general partners converting equity interests subject to the achievement of certain performance thresholds into current equity interests based on inflated valuations. In most cases, the real harm done to limited partners through the use of exchange values in rollup transactions is that some sponsors have used these exchange values to establish that they have satisfied certain performance thresholds. If these general partners had used the trading value of shares after the rollup, those performance thresholds would not have been achieved. Therefore, the IPA believes that there should be no accelerated payment of performance fees unless such acceleration is tied to the trading price of the shares (or some other appropriate performance measure), not the exchange value.

Once the solicitation playing field is level and general partners cannot unreasonably accelerate the payment of fees, limited partners, after reviewing an understandable prospectus, would have an opportunity to render a judgment as to whether they should accept any given rollup proposal made by a general partner. To the extent a general partner's voting interest or fees increase, a limited partner would have the opportunity to evaluate whether the cost is worth the potential benefit. In the end, if a majority of the limited partners approve the transaction, the transaction should be completed.

The IPA has also supported the concept of providing dissenters rights in reorganization transactions. The IPA believes it is essential, however, that the partnership be given the flexibility to design dissenters rights in a way that provides the partnership a reasonable opportunity to succeed after the rollup. The cash flow of any given entity may make it impossible to give all dissenters the full value of their units in cash or notes, even if only 10% or 20% of the limited partners dissent. The approach of S. 1393, the imposition of an excise tax on general partners for amounts received in rollup transactions that do not offer dissenter's rights, will likely make it impossible to complete a rollup even if it would be an appropriate transaction supported by the majority of limited partners. Many troubled partnerships will not have the financial ability to pay dissenter's rights to the extent required by the bill. Moreover, it is sometimes virtually impossible to properly value assets held by a partnership for purposes of paying a partner his or her allocable share of such value. The appraisals performed in connection with most rollups determine relative values, a much easier task than determining absolute values.

Furthermore, imposing a 50% tax on general partners for services provided to an entity resulting from a rollup, even if there is no change in the compensation as a result of the rollup, is blatantly unfair. The general partner must continue to provide services to the new entity and should not be forced to do so for half the fee it previously received even if the new entity resulted from the approval of a majority of limited partners.

Under state law a general partner has a fiduciary duty to the limited partners. A general partner must evaluate each decision it makes in connection with the operation of the partnership in light of this duty. Because it is almost impossible to make a decision that benefits all limited partners equally, a general partner must make a determination of the effect of each decision on the majority of limited partners. When major decisions must be made, as in whether or not to reorganize a partnership, limited partners are asked to vote on the proposal and the majority determines the future course of the partnership. If a general partner, in fulfilling its fiduciary duty, believes that a reorganization is the best business decision to maximize the value of partnership assets, the general partner should not be subject to a 50% tax if the transaction is approved by a majority of the limited partners (thereby validating the general partner's decision) but cannot be designed in a way to satisfy the requirements of S. 1393. This could put the general partner in an impossible

situation by either preventing the general partner from fulfilling its fiduciary duty under state law or doing so at an exorbitant cost.

Legislation is under consideration in the House (H.R. 1885) and Senate (S. 1423) that addresses the broad range of issues relating to partnership reorganizations. Furthermore, the SEC and the self-regulatory organizations have already made proposals addressing many of the problems associated with these transactions. Tax legislation is not appropriate in this context nor will it solve the problems already discussed.

One way in which tax legislation can affect the rollup process would be for the Congress to pass S. 1394, (H.R. 2777) The Tax Simplification Act of 1991. An important reason rollups are initiated is to simplify the tax reporting requirements of the limited partners by converting the partnership to a real estate investment trust. The tax results of REITs are reported to investors on a form 1099 while limited partners receive a much more complicated K-1. The Tax Simplification Act would allow partnerships to report tax results to limited partners on a much more simple form. By passing this legislation, Congress would simplify the tax reporting for large limited partnerships and their partners and thereby eliminate one of the reasons rollups are initiated. This would be the most positive contribution this subcommittee could make to the rollup reform process.

Reorganization must be preserved as a viable option for the maximization of the value of partnership assets. The process by which votes are solicited is being improved and the rights of dissenters must also be protected without unduly damaging the rights of the majority of partners who support a restructuring. Much of this necessary work has already been done by the SEC and the NASD and they are well ahead of legislation with the proposals they have already made. This work should be allowed to continue. S. 1393 will unduly impair the ability to restructure partnerships without addressing many of the problems associated with the rollup process. The direct effect of S. 1393 will be to lock investors into underperforming securities

PREPARED STATEMENT OF ROBERT A. STANGER

Let's look at capital formation. During the decade of the 1980's more capital was raised through the initial public offering of partnership securities than through the initial public offering of common stock. Gradually, through changes in the tax law, some of the attractiveness of partnerships has been removed at a time when the economic results of partnership investing have been mediocre to poor. The combination of the two factors has cut the issuance of SEC filed initial public offerings of partnership securities from $13 billion in 1987 to less than $2 billion according to my company's estimate of 1991's partnership securities sales. Capital formation is an issue which policy makers such as yourselves need to address because there is a national need for capital formation but the issue has no voter constituency.

By restricting the flexibility to merge, consolidate or restructure you make the partnership form of organization, and hence partnership securities, less valuable. In our view many general partners are not adequately capitalized and are not managing the assets under their control well and in my view market forces would naturally bring about some rationalization of the situation though friendly and hostile mergers, tenders and reorganizations. Legal impediments will reduce such activity to the long term detriment of partnership investors.

To the extent the legislation forces partnerships to remain as single entities you also force partnership investors to operate in the so-called "secondary market" if they want liquidity. Let me give you a snap shot of that market. Of the 3500 partnerships currently filing 10-K and 10-Qs with the SEC we estimate that only about 400 trade in any one year. Many don't even trade once in a calendar quarter. The total volume of trading annually is about $250 million whereas outstanding publicly registered partnership securities at original cost represent an investment of roughly $82 billion. The turnover in the so-called secondary market for partnership securities is ⅓ of 1% per year which contrasts to a turnover 100 times greater for securities traded on the NYSE.

Our sense as analysts is that about one-third of partnership securities involved in real estate are in good shape, defined as currently paying 6% or more on original investment. About one-third is in bad shape paying no cash currently to investors. (The bell curve distribution of investment performance by the way is about the same in partnerships as you'll find looking at mutual funds. 20% to 30% of mutual funds keep up with the S&P 500, 20% to 30% lag way behind and the rest are in the middle.)

I believe that assets should be grouped in larger entities than individual partnerships and that investors are best served if the process is allowed to take it's natural course. The roll-up is not the cause of the loss in the portfolio nor the most pressing current problem but is the solution in many cases.

Attachment.

ROBERT A. STANGER & CO.,
Shrewbury, NJ, July 24, 1991.

Senator THOMAS A. DASCHLE,
U.S. Senate

Dear Senator Daschle: I have enclosed a copy of my remarks before your subcommittee and an analysis of the pre and post roll up prices of Damson partnership securities. The bottom line—depending on which Damson partnership you owned, the value of your security (plus cash you received at the time of the exchange) is up 249% to 421% versus pre roll up. The result is also confirmed in written testimony of the S.E.C. submitted to the Marked subcommittee.

Let me add this result is unusual, but clearly proves the point it's not the roll up per se that's at fault.

Sincerely,

ROBERT A. STANGER.

Encl.

ANALYSIS—THE EFFECT OF THE PARKER & PARSLEY EXCHANGE & ACQUISITION ON THE DAMSON PARTNERSHIPS' PRICES

CLOSING TRADE PRICES 6/1/90 - 2/19/91 & PRORATED PRICES 2/20/91 - 3/28/91

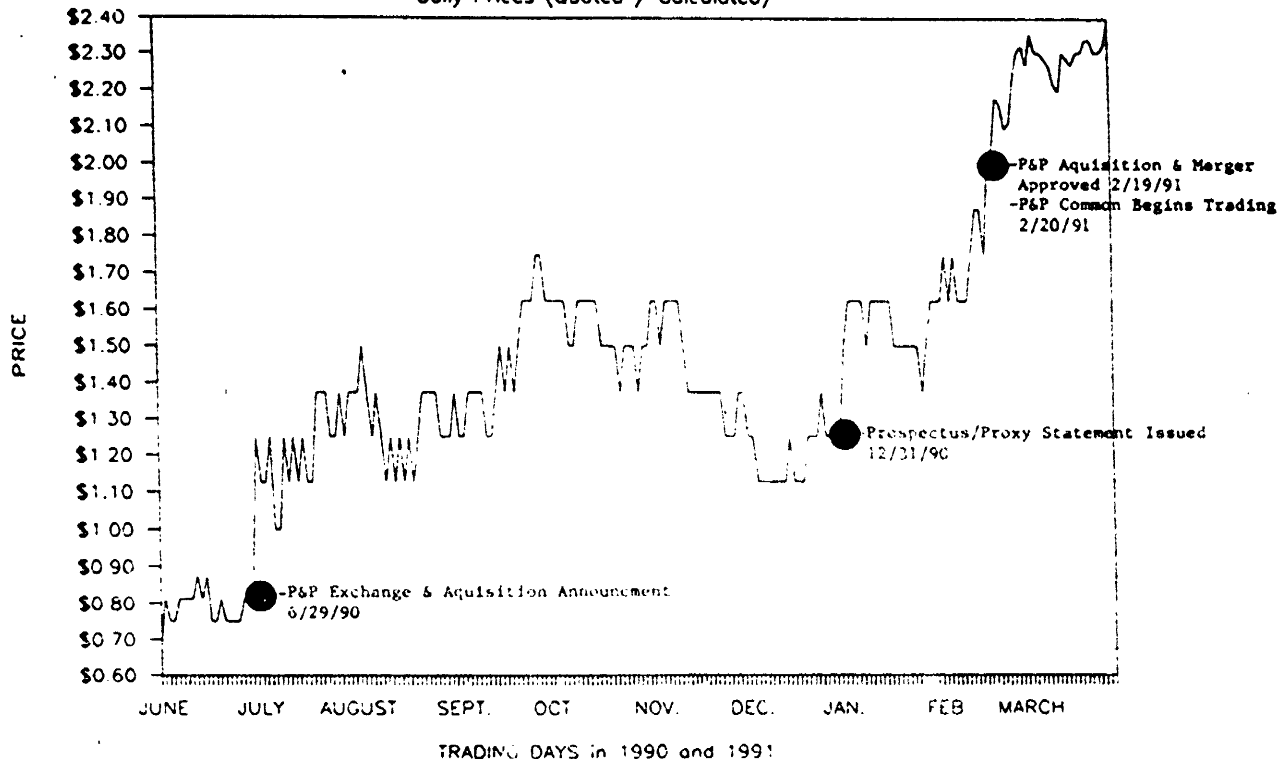
	DAY	DEP.A Price	DEP.A % Inc.	DEP.B Price	DEP.B % Inc.	IPX Price	IPX % Inc.	IPY Price	IPY % Inc.	PDP Price
1990 JUNE	1	$0.6875	--	$0.6875	--	$2.6875	--	$2.7500	--	
P&P Exchange & Aquisition Announcement	29	0.8125	118.2%	0.8125	118.2%	2.6875	100.0%	2.7500	100.0%	
1990 JULY	2	1.2500	181.8%	1.3750	200.0%	2.8750	107.0%	2.8750	104.5%	
Prospectus/Proxy Statement Issued	31	1.2500	181.8%	1.5000	218.2%	4.4375	165.1%	4.6875	170.5%	
1991 FEB.	1	1.6250	236.4%	2.0000	290.9%	4.3125	160.5%	4.9375	179.5%	
P&P Exchange & Aquisition Approved	19	2.0000	290.9%	2.3750	345.5%	4.6875	174.4%	5.3125	193.2%	
P&P Common Begins Trading FEB.	20	2.0402	296.8%	2.4811	360.9%	5.7449	213.8%	6.5896	239.6%	$9.1250
1991 MARCH	1	2.3208	337.6%	2.8123	409.1%	6.5131	242.3%	7.4706	271.7%	11.1250
	28	2.3910	347.8%	2.8951	421.1%	6.7052	249.5%	7.6908	279.7%	11.6250

NOTES:

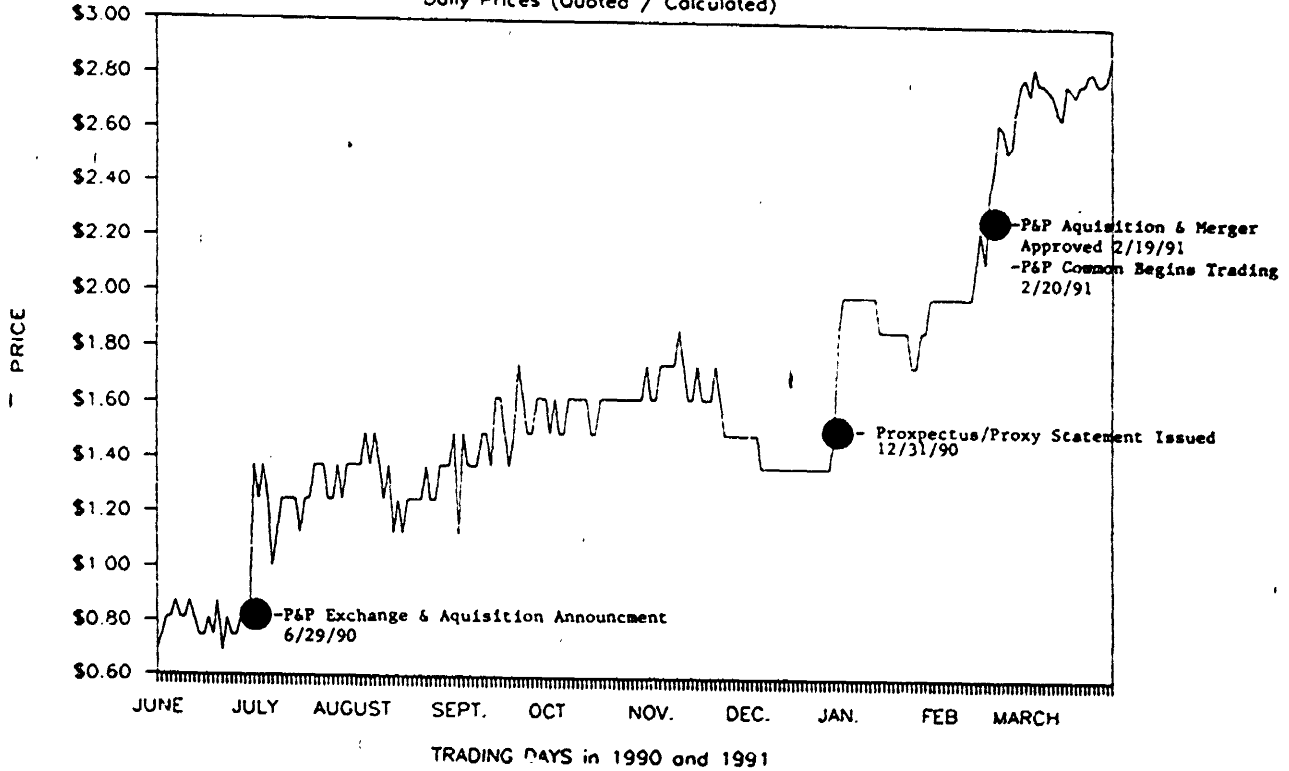
1.) The Damson Partnerships ceased trading after 2/19/91. Starting on 2/20/91 Damson Partnerships' prices represent the PDP common stock price times the share exchange amount plus the liquidating cash distribution for each partnership as indicated in the table below:

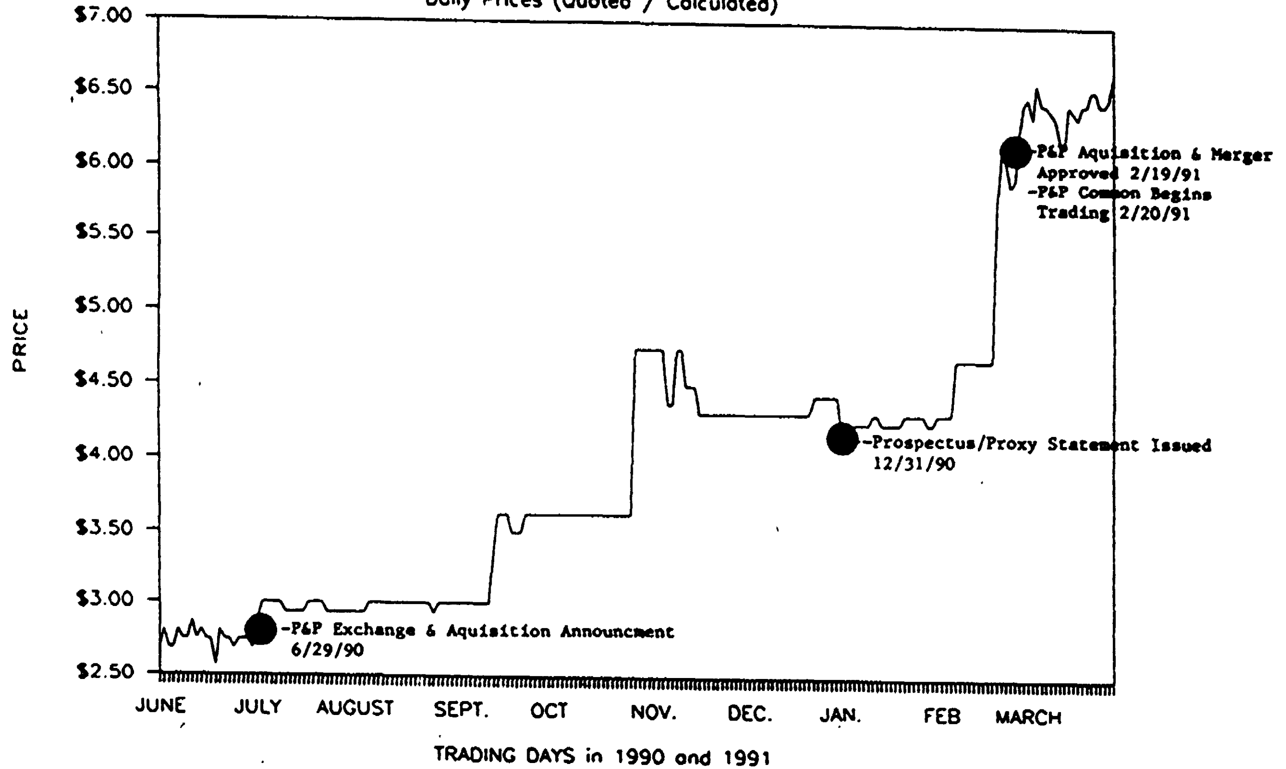
	SHARES	CASH
DEP.A	0.1403 sh	$0.7600
DEP.B	0.1656 sh	0.9700
IPX	0.3841 sh	2.2400
IPY	0.4405 sh	2.5700

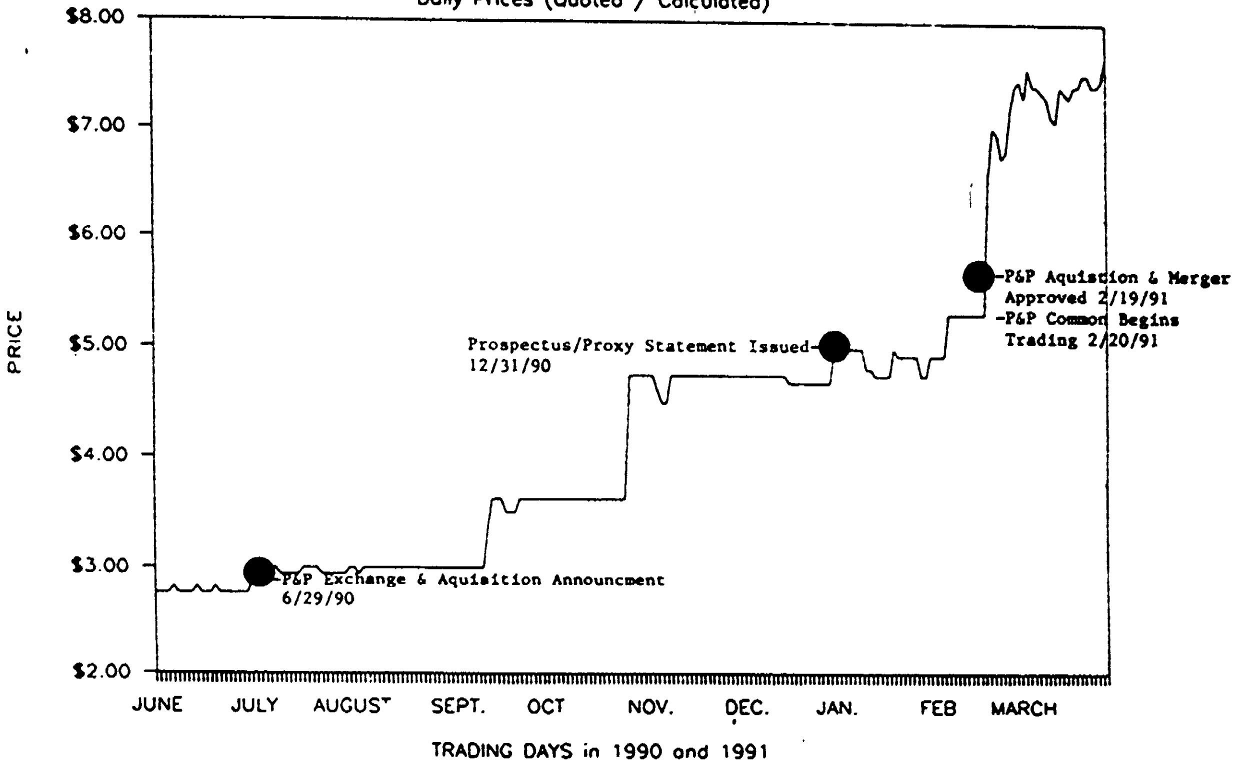
2.) % Chgd reflects the increase in each Damson Partnerships' daily price using the June 1 price as the comparative.



DAMSON ENERGY A, L.P.
Daily Prices (Quoted / Calculated)
PRICE
$2.40
$2.30
$2.20
$2.10
$2.00
$1.90
$1.80
$1.70
$1.60
$1.50
$1.40
$1 30
$1 20
$1.10
$1 00
$0 90
$0 80
$0 70
$0.60
-P&P Exchange & Aquisition Announcement
6/29/90
Prospectus/Proxy Statement Issued
12/31/90
-P&P Aquisition & Merger
Approved 2/19/91
-P&P Common Begins Trading
2/20/91
JUNE
JULY
AUGUST
SEPT.
OCT
NOV.
DEC.
JAN.
FEB
MARCH
TRADING DAYS in 1990 and 1991


DAMSON ENERGY B, L.P.
Daily Prices (Quoted / Calculated)
PRICE
$3.00
$2.80
$2.60
$2.40
$2.20
$2.00
$1.80
$1.60
$1.40
$1.20
$1.00
$0.80
$0.60
JUNE
JULY
AUGUST
SEPT.
OCT
NOV.
DEC.
JAN.
FEB
MARCH
TRADING DAYS in 1990 and 1991
-P&P Exchange & Aquisition Announcment 6/29/90
- Proxpectus/Proxy Statement Issued 12/31/90
-P&P Aquisition & Merger Approved 2/19/91
-P&P Common Begins Trading 2/20/91


DAMSON INSTITUTIONAL ENERGY LP
Daily Prices (Quoted / Calculated)
PRICE
$7.00
$6.50
$6.00
$5.50
$5.00
$4.50
$4.00
$3.50
$3.00
$2.50
-P&P Aquisition & Merger
Approved 2/19/91
-P&P Common Begins
Trading 2/20/91
-Prospectus/Proxy Statement Issued
12/31/90
-P&P Exchange & Aquisition Announcment
6/29/90
JUNE
JULY
AUGUST
SEPT.
OCT
NOV.
DEC.
JAN.
FEB
MARCH
TRADING DAYS in 1990 and 1991


DAMSON INCOME ENERGY LP
Daily Prices (Quoted / Calculated)
$8.00
$7.00
$6.00
$5.00
$4.00
$3.00
$2.00
PRICE
-P&P Aquistion & Merger
Approved 2/19/91
-P&P Common Begins
Trading 2/20/91
Prospectus/Proxy Statement Issued-
12/31/90
-P&P Exchange & Aquisition Announcment
6/29/90
JUNE
JULY
AUGUST
SEPT.
OCT
NOV.
DEC.
JAN.
FEB
MARCH
TRADING DAYS in 1990 and 1991

Prepared Statement of Frank J. Wilson

I am Frank J. Wilson, Executive Vice President, Law and Regulatory Policy and General Counsel of the National Association of Securities Dealers, Inc. (NASD). The NASD is pleased to have this opportunity to appear before you today to discuss limited partnership reorganizations, referred to as "roll ups."

I. THE NASD

The NASD is registered with the Securities and Exchange Commission (SEC) as a national securities association under the Securities Exchange Act of 1934. The NASD is the only association so registered. It is a regulator and a market operator. As a market operator it runs the National Association of Securities Dealers Automated Quotation System, or NASDAQ Stock Market, which is the second largest securities market in the United States and the fifth largest in the world. As a regulator it is charged with the responsibility of regulating both NASDAQ and the over-the-counter securities markets. This task encompasses both regulation of NASD member broker-dealer firms and the regulation and operation of the NASDAQ system as well as, within the scope of the pertinent securities acts, the municipal and government securities markets.

The NASD has 5,600 broker-dealer members employing 411,000 registered sales persons and principals. Some 4,600 securities issued by 4,100 companies are quoted on the NASDAQ Stock Market and 417 NASD members serve as market makers in those securities.

The scope of the NASD's regulatory jurisdiction extends to all such members and their associated persons. While the 2,300 staff of the SEC and the roughly half that number of state securities regulatory staff must deal with all aspects of securities regulation, the 1,940 staff of the NASD focuses on regulation of its members and the operation of its stock market, which is only a segment of Federal and state regulation. Through close cooperation with Federal and state regulators, overlap and duplication is minimized, freeing governmental resources for securities regulation to be focused on other areas.

The NASD carries out its examination, disciplinary, and other regulatory responsibilities through its Washington headquarters and 14 offices located in major cities throughout the country. In addition to disciplinary committees that work with each District Office, the NASD has a national Market Surveillance Committee that deals specifically with market and trading related issues. A committee of the NASD Board of Governors, the National Business Conduct Committee, reviews as an appellate body the disciplinary activities of the District Business Conduct Committees and the Market Surveillance Committee, and seeks, to the extent possible, uniformity in disciplinary actions. Final NASD disciplinary actions can be appealed to the SEC and then to the United States Courts of Appeals.

The NASD is governed by a 30 member Board of Governors drawn from its membership, leaders of industry and academia, executives of NASDAQ companies, and the public. The Board, through a series of standing and select committees, monitors trends in the industry and promulgates rules, guidelines, and policies that it deems necessary to protect investors and the markets.

The NASDAQ stock market is a highly visible screen-based market with intense competition between market makers. Their bid and offer quotations are continuously displayed over thousands of subscriber terminals, with real-time transaction reports for all NASDAQ/National Market System stocks. Ownership and participation by investors in the NASDAQ market is broad and diverse. Individual investors own approximately two-thirds of the market value of NASDAQ stocks. Institutional investors are also very active in NASDAQ—and are becoming a growing part of our market—but individual participation is paramount, thus the NASD is concerned with the perceptions of individual investors about today's markets. Investor protection is the cornerstone of the NASD's regulatory and enforcement efforts.

One of the standing committees of the Board, the Direct Participation Programs/Real Estate Committee (DPP Committee), is currently considering the abuses that exist when general partners roll up existing partnerships into master limited partnerships, real estate investment trusts (REITs) and corporate entities that trade on organized markets. Any action that this committee believes should be taken to regulate these abuses is referred to the Board of Governors for final NASD action.

II. CHARACTERISTICS OF LIMITED PARTNERSHIP ROLL UPS

Limited partnerships, sometimes called direct participation programs because of the flow-through of tax benefits directly to investors, are entities that consist of a general partner or sponsor, who manages the project, and limited partners, who

invest money but have limited liability—so they cannot lose more than their capital contributions—and are not involved in the day to day management of the project. Limited partners usually receive income, capital gains and tax benefits and have a priority on the profits derived from asset sales of the project. The general partner is usually a knowledgeable individual who puts up some of the money for the project, receives a share of the profits after the limited partners have received profits, and accepts liability for losses in excess of partnership capital.

The general partner has a subordinated interest to the limited partners in the proceeds generated from the sale of assets. Limited partnerships invest in real estate, oil and gas, and equipment leasing, but they can also finance research and development, movies, and other projects, and generally are attractive because they flow profits through the partnership to limited partners without taxation at the partnership level. Typically, public limited partnerships are sold through brokerage firms for minimum investments of $2 to 5 thousand, with a typical investment of less than $10 thousand.

Although roll ups are very complex, they can basically be described as transactions in which a number of limited partnerships are combined or reorganized into a single entity that will trade publicly.

A. Purpose of Reorganization

The purpose of these reorganizations, according to the general partners that propose them, is to reduce expenses by taking advantage of economies of scale in management and to provide liquidity to the limited partners by listing on an organized securities market. Sponsors that have a number of partnerships, each of which had typically proposed to liquidate in 7-10 years, find it difficult to liquidate the partnership portfolios at a price that would be advantageous to the investors. As an alternative to liquidating the portfolio and distributing the proceeds to investors, they determine to provide liquidity by rolling up the partnerships into one publicly-traded instrument, thereby allowing investors the opportunity to sell their interests. After the roll up, the administrative and management functions of each partnership can be centralized, which ostensibly reduces costs.

B. Advantages and Disadvantages of Combining Independent Non-traded Limited Partnerships into a New Publicly-traded Entity

The principal advantage touted by those that propose roll ups is liquidity, since sponsors and general partners assert that limited partners desire a way to liquidate their investments. The principal disadvantage is that such liquidity is only available at a heavily discounted price. Other disadvantages include: dilution of good properties by rolling them up them with the bad, the change from finite to infinite life so that liquidation proceeds are not required to be distributed to limited partners, change in fee structure that very often results in increased fees for the general partners, and the accelerated interest of the general partner from a subordinated interest to an equity interest.

C. Reorganization's Impact on Limited Partners

The most dramatic impact on limited partners seems to be the deep discount in the publicly traded market for their securities. The value of the interests in publicly-traded entities resulting from roll ups have, in virtually all cases, traded down from the exchange value. It is not unusual for the securities to trade down 40% in the first 30 days of trading.

Other impacts include the fees paid by the partnerships to professionals such as lawyers, accountants, and financial advisers, which further reduces the value of the partnership securities in the after-market.

Further, in the original partnerships, the general partner's compensation is based on front end fees received directly from the offering proceeds, a portion of cash available for distribution received on an ongoing basis during the life of the partnership, and a share of profits achieved after the sale of assets. Since the general partner's share of the cash available for distribution is expressed as a percentage of distributions to limited partners, cash flow must remain constant or increase in order for the general partner's compensation to remain steady. Given the current economic climate, particularly in real estate, a general partner's compensation from cash available for distribution has fallen off substantially. After the roll up, the compensation is often based on the amount of assets under management. Thus, rather than relying on cash flow the general partner is paid on the basis of assets under management; the entity does not have to be profitable ever again for the general partner to be paid.

Finally, by combining the revenue streams of good and bad partnerships into a new entity, a roll up tends to dilute the return of limited partners whose partner-

ships are performing well. The good partnerships offset the performance of the bad partnerships, thus reducing general partner liability for non-performing properties while permitting the general partner to receive an asset-based fee that ensures the general partner a healthy income stream. Limited partners of the good partnerships are thus harmed.

D. Potential Conflicts of Interest When General Partners Pursue a Roll Up

Roll ups present an inherent conflict in that the general partners have a fiduciary responsibility to act in the interests of their limited partners, while the general partners are also structuring the terms of the roll ups to favor themselves. These are not arm's length transactions. Under general partnership law, the general partner has a fiduciary duty to act in the best interests of the limited partners. The limited partners must trust and rely upon the general partner's good faith in managing the assets of the partnership since a limited partner, by definition, may have no direct management or decision-making responsibility.

III. ADEQUACY OF THE CURRENT REGULATORY TREATMENT OF ROLL UPS

The SEC is responsible for reviewing the accuracy and adequacy of the disclosure in documents provided to investors in connection with a proposed roll up. Such disclosure is both exhaustive and exhausting to read, lengthy, weighty and not easy to understand. The documents do not usually contain an easy to understand summary of the advantages and disadvantages of the transaction, or of the trading history of these issues. Disclosure of NASD members' roles in the transaction is provided, as well as the potential for a conflict of interest in receiving compensation for securing only "yes" votes.

The SEC is also responsible for compliance with the proxy rules. The problem with the proxy rules is that if a dissenting limited partner wants to advise other limited partners of the disadvantages of the transaction, he or she cannot communicate with more than ten other investors because the communication in and of itself would require a proxy filing. The comment letters we received on our differential compensation proposal, which will be covered shortly, state that NASD members are unsure as to what they are permitted to do in contacting and making recommendations to their clients.

Most state securities commissions do not directly regulate roll ups since a "blue sky" exemption from state securities registration is available for securities listed or to be listed on an exchange. Therefore, the protections for investors afforded by state review is not available to participants in roll ups.

IV. REGULATORY PROPOSALS

In May, 1991 the NASD Board of Governors approved amendments to the NASD's Rules of Fair Practice that would prohibit NASD members from receiving compensation for soliciting votes or tenders from limited partners in connection with rollups of direct participation programs unless such compensation is paid regardless of whether the limited partner investor votes "yes" or "no" for the transaction. In addition, the total amount of solicitation compensation would not be permitted to exceed two percent of the exchange value of the newly-created securities and such compensation would be required to be paid regardless of whether the limited partners accept or reject the proposed rollup. Further, NASD members would be prohibited from participating in a rollup unless the general partner or sponsor proposing the rollup agrees to pay all solicitation expenses related to the rollup, including all preparatory work related thereto, in the event the rollup is not approved.

The purpose of the NASD amendments is to eliminate any conflict of interest, or the appearance of any conflict of interest, that may be present when NASD members soliciting limited partners in a rollup receive compensation only when the investor votes "yes" to the transaction. The result of the NASD's action is that if the general partner or sponsor is facing the responsibility for paying the costs of the solicitation if it is not successful, and is required to pay compensation for any vote solicited by an NASD member, a strong incentive is created for general partners to structure and propose rollup transactions that are fair to limited partners and which can be endorsed by NASD members soliciting votes.

The NASD has filed the proposed amendments for SEC approval and the SEC has published the amendments for public comment. The public comment period has just ended and the NASD is anticipating that the SEC will approve the amendments promptly.

In response to concerns of NASD members and other interested parties, the NASD has established a special Rollup Subcommittee which has been directed to consider additional regulation of limited partnership rollup transactions. Specifical-

ly, the Subcommittee has been directed to consider recommending additional regulation on NASD members' participation in public rollup transactions if any of the following concerns are present:

- Lack of dissenter's rights and other protections for limited partners;
- Installation of supermajority voting rights or other diminutions of limited partners rights;
- Unfair allocations of transaction costs to limited partners; and
- Unfair changes in general partner fee structures.

The work of the Subcommittee is not yet complete but it is anticipated that the Subcommittee will recommend amendments to NASD rules that would deal specifically with these subjects .

The SEC has also acted affirmatively in responding to the abuses present in rollup transactions. It has first and foremost issued an interpretive release on existing disclosure requirements applicable to limited partnership rollup transactions that will insure that investors are provided with clear, concise and understandable disclosure of material information about the transactions. The interpretive release addresses the application of current requirements to rollups and is intended to improve the overall quality and readability of disclosure documents used in rollup transactions. Since this release is an interpretation of existing rules its provisions are immediately applicable.

In addition to interpreting present rules, the SEC has published for comment proposed rules to further enhance the quality and readability of information provided to investors in connection with limited partnership rollup transactions. The proposed rules would heighten disclosure requirements with respect to conflicts of interest and fairness of a rollup transaction, and would mandate enhanced disclosure regarding the general partner's reasons for proposing the rollup, alternatives to the rollup considered by the general partner, and appraisal methods used to determine the value of the assets subject to the rollup. Information relating to securityholders appraisal and dissenter's rights, changes in voting rights and rights to a list of limited partners would be required as well. In order to provide investors in individual partnerships subject to the rollup with all of the effects and risks of the transaction, the proposed rules would also require delivery of individual partnership prospectus supplements that would set forth partnership specific information to assist individual investors in their evaluation of the proposed transaction.

Finally, but no less significantly, the SEC has issued a release requesting comments on amendments to its proxy rules under Section 14(a) of the Securities Exchange Act of 1934 that would facilitate securityholder communications among participants in rollup transactions. Modernization of the proxy rules as proposed by the SEC will provide valuable protections to limited partners who find themselves subject to rollup transactions.

The NASD believes that the combined effect of the regulatory initiatives of both the NASD and the SEC will have a significant impact on the fairness of rollup transactions from an investor's point of view, and will prevent the continuation or repetition of abuses that were present in early rollups.

V. LEGISLATIVE PROPOSALS

S. 1393 would deal with the roll up problem by imposing a tax on certain persons receiving payments as a result of a "prohibited roll up transaction." A prohibited roll up transaction is generally one where limited partners who dissent to the transaction are not afforded the right to redeem their security for cash, marketable securities or promissory notes or the right to receive securities which have substantially the same value, rights, powers and privileges.

Our specific concerns with respect to S. 1393 is that it may be difficult to provide a financial remedy without damaging the financial viability of the partnership. While it might seem inherently fair to provide dissenters with a redemption right for compensation, it should be noted that the partnership may not have the resources necessary to redeem dissenter's interests or it may force the partnership to liquidate properties at an inappropriate time. Providing rights to dissenters should not negatively impact the majority of limited partners.

We would note in this respect that S. 1423 and H.R. 1885 both titled the "Limited Partnership Rollup Reform Act of 1991" provide for dissenters rights with more flexibility than S.1393. These bills provide dissenters with the right of an appraisal and compensation or a security under the same terms and conditions as the original security and further provide that if the NASD finds that the granting of such rights would be impractical or not in the financial interest of the dissenting limited part-

ners then other comparable rights may be offered. Other comparable rights will be the subject of rulemaking by the NASD.

As a general matter, in light of the SEC's proposed rulemaking, the NASD's proposed rulemaking as well as the legislative actions pending in both the House and Senate, we question whether S. 1393 is necessary. We believe that the roll up problems are regulatory in nature and are being addressed in the regulatory proposals by the SEC and NASD. We do not believe it necessary to indirectly deal with this regulatory problem by amending the tax code. We would recommend that action on S. 1393 be deferred pending the results of the regulatory proposals.

[SUBMITTED BY RICHARD G. WOLLACK]

LIQUIDITY FUND

MANAGEMENT, INCORPORATED

<u>VIA FACSIMILE</u>

July 30, 1991

Senator Thomas Daschle
United States Senate
317 Hart Building
Washington, D.C. 20510

RE: Response to Stanger Letter of July 24
Related to Hearing Record for S1393

Dear Senator Daschle:

In the fourth panel of your hearing on partnership roll-ups, Mr. Robert Stanger and I discussed the relative merits and abuses of limited partnership roll-ups and the role your legislation would play in curbing abuses. During the course of that testimony Mr. Stanger made a comment that the roll-up you were involved in--Damson/Parker & Parsley--had, in fact, performed very well and used it as evidence to attempt to come up with a first example of a roll-up that had performed well for investors. He then offered, and you accepted, to provide an analysis of the same to prove that it had been a good transaction. I later indicated that I would like an opportunity to comment on his analysis because I believed it would likely need some "clarification."

Now that I have reviewed his analysis, which accompanies his July 24th letter to you, I can only say that, indeed, a major clarification is needed.

<u>Simply, what the record should show is that Mr. Stanger's analysis is totally irrelevant</u>. Let me explain. Your legislation specifically deals only with <u>non-traded</u> limited partnerships being rolled-up into a traded (existing or new) entity. Yet, Mr. Stanger's analysis has only used the Damson partnerships which were <u>previously traded</u> and then merged with other previously traded securities. Such traded partnership "mergers" are not "roll-up" transactions which cause the abuse which your legislation deals with. That is because they do not "cram down" limited partners. It is fascinating that Mr. Stanger <u>totally neglects</u> to analyze--or even mention--the two non-traded Damson partnerships which were indeed rolled-up in the merger.

Perhaps the reason he fails to discuss these two non-traded Damson partnerships (which would be covered by the definition in your legislation) is because they were merged into the new entity by virtue of a cram down (i.e. investors were forced to participate in the transaction). Or, perhaps it was because together they represent less than 1% of the value in the resulting entity, thereby making it impossible to use the after merger share price performance of the resulting

entity to produce any meaningful analysis to support a claim of beneficial effects of the merger to the limited partners of these two partnerships.

Even though his analysis is irrelevant to your legislation, we did want to point out two important methodological problems with his analysis. First, he uses an arbitrary date of June 30, 1990 as a starting point from which to determine the future increase in value, when in fact the merger had not been announced as of that date; we would think the earliest one could argue for as a starting point for analyzing performance would be the date of announcement. (Further, we would argue that one should not use the announcement date, but use the day before the actual exchange occurs, because prior to that investors did not own the combined entity.) Secondly, his calculation of the percentage gains in the price of the shares that he quotes in his letter and analysis is seriously flawed. Simply, the percentage increases Mr. Stanger quotes are high by 100% because he incorrectly includes the original value in calculating the percentage increase. For example, let's take an investor who had $100 in value at the beginning of the transaction whose shares are currently worth $150. According to Mr. Stanger's analysis the "increase" would be 150%, when in fact we know that the increase is actually only $50, or 50%. This flaw runs throughout his percentage calculations[1].

We appreciate the opportunity to clarify the record on this matter. In sum, we have yet to see any data which refutes the substantive results of our analysis of transactions which are covered under the definition of a roll-up in your bill. That analysis clearly shows that non-traded partnerships which are rolled-up into a traded entity have never achieved a successful result for investors.

Very truly yours,

Richard G. Wollack
Chairman

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[1] It is interesting to note that if one uses the date immediately before the exchange as a starting point and adjusts for Mr. Stanger's errors in calculating percentages, the actual increases (which Mr. Stanger cites as ranging from 249% to 421%) actually ranged from 9% to 32%! (See attached calculation.)

Merger Analysis

Parker & Parsley Petroleum Company

Analyzed by Stanger	Merged Partnerships	Per 100 Units @ 7/29/91 — Shares of PDP	Cash	Stock Value ($10.13)	Total Value*	Value on Day Before Exchange (2/19/91)	% Rise In Value	Exchange Previously Traded
YES	PDP Unit Holders	200	$0	$2,025	$2,025	$1,750	16%	American Stock Exchange (PDP)
YES	Damson Energy (A Units)	14	$76	$142	$218	$200	9%	American Stock Exchange (DEP.A)
YES	Damson Energy (B Units)	17	$97	$172	$269	$238	13%	American Stock Exchange (DEP.B)
YES	Damson Institutional	38	$224	$385	$609	$467	30%	Over-The-Counter ("Pink Sheets")
YES	Damson Income	44	$257	$446	$703	$531	32%	Over-The-Counter ("Pink Sheets")
				--------Not Analyzed by Stanger--------				
NO	Damson 85-1	17	$101	$172	$273	N/A	N/A	NON-TRADED
NO	Damson 85E-1	16	$94	$162	$256	N/A	N/A	NON-TRADED

Merger Composition

	Shares for 1 Unit	Units Outstanding	Total Units Exchanged	Total Units % of Total
PDP Unit Holders	2	5,751,229	11,502,458	54%
Damson Energy (A Units)	0.1403	18,234,812	2,558,344	12%
Damson Energy (B Units)	0.1656	16,582,359	2,746,039	13%
Damson Institutional	0.3841	4,988,236	1,915,981	9%
Damson Income	0.4405	4,979,611	2,193,519	10%
Damson 85-1	0.1737	781,542	135,754	.64%
Damson 85E-1	0.1608	420,020	67,539	.32%
			21,187,546	

Together, the two non-traded partnerships make up less than 1% of the total consolidation.

THE HASTINGS GROUP

Scott E. Stapf
Maureen A. Thompson

Via Hand Delivery

July 30, 1991

Jeanie Roby
Senate Finance Committee
205 Dirksen Senate Office Bldg.
Washington, DC 20510

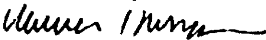
Jeanie:

Enclosed please find a document, "Roll-up Reform: The Rhetoric and the Reality," submitted on behalf of Richard Wollack, Chairman, Liquidity Fund. This document is being submitted for the hearing record in connection with the July 16th hearing of the Senate Finance Subcommittee on Energy and Agricultural Taxation. The subject of the hearing was S. 1393 and limited partnership roll-ups. Mr. Wollack was a witness at the hearing.

In addition, you should know that Mr. Wollack sent by fax today an additional submission for the July 16th hearing record.

Please do not hesitate to contact me if you have any questions. I may be reached at 8\703/276-1116.

Sincerely,



Maureen A. Thompson

1901 North Fort Myer Drive • Suite 1012-1014 • Arlington, VA 22209
Phone: 703/276-1116 • FAX: 703/276-1119

LIQUIDITY FUND

MANAGEMENT, INCORPORATED [illegible]

July 1991

ROLL-UP REFORM:

THE RHETORIC AND THE REALITY

The debate over reform of the roll-up of limited partnership interests pits those who want to perpetuate the inequities of the status quo against those seeking reform for America's eight million limited partners . . . It pits a tight knit group of general partners, proxy solicitors and investment bankers that now make enormous profits on roll-up deals against the hundreds of thousands of small investors who are victimized in the process . . . **It also is a debate that pits self-serving rhetoric of roll-up "profiteers" against the harsh reality suffered by limited partners who will go unprotected without passage of corrective federal legislation.**

This submission sets the record straight on roll-up reform and, in doing so, seeks to distinguish between the rhetoric and the reality of seven key points in the current debate.

* * * * *

__THE RHETORIC:__ SHARES OF ROLL-UPS DROP SO STEEPLY BECAUSE OF THE ERODED VALUE OF THE ASSETS, NOT THE ROLL-UP PROCESS ITSELF. Those who stand to gain from the current inequities in the roll-up process claim that the dramatic drop in the value of roll-up shares is caused by the troubled status of the assets underlying the partnerships. For example, the Investment Program Association (IPA), which represents the sponsors of these deals, told Congress said that the decline in value of real estate roll-up shares is caused by " ... an erosion in the value of the assets held by the partnerships over the period of time prior to the roll-up. The roll-up has not caused the erosion, it has only caused a recognition of its extent."

__THE REALITY:__ ROLL-UPS ARE "JUNK SECURITIES;" THE MARKET RECOGNIZES THAT FACT AND VALUES THEM ACCORDINGLY. The simple fact is that roll-up securities trade at a substantial discount because the markets are remarkably accurate in valuing shares. How do roll-ups stack up? A review of the characteristics of the typical roll-up make their shortcomings very clear. Most importantly, they have lacked dedicated and focused managements, their fee structures have been extremely high, conflicts of interest have been abundant and they been designed with absolute and total control in favor of management. It is little wonder, then, that they have traded at share prices which have caused investors to suffer substantial losses. Take, for example, real estate roll-ups. If the depressed real estate market actually was to blame for the poor performing roll-ups, it would stand to reason that __all__ real estate-related investments would be lagging. But such is not the case: **The value of real estate investment trusts (REITs) __increased__ 84.13 percent in the 1980s, while the average real estate roll-up __fell__ 84 percent.**

Martin Cohen, president of the New York-based Cohen & Steers Capital Management and perhaps __the__ leading analyst and investment adviser in traded real estate securities, used this hypothetical example to explain why the value of a limited partnership drops after a roll-up: Begin with $100 as the exchange value; subtract $19 for the up-front cost of the roll-up; subtract $7 for the dilution of value due to the high fee structure; subtract $15 for the additional discount due to conflicts and sponsor control; and subtract another $15 for the natural market discount from asset value. What you have lost in a roll-up is $56 of the original $100. Given this, **it should be no surprise that, of 13 major roll-ups carried out to date, a full 100 percent have lost money for investors, including a dramatic drop of 44 percent on the very first day of trading and a decline of 63 percent in the value of the equity overall.**

__THE RHETORIC:__ PROPOSED SEC RULES ON ROLL-UPS SHOULD TAKE CARE OF ANY PROBLEMS THAT EXIST AND, THEREFORE, CONGRESSIONAL ACTION IS UNNECESSARY. Opponents of basic fairness for limited partners point to the Securities and Exchange Commission's (SEC) recent announcement of proposed rules in this area as the cure to the "ills" that now riddle the roll-up process. The SEC's initiatives are aimed at: (1) improving the quality, clarity and usefulness of the roll-up disclosure documents; and (2) facilitating communication among investors in the proxy process. The public comment period on these proposed rules ends in late September, at which time the Commission will consider whether to adopt the proposed rules, and if so, in what form.

__THE REALITY:__ THE SEC PROPOSALS DO NOT ADDRESS EVEN THE MOST BASIC INEQUITIES NOW FACING LIMITED PARTNERS THREATENED BY ROLL-UPS. When introducing the proposed rules, even SEC Chairman Richard Breeden acknowledged their shortcomings: **"The proposals for roll-up and proxy reform that we consider today will not be a panacea for every unfairness in roll-up ... transactions."** It may well be that the Commission's proposals go as far as possible under the law. However, the resulting tools that the SEC would provide small investors are inadequate because the SEC is not empowered to promulgate the sort of rules needed to remedy the basic structural inequities

of roll-up deals. More sweeping action of this sort is something only Congress can do through new legislation. In short, the SEC's remedies are limited to offering "Band-Aids" for limited partners, when what is needed is major surgery.

The American Association of Limited Partners (AALP), which represents America's eight million limited partners, had this to say about the rule proposals: " ... There is no reason to believe they would have the effect of stopping even one abusive one roll-up deal. Left entirely unaddressed by the SEC are such critical issues as dissenters' rights, biased fairness opinions, and outrageous fees and commissions for general partners."

Commission officials have claimed that they cannot evaluate the fairness to investors of roll-up transactions because the agency does not engage in a substantive review of securities offerings to determine basic fairness. But, the truth is that, although the federal securities laws do predominately rely on a philosophy of full disclosure, in those types of transactions where small investors are heavily concentrated and in which unique problems and concerns related to the protection of those investors arise -- as is true of mutual funds -- the Commission has been given the authority to use substantive standards in order to safeguard the interests of the small investors. Certainly, limited partnership roll-ups are more similar to mutual fund investments than they are to traditional corporate securities. Thus, it is entirely appropriate that Congress direct the SEC to put in place for roll-ups certain substantive standards designed to protect the rights and interests of limited partners.

<u>THE RHETORIC:</u> ROLL-UPS ARE NEEDED BECAUSE THEY CREATE LIQUIDITY. Defenders of limited partnership roll-ups assert that investors need and want the liquidity option these transactions provide. Limited partnership interests usually are not publicly traded and are therefore highly illiquid investments. Now that many limited partnerships are faltering, general partners claim that the roll-ups serve as a means of creating liquidity through the combination or reorganization of one or more illiquid partnership entities.

<u>THE REALITY:</u> FEW INVESTORS WOULD DEFINE "LIQUIDITY" TO MEAN A 63 PERCENT DECLINE IN THE VALUE OF THEIR EQUITY -- THE AVERAGE LOSS WHEN ROLL-UPS BEGIN TRADING! First, the experience of the partnership secondary market <u>clearly</u> demonstrates that, when investors know in advance the exact price they will receive for selling their partnership units, only a small fraction each year -- far less than one percent -- of all limited partners choose this option. This is the best evidence that investors, when they are allowed to make the decision themselves (rather than having it made for them by the general partners), really do no want liquidity when they fully understand what this liquidity will cost. In many cases, the investors would be better off gaining liquidity by virtue of liquidation of the partnership's assets, not by a roll-up. Of course, there are ways to create liquidity without harming limited partners. For example, non-traded limited partnerships could be converted into a traded instrument that retains its original liquidation feature. This is one way in which to offer liquidity for the limited partners who want it (at a much lower discount than they would have to take in a typical roll-up) but would retain the original terms of the eventual asset liquidation for all other investors.

<u>THE RHETORIC:</u> ROLL-UPS ARE NEEDED TO REVIVE THE DEPRESSED REAL ESTATE MARKET, AS WELL AS FOR GENERAL CAPITAL FORMATION PURPOSES. Among the arguments offered for a continuation of the current roll-up process is that they benefit capital formation and therefore benefit the economy. This argument is made most often in relation to the real estate markets, where it has been said that what is needed is a capital infusion in order to ride out the hard times. William Dockser, chairman of CRI, Inc. of Rockville, Maryland, told Congress that the fundamental problem with real estate limited partnerships resides not in roll-ups, but rather in that a significant portion of this country's wealth is tied up in non-performing real estate investments. Mr. Dockser suggested that roll-ups of these real estate limited partnerships may in fact represent at least a partial solution to the depressed real estate market.

***THE REALITY:* MILLIONS OF DOLLARS IN NEW FEES AND COMMISSIONS FOR GENERAL PARTNERS AND OTHER PROMOTERS OF ROLL-UPS MAY QUALIFY AS AN UNUSUAL KIND OF "CAPITAL FORMATION," BUT NOT ONE THAT HAS BROADER BENEFITS FOR THE ECONOMY.** Limited partners who lose sleep at night out of fear that their partnership may be the next in line for a roll-up are not likely candidates for placing any additional funds in new investment vehicles. In fact, it may be that what is needed to encourage an infusion of capital into the economy is to send a strong signal to small investors that the system works for them rather than against them. Once burned, many investors turn their backs on the capital markets forever, preferring the safety of a tin can buried in the backyard to a system where insiders play with a stacked deck. There is a tremendous price to paid for the loss of investor confidence in the basic fairness and integrity of the capital markets.

More than $1.5 billion of investor capital already has been lost due to abusive limited partnership roll-ups. That represents money not available for other worthwhile investments -- investments that very well might have been put to use to help boost the sagging economy. In fact, not only has this $1.5 billion in investor capital vanished, it is likely that a high percentage of the more than 275,000 limited partnership investors who were caught up in 13 of the major roll-up deals conducted through 1990, will never invest again. The lack of investor confidence in the partnership market casts a pall on such new investments, which in the past have served as the foundation for research, exploration and development ventures. Finally, it should be highlighted that, **although roll-ups have been a net "loss" for the economy as a whole, they have served as a financial "shot in the arm" for general partners who have made sure that their own pockets would be lined with more than $200 million in fees and other costs.** Also profiting handsomely off of these deals are the legions of investment bankers, accountants and attorneys, all of whom work on behalf of the general partners yet are paid with the money of the limited partners.

***THE RHETORIC:* ROLL-UPS ARE A THING OF THE PAST AND, AS SUCH, REFORMS ARE UNNECESSARY.** The mantra of roll-up reform critics is "roll-ups are dead; no reforms are needed." Statement after statement issued by organizations of general partners, investment bankers, and even some regulatory officials, point to a declining number of roll-ups as reason enough to justify inaction on the part of Congress. "Why fix a problem that no longer exists?" reform critics ask.

***THE REALITY:* SEC TESTIMONY INDICATES THAT THERE HAVE BEEN AT LEAST THREE ROLL-UP FILINGS IN RECENT MONTHS. IT ALSO IS LIKELY THAT MORE ROLL-UPS WILL OCCUR IF CONGRESS FAILS TO ACT.** The answer here is simple: first, roll-ups are <u>not</u> dead; and second, there is little comfort to be taken in what may be a decline in roll-up activity due to the harsh glare of the spotlight. The false impression that roll-up activity had stopped cold may have been caused by the SEC's testimony before Congress in April, where the Commission reported that there were eight roll-ups filed in the last quarter of 1989 and the first quarter of 1990, but that since October 5, 1990, <u>no</u> new roll-ups had been filed. However, just three short months later, the Commission reported to another Congressional committee that, in fact, there had been <u>three</u> roll-up filings made during the first two quarters of 1991. While the pace may be off that of previous years, it is not insignificant.

Why is it safe to assume that roll-ups are not dead? First, the limited partnership industry is now moribund and has been for some time. As a result, general partners can only continue to make money in the limited partnership industry through the manipulation of <u>existing</u> partnerships. For these general partners, the only readily available source of new fees and commissions is the roll-up process. Unless Congress acts, it is inconceivable that general partners will simply "walk away" on their own from the hundreds of millions of dollars available to them through roll-up abuses.

Second, as to the very recent decline in roll-up activity, what is being seen is a sort **"speed trap effect."** The effect here is much like that that occurs when motorists hit the brakes and slow down when they see a police or highway patrol car. When the law officer's vehicle is out of sight, motorists return to the higher speed. It is in much the same way that general partners now appear to have many roll-ups on hold as a result of the extensive Congressional interest in recent abuses. It is reasonable for America's eight million limited partners to be concerned that, if Congress fails to pass legislation barring roll-up abuses, general partners will return to abusive roll-ups once they feel as though they are out of the Congressional "speed trap" on the issue.

__THE RHETORIC:__ ROLL-UP REFORMS INVOLVE STATE LAW ISSUES AND SHOULD BE HANDLED BY THE STATES, NOT CONGRESS. Another argument made by reform opponents is that roll-ups are a matter of state law and that any "fixes" to the process should be made at the state level. This discussion becomes muddled because critics of reform make reference to both state partnership law and state corporate law. For example, critics have attempted to stymie roll-up reform by noting the following state-level protections: (1) both the rights and responsibilities of participants in limited partnerships are governed by state partnership law; (2) state law generally imposes on general partners fiduciary duties to limited partners; and (3) where this fiduciary duty is believed to have been violated, limited partners may seek redress in the courts.

__THE REALITY:__ STATE OFFICIALS HAVE TESTIFIED THAT ROLL-UPS (WHICH ARE EXCHANGE-LISTED SECURITIES) ARE EXEMPTED FROM THEIR REVIEW AND THEY HAVE CALLED UPON CONGRESS TO REFORM THE PROCESS. By attempting to fuzz up two very distinct investment concepts -- traded securities and non-traded limited partnerships -- reform opponents misrepresent the precise state and federal laws applicable to roll-up transactions. **First**, and most importantly, it should be recognized that the roll-up process converts limited partnerships from non-traded, finite life instruments into publicly-traded, infinite life __securities__. These roll-up securities generally are listed on a national securities exchange, and as such, are outside the ambit of any state regulation or control. Exchange-listed securities are overseen exclusively by the SEC and the exchange itself. Thus, it is inexplicable that critics of federal action on roll-ups would not recognize that these transactions appropriately fall within the purview of the SEC's jurisdiction. Clearly, it is the federal __securities__ laws that need overhauling if meaningful protections are to be provided to limited partners.

Second, any misunderstandings about the function of state partnership law need to be cleared up. State partnership law simply involves contractual obligations -- enforced solely by the courts -- on the part of the general partners and the limited partners. Because state partnership law is not administered by any particular state regulatory agency which can enforce compliance with its provisions, reforms of the same would have little, if any, noticeable impact on the conduct on roll-up sponsors.

Third, state securities regulators have called upon Congress to adopt federal securities law reforms. The North American Securities Administrators Association (NASAA), which represents the 50 state securities administrators, has made a persuasive case that their hands are tied when it comes to exchange listed securities and that the appropriate target of reform is the federal securities laws.

__THE RHETORIC:__ THE SECONDARY MARKET FOR LIMITED PARTNERSHIPS IS NO BETTER THAN THE ROLL-UP PROCESS. Opponents of fundamental fairness for America's eight million limited partners have attempted to divert attention from the abuses that now riddle the roll-up process by pointing fingers at the partnership secondary market. In so doing, these reform critics have launched a series of verbal attacks on the secondary market, claiming that: (1) the roll-up discount is no different than the partnership secondary market discount; and (2) the secondary market buyers exact a huge and unfair discount.

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<u>THE REALITY</u>: UNLIKE ROLL-UPS, IN WHICH LIMITED PARTNERS OFTEN ARE FORCED TO ACCEPT A PIECE PAPER WITH AN UNKNOWN VALUE, THE SELLER IN THE SECONDARY MARKET KNOWS EXACTLY WHAT PRICE IS BEING OFFERED FOR THE UNITS. FURTHER, SELLING IN THE SECONDARY MARKET IS <u>VOLUNTARY, NOT COMPULSORY</u>. In fact, the recent data clearly indicates that the secondary market provides a far better liquidity option -- for those who desire it -- than roll-ups. An analysis of the four most recent roll-ups showed that the secondary market price was 170 percent of the price of the first day of trading after partnerships were rolled-up. Further, if investors had sold in the secondary market they would have realized approximately 6.5 times more money than those who stayed in the roll-up and still hold their shares. The superiority of the secondary market pricing was also confirmed in the SEC's recent study of such issues.

Why does the partnership secondary market provide a superior price compared to roll-ups? There are no cram-downs; limited partners sell voluntarily and with full knowledge about what price their units will bring. There is no adverse change to the underlying partnership. There is no combination of good assets with bad assets. There are no dramatically increased fees or substantial initial fees and costs. And, there is no radical change in investment objectives or conversion to an infinite life vehicles.

Finally, and most importantly, the issue is roll-ups, not the secondary market. By attempting to compare these very different investment concepts, reform critics ignore a a fundamental distinction. The secondary market is completely voluntary, roll-ups, where there is just the slimmest possible majority vote, are compulsory.

PREPARED STATEMENT OF ROBERT R. WOOTTON

Mr. Chairman and Members of the Subcommittee. I am pleased to be here today to present the views of the Treasury Department on S. 1393, which seeks to regulate so-called partnership "rollup" transactions through the imposition of a 50% federal excise tax on transactions that do not provide specified dissenters' rights to limited partners.

We oppose S. 1393. We believe that the federal tax laws should not be used to attempt to regulate the terms of securities transactions on the merits.

The Internal Revenue Service personnel who would be asked to enforce the new excise tax would not have experience with the securities-law concepts that the statute would embody. In particular, the application of the tax would depend on whether, in connection with a partnership rollup, the limited partners have a reasonable opportunity to dissent and dissenters' rights. Making this determination would involve the examination and resolution of issues that are well outside our normal areas of experience.

If S. 1393 were enacted, we might well look to applicable federal or state laws for rules governing the form, content and timing of disclosure and proxy solicitation, the methodology of valuation and appraisal, and other matters implicated by S. 1393. This would require Internal Revenue Service agents to learn and interpret federal securities and state securities and corporation laws, in order to enforce the federal tax law. Alternatively, we could through Treasury regulations adopt a set of uniform rules governing these matters. However, this approach would lead to inconsistencies with applicable federal and state laws and, in the case of state laws, might raise questions of pre-emption.

On audit, issues regarding compliance with S. 1393 would typically arise in combination with other federal tax issues, and agents could not be expected to pursue rollup violations single-mindedly if other meritorious audit issues were present. As a practical matter, agents seldom have the experience, knowledge or time to raise all possible issues. Issues that require applying non-tax law may be less likely to be raised than those closer to the agent's usual experience. Further, in proposing adjustments or penalties, agents give first priority to revenue collection. An agent might reasonably decline to assert liability for the rollup excise tax in cases in which the liability is unclear and potential collections appear small. The agent might also compromise the excise tax in exchange for concessions on other issues.

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These considerations might make the new excise tax a less effective deterrent against the targeted rollup transactions. Yet deterrence would be the only justification for the tax. Tax laws do not create private remedies. Accordingly, if the new excise tax did not deter a transaction, the only possible beneficiary would be the federal fisc. The intended beneficiaries, the dissenting limited partners, would be simply out of luck. In contrast, state dissenters' rights laws, such as those recently added to the limited partnership statutes of New York and California, do create private rights of action. Careful consideration should be given as to whether the enactment of S. 1393 would inhibit the further development of appropriate responses by state legislatures and federal or state securities regulators.

PARTNERSHIP ROLLUP TRANSACTIONS

"Rollup" is a term popularized in the financial press that is generally used to describe the merger or consolidation of two or more limited partnerships into a single surviving entity. Often, the old partnerships have failed to achieve their original investment objectives and have performed poorly. The rollup may have been proposed as a way to salvage some portion of the limited partners' investments.

Partnership rollup transactions have generated controversy and a good deal of Congressional interest. A series of hearings has identified numerous concerns that may arise in a rollup transaction, including lack of clear, concise and understandable disclosure of the consequences of the rollup to limited partners; enhancement of the general partner' s compensation, voting rights and ownership interest; changes relating to the partnership's borrowing policies, business plan, investment objectives and intended term of existence; and absence of legal or equitable alternatives to the rollup for dissenting limited partners. See Securities Act Release No. 33-6900 (June 17, 1991), at pp. 3-5.

The Securities and Exchange Commission (SEC) has taken several actions to improve the disclosure of information to limited partners, which it will describe in testimony today. The National Association of Securities Dealers has also recently proposed to amend its rules to prohibit its members from receiving higher compensation for "yes" votes than for "no" votes from limited partners in connection with rollup transactions.

Currently, the laws of at least three states (New York, California and Maryland) and the District of Columbia grant compensation rights to limited partners who dissent from partnership merger or consolidation transactions. The New York statute became effective on April 1, 1991; the California statute on January 1, 1991. See Testimony of Richard C. Breeden, Chairman of the Securities and Exchange Commission, before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce (April 23, 1991), at p. 23 n. 10.

TECHNICAL COMMENTS ON S. 1393

Scope. The new excise tax would apply if (1) as a result of any transaction, a limited partner who was entitled to a proportionate share of all net proceeds of all sales or refinancings of the partnership's assets is no longer entitled to such a proportionate share, (2) in connection with the transaction, there is a securities offering that must be registered with the SEC or a comparable state or local governmental agency or there is a request for a proxy or other vote, and (3) specified dissenters' rights are not provided.

The excise tax would be equal to 50% of the gain or other income realized by reason of the covered payments. The tax would apply whether or not the gain or other income is recognized.

Proportionate share. The excise tax would apply to any transaction that changes a limited partner's right to a proportionate share of net proceeds from sales and refinancings. It would apply even if the transaction does not involve the combination of two or more limited partnerships into a single entity. The bill makes no provision for special allocations, preferred returns and the like. The excise tax would accordingly apply (unless dissenters' rights were provided) to a registered offering of a new class of limited partnership interests, if the new limited partners received, for instance, a right to a preferred return. While it is doubtful this scope of coverage is intended, the existing language of the bill would reach a number of common (and legitimate) partnership transactions that could not reasonably be viewed as "rollups."

Dissenters' rights. The excise tax would not apply if the limited partners have a reasonable opportunity to dissent from the transaction and, if they dissent, the right to require redemption of their limited partnership interests for net asset value (in cash, marketable securities or negotiable promissory notes) or to receive securities

with substantially the same value, rights, powers and privileges. For this purpose, the value of a limited partnership interest cannot be less than its share of the amount represented as the value of the partnership's assets in any filing with the SEC or other governmental authority. It is not entirely clear that the bill as drafted requires a comparison of the value of the partnership interest with its share of represented partnership asset values (although this is surely the intention). The provision also appears flawed in not focusing on net asset values.

Payments subject to excise tax. The excise tax would be imposed on any payment received for services rendered in connection with the transaction or to the entity resulting from the transaction. The excise tax would also be imposed on any payment received in exchange for an interest in, or contract right with, any limited partnership that is a party to the transaction or on account of holding an interest in the entity resulting from the transaction

In the case of payments for services, the excise tax would apply only to the extent that the payment exceeds the amount that would have been paid had the transaction not occurred. This may be a difficult standard to apply to fees based on revenues, profits, assets under management or similar performance-based measures. In addition, the exception would not seem to apply in cases where each partnership participating in a rollup transaction has a different general partner, but the resulting entity has a single general partner being paid no more than what would have been paid in the aggregate to the several general partners In such cases, it seems that this exception should be available

The excise tax would apply to payments received by any person who is a general partner, manager or investment advisor of a limited partnership that is a party to the transaction It would also be imposed on payments received by any person who performs services as a broker, dealer, underwriter, promoter, investment banker or appraiser in connection with the transaction Thus, the excise tax would apply not only to those who structure and sponsor the rollup transaction, but also to others such as brokers and appraisers who have no control over the terms of the transaction and may indeed have no reason to know that it is a transaction to which the excise tax is applicable It does not seem that the effectiveness of the excise tax is greatly enhanced by covering this latter group

The excise tax would apply to payments to the persons described above whenever they are made, even years after the rollup transaction has been completed, and even if they have no connection to the transaction It appears, for example, that the excise tax would apply to any future fees paid to an individual who performed an appraisal in connection with the rollup, even though the fees are paid for services unrelated to the rollup and the individual is chosen for the subsequent work through open bidding and not because of his connection with the prior rollup transaction

In conclusion, we believe it is inappropriate to use the federal tax laws to regulate the merits of securities transactions, such as partnership rollups We believe that any regulation of partnership rollups should be left to those with greater expertise in securities regulation