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1st Session

SENATE

REPORT
103–121

LIMITED PARTNERSHIP ROLLUP REFORM ACT OF 1993

REPORT

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

TO ACCOMPANY

S. 424

together with

MINORITY VIEWS

AUGUST 3 (legislative day, JUNE 30), 1993.—Ordered to be printed

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AUGUST 3 (legislative day, JUNE 30), 1993.—Ordered to be printed

Mr. RIEGLE, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

together with

ADDITIONAL VIEWS

[To accompany S. 424]

INTRODUCTION

On June 29, 1993, the Senate Committee on Banking, Housing, and Urban Affairs marked up and ordered reported a bill, the Limited Partnership Rollup Reform Act of 1993, to amend the Securities Exchange Act of 1934 (Exchange Act) to curb abusive practices in limited partnership rollup transactions and provide enhanced protection for investors affected by limited partnership rollup transactions. The Committee, by a vote of 18–0, voted to report the bill to the Senate with the recommendation that the bill do pass.

PURPOSE AND SUMMARY

The Limited Partnership Rollup Reform Act of 1993 ("Rollup Reform Act" or "Act") is designed to address problems that have harmed thousands of investors who have been subject to abusive limited partnership rollups.

Limited partnership rollups generally are transactions in which investors in an existing limited partnership are solicited to approve a reorganization of their partnership, or a combination of their partnership with other partnerships; the reorganization or combination results in a direct or indirect exchange of the existing limited partnership securities for securities in a new publicly-traded corporation, partnership or other entity; and the investors' rights

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in the resulting entity are substantially different from their rights in the original partnership.

In these transactions, concerns have been raised about the fundamental change in the nature of the investment forced upon limited partners who object to the rollup but are bound by the vote of other limited partners. Problems associated with many of these transactions have included confusing disclosure to investors; regulatory impediments that prevented limited partners from communicating with each other; brokers being paid commission for obtaining votes by investors to approve rollup transactions but receiving smaller or no commissions for votes against a transaction; limited partners being forced to accept shares in a new entity with substantial reductions in their voting or other rights; and general partners gaining greater equity shares and other fees in excess of those agreed to in the original partnership deals.

The Rollup Reform Act addresses these concerns by improving the proxy process and disclosure to investors and establishing rules of fair practice for limited partnership rollup transactions. The Act ensures that limited partners have the right to obtain a list of the other limited partners involved in the proposed rollup and to communicate with each other about whether to oppose the rollup transaction. The Act prohibits compensating persons soliciting proxies in a rollup transaction based only on "yes" votes or on the contingency that the rollup transaction be completed. The Act also requires that investors subject to a rollup transaction be given at least 60 days to review a rollup, unless state law mandates a shorter period.

The Act requires clear, concise disclosure in solicitations sent to investors regarding: changes in the business plan, voting rights, form of ownership interests, and general partner's compensation; conflict of interest; expected differences in exchange value and the trading price of securities; valuation of limited partnership interests; risks and effects of the proposed rollup transaction; and disclosure of any opinion or appraisal. The Act also requires that the general partner include a statement of the fairness of the rollup transaction to investors in each limited partnership. In addition, the Act requires that a summary of the required disclosure be included in the soliciting material.

The Act establishes rules of fair practice for limited partnership rollup transactions by prohibiting exchanges and national securities associations and their members from participating in or listing securities resulting from a rollup transaction that does not contain certain protections. Those protections include the rights of dissenting limited partners to one of the following: an appraisal and compensation; retention of a security with substantially the same terms and conditions as the original limited partnership; approval of the rollup transaction by not less than 75 percent of the outstanding units of each participating limited partnership; or other rights designed to protect dissenting limited partners. Protections for limited partners also include the right of limited partners not to have their voting power unfairly reduced, the right not to bear unfair costs associated with a rollup transaction that is rejected, and certain restrictions on abusive changes in management fees and compensation.

The definition of "limited partnership rollup" in the Act is tailored to target transactions that have the potential to involve the abuses the legislation is designed to address. The Act contains specific exclusions for transactions in which the rights of limited partners are otherwise protected.

HISTORY OF THE LEGISLATION

The Limited Partnership Rollup Reform Act of 1993, S. 424, was introduced on February 24, 1993, by Senators Dodd, Riegle, D'Amato and 29 other Senators.

The bill originated in legislation introduced in the 102nd Congress. On February 27, 1991, the Subcommittee on Securities held a hearing on the subject of limited partnership reorganizations. The hearing focused on widespread investor losses in limited partnership rollups and abuses that reportedly had arisen in the market for publicly-held limited partnerships. At the hearing the following witnesses testified: Richard C. Breeden, Chairman of the Securities and Exchange Commission (SEC); Frank J. Wilson, General Counsel and Executive Vice President of the National Association of Securities Dealers (NASD); Dee Harris, Director, Arizona Securities Division; Margaret Hooker, a limited partner from New Canaan, Connecticut; Ronald Rybicki, a limited partner from Detroit, Michigan; Richard Wollack, Chairman of the Liquidity Fund Management Inc.; and Lee Errickson, Managing Director of Robert A. Stanger & Company, on behalf of Robert A. Stanger & Company.

On June 28, 1991, Senators Dodd, Riegle, D'Amato, and eight other Senators introduced S. 1423, the Limited Partnership Rollup Reform Act of 1991. By the end of the 102nd Congress, S. 1423 was cosponsored by 74 Senators.

On June 24, 1992, Senator Dodd offered the text of the Limited Partnership Rollup Reform Act as amendment number 2440 to S. 2733, the Federal Housing Enterprises Regulatory Reform Act of 1992. A motion to lay the amendment on the table was rejected by a vote of 10 yeas to 87 nays, and the amendment was agreed to by a voice vote. Although S. 2733 passed the Senate, no conference on the legislation was convened. The primary provisions of S. 2733 were included in the Conference Report on H.R. 5334, the Housing and Community Development Act of 1992, but it did not include the provisions relating to rollups.

On February 24, 1993, Senators Dodd, Riegle, D'Amato, Bond, Sarbanes, Domenici, Sasser, Shelby, Kerry, Bryan, Boxer, Murray, and 20 other Senators introduced S. 424, the Limited Partnership Rollup Reform Act of 1993, which contained provisions identical to amendment number 2440 discussed above.

On April 20, 1993, the Subcommittee on Securities held a hearing on S. 424, at which the following witnesses testified: Charles K. Barbo, Chairman of Shurgard Incorporated; Joseph Bridges, President of Kelley Oil Corp.; Phillip Cottone, Chairman of the Direct Participation Programs Committee of the NASD; Louis Garday, Chairman of the National Association of Real Estate Investment Trusts Government Relations Committee; Mark Goldberg, Director of Due Diligence for Royal Alliance Associates, Inc.; Barry Guthary, President of the North American Securities Admin-

istrators Association; Estelle and Robert Heyman, limited partners from Bellmore, New York; Bob Nelson, an investor from Dallas, Texas; Spencer Jefferies, Editor of Partnership Profiles, Inc.; and Douglas Peabody, of Meigher Peabody & Co.

On June 29, 1993, the Committee marked up S. 424, containing an amendment in the form of a substitute offered by Senators Dodd and Gramm. On that date, a total of 38 Senators had sponsored the original bill.

PURPOSE AND SCOPE OF THE LEGISLATION

Limited partnerships

Partnership structure

In the typical publicly-offered limited partnership, a sponsoring organization solicits funds from investors to use in the purchase of real estate, oil and gas facilities, high technology research, or other enterprises. The sponsor usually serves as the general partner and has the responsibility to manage the assets and fulfill any obligations to the investors under the terms of the partnership agreement. The investors are the limited partners and, under the typical terms of the partnership agreement, expect to receive periodic payments during the life of their investment as well as a return of their principal, plus a specified return or profit and a portion of any additional proceeds upon the liquidation of the partnership assets.

Partnership investors

According to the Securities and Exchange Commission, during the 1980s, over $150 billion of public limited partnership interests were sold to U.S. investors. Industry sources estimate that 11 million investors have purchased these limited partnerships, and of these, approximately eight million are small investors, with an average investment of about $10,000. Barry Guthary, Director of the Securities Division of the Massachusetts Secretary of Sate, noted in his testimony that limited partnerships are "among the riskiest and most illiquid of all instruments in the investment marketplace." He also noted that, "in addition to the absence of an active 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."

Advantages for investors

Investors have been attracted to limited partnerships for a variety of reasons. Limited partnerships provide a means for small investors to participate in commercial and multi-family real estate, oil and gas facilities, and other investments that require significant capital and generally are accessible only to institutional or other large investors. The partnership agreement usually provides that the partnership assets will be sold and cash will be distributed in a finite though unspecified time period, assuring investors a direct share of the assets' performance. The general partner is motivated to work in the best interest of the investors, since the general partner's share of profits often is subordinate to the return of 100 per-

cent of limited partners' capital plus a predetermined cumulative annual return. The fee structure is fixed. In addition, the partnership usually is set up to be self-liquidating, and proceeds of asset sales are distributed to limited partners. Consequently, the general partner cannot continue to earn fees by churning assets or reinvesting proceeds of asset sales. Perhaps most important in the case of real estate partnerships prior to the 1986 Tax Act, there were significant tax benefits involved in investing in limited partnerships.

Advantages for partnership sponsors

General partner shave a financial incentive to organize limited partnerships for at least two reasons. First, the general partner expects to realize a profit on any appreciation of the assets after the limited partners receive their share. Second, the general partner derives income on an on-going basis for the management services provided in maintaining and operating the property. The general partner may also receive up-front fees for organizing the limited partnership.

Recent partnership performance

In the late 1980's, the troubled real estate and oil and gas markets, along with a series of other circumstances, resulted in many general partners facing a decreasing revenue base and a growing number of financial problems. Following the 1986 Tax Act, there were a string of year-to-year declines in new public partnership sales. The dramatic decline in real estate values during the late 1980's reduced or eliminated the value of both general and limited partners' interests. General partners perhaps realized such losses first, since they receive profits only after the limited partners receive their share. For the general partner, management fees declined and properties under management experienced increasing vacancy rates or became non-performing.

Because of this troubled environment, many general partners stopped raising new capital altogether. Sales of assets from existing partnerships exceeded new capital raised, thereby eroding assets under management and significantly reducing general partner management fees. Thus, some general partners sought to change the original partnership agreements and restructure the limited partnerships by proposing to reorganize or, in many cases, "roll up" existing limited partnership interests into new, publicly-traded securities.

Limited partnership rollups

From January 1, 1985 to January 1, 1993, approximately 73 limited partnership rollup transactions involving two or more entities were registered with the SEC. These rollups have involved approximately 1,800 separate limited partnerships with an estimated aggregate value of over seven billion dollars.

Rollup structure

A typical "rollup" usually combines a number of previously non-traded individual limited partnerships into a single new entity that publicly trades on a national securities exchange or on the national

market system. As a result, one effect of a rollup is to convert an investment with a limited or finite term into an infinite life vehicle, which is designed continually to reinvest proceeds from asset sales, rather than distribute them to limited partners as originally agreed to. A rollup also can involve the reorganization of a single partnership into a new entity.

Benefits of rollups

In some cases, reorganizing non-traded public limited partnerships and creating a new publicly-traded, infinite life vehicle can improve the value of the investments of the limited partners. For example, the new rolled up entity may offer investors liquidity previously unavailable, create economies of scale and reduce administrative costs to improve performance, and create broader diversification of assets which will improve investment safety. The new entity also may result in better access to capital markets, allow for growth in asset values because of an infinite time horizon and greater asset base, broaden the market for attracting new capital to the enterprise from new public investors, allow for the growth and expansion of the enterprise, including expansion into activities that could not be done (or only with difficulty) in a limited partnership structure, and in some cases, save the partnership from failure and bankruptcy.

Phillip Cottone, former Chairman of the NASD Direct Participation Programs Committee, stated in his testimony that, "rollups that are fairly done can provide important liquidity and economies of scale to partnerships in (these) economically troubled times."

Criticism of rollups

Critics have said that the vast majority of limited partnership rollups result in the newly-traded security immediately falling to a discount to its net asset value, as cash flow from the stronger partnerships is used to support losses from the weaker partnerships. They further argue that ongoing asset management fees and expenses assessed by the general partners offset, and in fact may exceed, the promised reduced administrative costs. As a result, the limited partners' equity is substantially diluted.

According to an industry witness, in the major rollup transactions, limited partners have realized, on average, a drop of 45 percent from the exchange value on the first day of trading in their newly issued rollup securities. By some measures, these limited partners when taken as a whole have lost approximately $2 billion in equity, while rollup sponsors have earned over $250 million in fees. By one estimate, completed rollups have involved approximately 510,000 limited partnership investors. According to such estimate, when compared to original exchange values, investors involved in public limited partnership rollups have experienced a decline of approximately 70 percent in limited partner equity.

It should be noted that, while investor complaints have been sparked by the enormous declines in the value of the rollup security compared with the "exchange value" stated in the prospectus, rollup sponsors have argued that the measure of investor losses that are actually attributable to rollups cannot be calculated with precision. They have said that the stated exchange value is not in-

tended to be the trading price of the security. Moreover, they have said that the decline in price from the initial partnership investment merely reflects the public market's valuation of the partnership assets. Losses in rollup transactions are not universal, with some transactions showing little loss or showing price appreciation.

However, critics of rollups have attributed investor losses in these transactions to three primary reasons. First, one practice criticized as abusive occurs when financially sound partnerships are merged with partnerships that are experiencing financial difficulty. In such cases, it appears that investors who own sound limited partnerships realize an immediate dilution of the quality and performance of their investment. Second, the Subcommittee received compelling evidence in hearings that some general partners have modified the original partnership's fee structure, giving much larger equity interests or fees to themselves, to the detriment of the limited partners. Finally, when the unattractive terms of the new rolled up security become apparent, the market further discounts the newly traded security, pushing its price even lower.

In his testimony before the Subcommittee, Mark Goldberg, Director of Due Diligence for Royal Alliance Associates, Inc., noted that, "the basic problem with rollups, absent regulation to prevent abuse, is that the general partner may extort benefits for itself as the price of providing the benefits of a rollup." He also noted that, "without regulation, general partners may present a complex rollup to the limited partner which includes significant benefits for the general partner at the expense of the limited partners."

Current regulation of rollups

The SEC, National Association of Securities Dealers (NASD), and state securities commissions each have separate regulatory authority over certain actions involving individual non-traded limited partnerships and the reorganized publicly-traded entity. In the last two years, the SEC, the NASD, the state of California, and the North American Association of Securities Administrators each has taken steps intended to curb rollup abuses. The Act, in certain respects, codifies some of the actions taken by the SEC under its existing authority and by the NASD. In addition, it addresses gaps in investor protection that have not been filled by the actions of the regulators.

In the Subcommittee's April 20, 1993 hearing, Phillip Cottone of the NASD commented about the coverage of the NASD rules and the need for the legislation. He stated that:

> Large nationwide rollups of partnerships are difficult to accomplish without the use of NASD members. However, smaller rollups with a limited number of partnerships can, and have, been solicited without NASD members and are not therefore covered by our rules. Moreover, this legislation will provide uniformity for listing of rollup securities on the major markets. Passage by Congress of legislation that mirrors our rules will assure a uniform standard for NASD members and non-members alike. * * * We believe legislation to provide equal regulation of non-NASD members and equal regulation of listing standards is appropriate.

Barry Guthary, testifying on behalf of the North American State Securities Administrators, described the gap that exists in the NASD rules and the potential consequences of not enacting comprehensive federal legislation. He noted that:

> The necessarily limited reach of the NASD's rules may encourage general partners to avoid this marketplace. The NASD's rules will apply only to transactions involving its members and securities listed on the NASDAQ system. Rollups listed on other exchanges and transactions which do not involve NASD members will not be covered by the rules * * * absent the adoption of comprehensive federal legislation applied evenly to all marketplace participants, we will fall short of meeting the needs of limited partners.

State securities laws generally exempt from state registration and review securities traded on national securities exchanges or on the national market system. In September 1992, California enacted a law removing its exemption for securities issued in a rollup, unless the rollup was conducted in accordance with certain procedures designed to protect limited partners. Witnesses at the Subcommittee's hearing testified that the California law relating to rollup transactions only applies to transactions in which there are California investors.

Several witnesses who testified before the Securities Subcommittee urged that the legislation include a provision specifically preempting state laws with regard to limited partnership rollups. They expressed concern that a Federal statute would merely become one set of rules regulating partnership reorganizations, to which states would add further (and perhaps conflicting) regulations and restrictions. The result could be a burden on sound business transactions and could be detrimental to investors.

State securities representatives assured the Committee that the enactment of Federal legislation which adequately protects investors facing a rollup would remove the need for further state legislation. Therefore, they argued, Federal preemption is not necessary.

The Committee considered the comments of state securities regulators and, therefore, did not include an explicit preemption in the bill. The Committee notes that the California law was passed in order to protect investors in the absence of nation-wide standards for limited partnership rollup transactions. States should not enact or administer laws in a manner that conflicts with this legislation, which provides nation-wide standards for rollups. If states enact or administer laws that inhibit the functioning of the national markets, the Committee will reconsider the need for an explicit preemption.

The legislation

The Committee believes partnership rollup transactions, when properly structured, can offer significant benefits to investors and for businesses that have used these structures to raise capital. However, abusive transactions harm investors, undermine investor confidence and threaten capital formation. The legislation, therefore, is designed to prohibit or restrict abusive transactions but

permit transactions where the rights of investors are protected to go forward.

Protections for limited partners.—The Rollup Reform Act provides important protections for limited partners in rollup transactions. The Act ensures that limited partners have the right to communicate with each other about whether to oppose a roll-up transaction and to obtain a list of the other limited partners involved in the proposed rollup. The Act prohibits compensating persons soliciting proxies in a rollup transaction based only on "yes" votes or on the contingency that the rollup transaction be completed. The Act also requires that investors subject to a rollup transaction be given at least 60 days to review a rollup, unless state law requires a shorter period.

The Act requires clear, concise disclosure in solicitations sent to investors regarding: changes in the business plan, voting rights, form of ownership interests, and general partner's compensation; conflicts of interest; expected differences in exchange value and the trading price of securities; valuation of limited partnership interests; risks and effects of the proposed rollup transaction; and disclosure of any opinion or appraisal. The Act also requires that the general partner include a statement of the fairness of the rollup transaction to investors in each limited partnership. In addition, the Act requires that a summary of the required disclosure be included in the soliciting material.

The Act also establishes rules of fair practice for limited partnership rollup transactions by prohibiting exchanges and national securities associations and their members from participating in or listing securities resulting from a rollup transaction that do not contain certain protections. Those protections include the rights of dissenting limited partners to one of the following: an appraisal and compensation, retention of a security with substantially the same terms and conditions as the original limited partnership, approval of the rollup transaction by not less than 75 percent of the outstanding units of each participating limited partnership, or other rights designed to protect dissenting limited partners. Protections for limited partners also include the right of limited partners not to have their voting power unfairly reduced; the right not to bear unfair costs associated with a rollup transaction that is rejected; and, certain restrictions on abusive changes in management fees and compensation. Dissenters rights can only be asserted by a person who, on the date that rollup soliciting material is mailed to investors, is a holder of a beneficial interest in the limited partnership that is the subject of the rollup.

Definitions.—The definition of "limited partnership rollup" in the Act is tailored to target certain transactions. The term is defined to mean a transaction involving the combination or reorganization of limited partnerships, either directly or indirectly, where some or all investors in the limited partnerships receive new securities or securities in another entity. The definition provides exceptions for certain kinds of private transactions or other transactions for which the protections of the Act are not needed. Exceptions from the definition include: a transaction in which the existing limited partnership securities trade on a national securities exchange or on the national market system and the security to be received is also

so traded; a transaction involving issuers that are not reporting companies under section 12 of the Exchange Act both before and after the transaction; a transaction in which the securities are not required to be and are not registered under the Securities Act of 1933; a transaction in which there will be on significant adverse change to investors in certain specified rights; and a transaction in which each investor is given an option to receive or retain a security under substantially the same terms and conditions of the original issue.

The definition of "limited partnership rollup transaction" also includes the reorganization of a single limited partnership in which some or all investors receive new securities or securities in another entity, if the transaction meets the following criteria: the securities to be issued will be traded on a national securities exchange or on the national market system; the existing limited partner ship securities are not traded on a national securities exchange or on the national market system; the issuer is a reporting company under section 12 of the Exchange Act both before and after the transaction, or the securities to be issued or exchanged are required to be or are registered under the Securities Act; there are significant adverse changes to security holders in voting and other specified rights; and investors are not provided an option to retain a security under substantially the same terms and conditions as the original issue. The provisions of the definition relating to the reorganization of a single limited partnership is intended to parallel the provisions relating to the combination of multiple limited partnerships.

Exclusions.—The legislation excludes from the definition of limited partnership rollup certain transactions where the rights of investors are otherwise protected. The legislation excludes any transaction involving a limited partnership or partnerships that are not finite life partnerships. The legislation also excludes transactions proposed by independent third parties that are approved by 66⅔ percent of the outstanding units of each of the participating limited partnerships and involve no special compensation paid to the general partners. Also excluded are transactions where the limited partnership interests are repurchased, recalled or exchanged substantially pursuant to the terms of the pre-existing limited partnership agreement for securities in an operating company that is identified at the time of the limited partnership's formation. The legislation further excludes transactions where securities offered in exchange for limited partnership units are listed on a national market system or an exchange, have been traded for 12 months, and no more than 20 percent of the traded entity's securities are offered for the limited partnership interests after giving effect to the issuance of securities.

SEC exemptive authority.—The Act specifies that the SEC has broad authority to exempt by rule or order securities, transactions, and persons or classes of persons from the definition of limited partnership rollup and from the disclosure and other requirements.

Effective date.—The legislation provides that, prior to the effective date of regulations adopted pursuant to the Act, the SEC shall continue to review and declare effective registration statements and amendments thereto relating to limited partnership rollup transactions in accordance with regulations then in effect. This re-

flects the Committee's intent that, after enactment of the Act and prior to the adoption of final rules, the SEC should not delay processing registration statements and declaring them effective if they are in accordance with existing regulations. The Committee intends that the SEC will continue to apply in the appropriate manner the public interest, protection of investors, and other standards set forth in Section 8(a) of the Securities Act.

SECTION-BY-SECTION ANALYSIS OF S.424

Limited Partnership Rollup Reform Act of 1993

Section 1. Short title

This section sets forth the short title of the Act, the "Limited Partnership Rollup Reform Act of 1993."

Section 2. Revision of proxy solicitation rules and disclosure with respect to partnership rollup transactions

This section adds a new Section 14(h) to the Securities and Exchange Act of 1934 to require that the SEC adopt, pursuant to its existing authority under Sections 14(a) and 14(d) of the Exchange Act, special proxy solicitation and tender offer rules to apply to limited partnership rollup transactions.

Communications among securityholders.—New Section 14(h)(1)(A) codifies to a limited extent and solely for the purpose of the Limited Partnership Rollup Reform Act, SEC rules permitting holders of securities in a proposed limited partnership rollup transaction to engage in preliminary communications with other limited partners, for the purpose of determining whether to solicit proxies, consents, or authorizations in opposition to the proposed transaction. Prior to the adoption of these rules, limited partners (like security holders generally) could not engage in preliminary communications that constitute a solicitation with more than 10 limited partners, unless they filed soliciting material with the SEC. The Committee heard testimony that, given the complicated nature of rollup transactions, limited partners have sought to communicate with each other to obtain information and determine whether to oppose a pending rollup. This section makes it clear that limited partners may communicate with each other without violating the SEC's proxy solicitation rules. Any holder of not less than five percent of the outstanding securities that are the subject of a rollup and who engages in the business of buying and selling limited partnership interests in the secondary market must disclose the ownership interest and any potential conflicts of interest in any communications. SEC rules relating to fraudulent, deceptive or manipulative acts or practices would continue to apply. This section is not intended to limit SEC rules relating to communications among corporate shareholders and other security holders, including limited partnership investors.

Securityholder lists.—New section 14(h)(1)(B) generally codifies SEC rules requiring the issuer to provide limited partners involved in a rollup transaction a list of names of other limited partners involved in the proposed transaction. The SEC determines, by rule, the terms and conditions under which lists are furnished. This responds to concerns that, in the past, general partners have with-

held from limited partners the names of other investors, in order to prevent them from organizing to vote against a rollup transaction. This new section would enable investors to get the information they need to order to communicate concerns related to the proposed partnership rollup transaction to other limited partners.

Differential compensation.—New section 14(h)(1)(C) would require the SEC to adopt rules to prohibit compensating any person soliciting proxies, consents, or authorizations from security holders concerning a limited partnership rollup transaction: (i) on the basis of whether the solicited proxies, consents, or authorizations either approve or disapprove the proposed transaction; or (ii) contingent on the transaction's approval, disapproval, or completion. This section would address the conflict of interest that arises when a person (for example, a broker-dealer or proxy solicitor) is soliciting proxies and is compensated for the delivery of a specific outcome (generally, approval of the proposed partnership rollup transaction). NASD rules implemented in 1991 prohibit NASD members from accepting compensation based upon the outcome of a transaction. This section closes a potential gap in coverage by applying this prohibition to nonmember proxy solicitors as well.

Full and fair disclosure.—New Section 14(h)(1)(D) requires that there be SEC rules related to specific limited partnership rollup disclosure. These provisions generally codify SEC rules promulgated in 1991 requiring clear, concise and comprehensible disclosure in the following areas:

(i) Any changes in the business plan, voting rights, form of ownership interest or the general partner's compensation in the proposed partnership rollup transaction from each of the original limited partnerships;

(ii) The conflicts of interest, if any, of the general partner;

(iii) Whether it is expected that there will be a significant difference between the exchange value of the limited partnership and trading price of the securities to be issued in the partnership rollup transaction;

(iv) The valuation of the limited partnership and the method used to determine the value of limited partners' interests to be exchanged for the securities in the partnership rollup transaction;

(v) The differing risks and effects of the transaction for limited partners in different partnerships proposed to be included, and the risks and effects of completing the transaction with less than all partnerships;

(vi) The statement by the general partner required by Section 14(h)(1)(E);

(vii) Any opinion (other than an opinion of counsel), appraisal, or report that is prepared by an outside party and that is materially related to the rollup transaction and the identity and qualifications of the party who prepared the opinion, appraisal or report; the method of selection of such party and material past, existing, or contemplated relationships between the party, or any of its affiliates and the general partner, sponsor, successor, or any other affiliate; compensation arrangements; and the basis for rendering and methods used in developing the opinion, appraisal or report; and

(viii) Such other matters deemed necessary or appropriate by the SEC.

Fairness statement.—New Section 14(h)(1)(E) provides that SEC rules require a statement by the general partner as to whether the proposed rollup transaction is fair or unfair to investors in each limited partnership, a discussion of the basis for that conclusion, and a description of alternatives to the partnership rollup transaction, such as liquidation.

Minimum offering period.—New Section 14(h)(1)(F) provides that SEC rules require that all shareholders have at least sixty calendar days to review a limited partnership rollup transaction disclosure document, unless a lesser period is required under state law. Due to the complex nature of rollup transactions, witnesses testified that solicitation materials and other disclosure documents are lengthy and complicated. The overwhelming majority of those invested in limited partnerships are individual investors, who may need an extended period of time to review and analyze the proposal, communicate concerns, and offer alternatives. This provision codifies SEC rules, giving limited partners additional time in which to conduct their review, unless applicable state law mandates a lesser period of time.

Commission discretion.—New Section 14(h)(1)(G) provides that the SEC may require other provisions it deems necessary and appropriate.

Summary.—New Section 14(h)(2) requires that the soliciting material include a clear and concise summary of the limited partnership rollup transaction, with the risks of the transaction set forth prominently in the forepart of the summary.

Exemptions.—New section 14(h)(3) would give the SEC broad authority to exempt by rule or order securities, transactions and persons or classes of persons from the requirements imposed pursuant to new section 14(h)(1) and (2) and from paragraph 5, which defines limited partnership rollup transactions. It is intended that the SEC use this authority to exempt those transactions that do not involve the potential for abuses of the kind that led to development of the legislation.

Effect on commission authority.—New section 14(h)(4) states that nothing in the Act shall be construed to limit the SEC's authority under subsections (a) or (d) of section 14 of the Exchange Act or any other provision of the securities laws or to preclude the SEC from imposing, under subsections (a) or (d) or any such other provision, a remedy or procedure required to be imposed under this subsection.

Definitions.—Section 14(h)(5)(A) defines the term "limited partnership rollup transaction" to mean a transaction involving the combination or reorganization of limited partnerships, either directly or indirectly, where some or all investors in the limited partnerships receive new securities or securities in another entity. The definition provides exceptions for certain kinds of private transactions or other transactions in which the protections of the Act are not called for. In addition, new section 14(h)(5)(B) defines the term "limited partnership rollup transaction" to include the reorganization of a single limited partnership, directly or indirectly, in which some or all investors receive new securities or securities in another

entity, if the transaction meets certain specified criteria in the Act. To fall under the definition, securities received in single or multiple partnership rollups could be received directly, or indirectly through a step transaction.

Transactions involving the combination or reorganization of multiple partnerships.—Transactions involving multiple partnerships defined as "limited partnership rollup transactions" are covered by the Act in Section 14(h)(5)(A), with the exception of the following:

(i) A transaction in which the existing limited partnership securities trade on a national securities exchange or on the national market system (and, therefore, have met specific listing requirements and can be sold readily in a liquid market) and the securities received by investors in exchange for their limited partnership securities also trade on a national securities exchange or on the national market system;

(ii) A transaction involving issuers that are not required to register or report under section 12 of the Exchange Act both before and after the transaction;

(iii) A transaction in which the securities are not required to be and are not registered under the Securities Act of 1933 (for example, private placements, Regulation D offerings, securities issued in bankruptcy proceedings, certain exchange offers);

(iv) A transaction where there will be no significant adverse change to investors in voting rights, the term of existence of the entity, management compensation, or investment objectives; or

(v) A transaction where each investor is provided an option to receive or retain a security under substantially the same terms and conditions as the original issue.

The phrase "directly or indirectly" is intended to make clear that multiple or step transactions designed to circumvent the purposes of the legislation would be included in the definition of "limited partnership rollup transaction." However, if one or more partnerships convert to corporate form in full compliance with the legislation, a subsequent unrelated merger of the corporations would not trigger the provisions of the Act.

The Reorganization of a single limited partnership.—Transactions involving single limited partnerships meet the definition of "limited partnership rollup transaction" and are covered by the legislation if they meet all of the criteria set forth below. These criteria are intended to parallel the exemptions applicable to multiple-partnership transactions:

(i) The securities issued in the transaction will be traded on a national securities exchange or on the national market system (and, therefore, generally are exempted from state securities registration and review);

(ii) The existing limited partnership securities are not traded on a national securities exchange or on the national market system;

(iii) The issuer is a reporting company under section 12 of the Exchange Act both before and after the transaction, or the securities to be issued or exchanged are required to be or are registered under the Securities Act;

(iv) There are significant adverse changes to security holders in voting rights, the term of existence of the entity, management compensation, or investment objectives; and

(v) Investors are not provided an option to retain a security under substantially the same terms and conditions as the original issue.

Exclusion from the definition.—New Section 14(h)(6) provides exclusions from the definition of limited partnership rollup:

(A) Excluded is any transaction involving a limited partnership or partnerships having an ongoing operating policy or practice of retaining cash available for distribution and reinvesting proceeds from the sale, financing or refinancing of assets, in accordance with such criteria as the SEC determines appropriate. This exclusion codifies the SEC's exclusion from its roll-up disclosure rules of transactions involving partnerships that are not "finite-life" entities.

In these kinds of reinvesting partnerships, investors typically expect that the partnership will be an ongoing reinvesting business operation, and have not necessarily relied upon the expectation that the partnership would be dissolved within a given period of time and cash distributed to limited partners. This exclusion would apply, for example, to a "clean up" transaction in which partnerships of this nature are converted to corporate form in anticipation of an initial public offering, or a transaction involving an ongoing concern which reinvests proceeds and that is set up as a partnership but is seeking to convert to a corporation or trust.

(B)(i) Also excluded is any transaction in which a non-affiliated party succeeds to the interest of a general partner if 66 ⅔ percent of the outstanding units of the participating limited partnership approves the transaction and the general partners receive no special compensation. This would exempt arms-length transactions involving a third party. The limitation on special compensation to the general partner in such transactions ensures that there will be no special payment to the general partners to secure their approval of the transaction.

(B)(ii) Also excluded is any transaction involving only limited partnership interests that are repurchased, recalled, or exchanged pursuant to the terms of the pre-existing partnership agreements, in exchange for securities in an operating company that is specifically identified when the original limited partnership is formed. The Committee intends that these transactions substantially comply with the terms of the pre-existing partnership agreements in all material respects. It is not necessary that the transaction in which the limited partnership interests are repurchased, recalled or exchanged be identical to the transaction described in the pre-existing partnership agreement. Such partnerships would include, for example, limited partnerships established solely for the purpose of conducting research and development and which were always intended to be merged with a parent or other affiliate. These types of transactions have not been involved in the abuses the legislation is designed to address. Moreover, investors in these types of limited partnerships are fully aware at the time of

their original investment that a future exchange of their limited partnership interests for other securities is contemplated.

(C) Also excluded is any transaction in which the limited partnership interests are exchanged for securities of another entity that are listed on a national securities exchange or on the national market system that have been traded for not less than 12 months and the securities to be issued to investors in the transaction do not exceed 20 percent of the outstanding securities of that entity after giving effect to the issuance of securities. Securities that are widely traded and "seasoned" have a readily ascertainable market value and permit holders of the limited partnership interests to evaluate the consideration being offered in exchange for their interest. Moreover, these types of securities are generally liquid and may be sold by investors following the exchange of securities. The 20 percent limitation is intended to limit the effect of the issuance on the market price of the issuer's securities.

Schedule for regulations.—This section requires that the SEC promulgate final regulations which shall become effective not later than 12 months after the enactment of this Act.

Section 3. Rules of fair practice and listing standards in rollup transactions.

Section 3(a). Registered securities association rules.—This section amends Section 15A(b) of the Securities Exchange Act of 1934. It requires that the rules of a registered securities association (for example, the NASD) to promote just and equitable principles of trade include rules to prevent members of the association from participating in any limited partnership rollup transaction that does not provide procedures to protect the rights of limited partners, including—

(A) The right of dissenting limited partners to one of the following: (i) an appraisal and compensation; (ii) retention of a security under substantially the same terms and conditions of the original issue; (iii) approval of the limited partnership rollup transaction by not less than 75 percent of the outstanding units of each of the participating limited partnerships; or (iv) other rights designed to protect dissenting limited partners;

(B) The right not to have their voting power unfairly reduced or abridged;

(C) The right not to bear an unfair portion of the costs of a proposed rollup transaction that is rejected; and

(D) Restrictions on the conversion of contingent interests or fees into non-contingent interests or fees and restrictions on the receipt of a non-contingent equity interest in exchange for fees for services which have not yet been provided.

"Dissenting limited partner" is defined to mean a person who, on the date on which rollup soliciting material is mailed to investors, is a holder of a beneficial interest in a limited partnership that is the subject of a limited partnership rollup transaction and who votes against the transaction and complies with procedures established by the NASD to assert dissenters' rights. By defining "dissenting limited partner" to mean a person who is a holder of the limited partnership interests on the date on which soliciting material is mailed, this section prevents persons who buy limited part-

nership interests after that date from asserting dissenters' rights. These persons are on notice of the proposed rollup transaction when they purchase their limited partnership interests and, therefore, do not need the same type of protections granted to existing limited partners.

Section 3(b). Listing standards of national securities exchanges.—This section amends Section 6(b) of the Securities Exchange Act of 1934 to prohibit an exchange from listing any securities resulting from a rollup transaction unless such transaction provides certain rights for limited partners. The rights set forth under this section are identical to those set forth in Section 3(a) of the legislation for registered securities associations.

Section 3(c). Standards for automated quotation systems.—This section amends Section 15A(b) of the Securities Exchange Act of 1934. It requires that the rules of a registered securities association prohibit the authorization for quotation on an automated interdealer quotation system sponsored by the association any security designated by the SEC as a national market system security resulting from a rollup transaction, unless such transaction provides certain rights for limited partners. The rights set forth under this section are identical to those set forth in Section 3(a) for registered securities associations.

Section 3(d). Effect on existing authority.—The amendments made by this section shall not limit the authority of the SEC, a registered securities association, or a national securities exchange under any provision of the Securities and Exchange Act of 1934, or preclude the SEC or such association or exchange from imposing, under any other such provision, a remedy or procedure required to be imposed under such amendments.

Section 3(e). Effective date.—The amendments made by this section shall become effective 12 months after the date of enactment of this Act.

Section 4. Review of filings prior to effective date

This section provides that, prior to the effective date of regulations adopted pursuant to this Act, the SEC shall continue to review and declare effective registration statements and amendments thereto relating to limited partnership rollup transactions in accordance with applicable regulations then in effect. This provision addresses the Committee's intent that, after enactment of the Act and prior to the adoption of final rules, the SEC should not delay processing registration statements and declaring them effective if they are in accordance with regulations then in effect. The Committee intends that the SEC shall continue to apply in the appropriate manner the public interest, protection of investors, and other standards set forth in Section 8(a) of the Securities Act.

REGULATORY IMPACT STATEMENT

In compliance with paragraph 11(b) of rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement regarding the regulatory impact of the bill. This bill will, in certain respects, codify SEC rules as well as codify and expand the application of existing and pending NASD rules with respect to protecting investors subject to limited partnership rollup transactions. The

bill also would require additional changes in listing standards for securities issued in limited partnership rollup transactions in order to provide uniform national standards.

The SEC advised the Committee that, during the 1980s, over $150 billion of public limited partnerships were sold to U.S. investors. In testimony submitted to the Committee by industry witnesses, it was estimated that 11 million investors have purchased limited partnerships and, of these, approximately eight million are small investors. Based upon data supplied by regulators and industry members, it is estimated that, of approximately 4,000 partnership programs, between 35 and 50 major sponsors have sponsored 500 to 1,000 of these programs. Information provided to the Committee by the SEC shows that from January 1, 1985 through January 1, 1993, 73 multiple limited partnership transactions were registered with the SEC. These rollup transactions involved approximately 1,800 separate limited partnerships. In addition, single partnership reorganizations were undertaken; however, the SEC did not keep records of the numbers of these transactions.

Although the Committee can estimate the potential universe of limited partnerships that may be affected by the Act, the Committee cannot estimate with any degree of confidence the number of partnership rollups that may be proposed subsequent to the enactment of this Act, since such actions are affected by future economic and business conditions. The Committee notes that, in developing exclusions to the definition of a limited partnership rollup transaction, the Committee sought to exclude transactions affording sufficient protection for investors. The Committee believes that a substantial number of limited partnerships combinations and reorganizations will fall within the exclusions to the definition. In addition, the SEC has broad exemptive authority under the Act, which it can exercise by rule or order to give parties relief from some or all of the Act's requirements.

The Committee believes that there will be a substantial regulatory burden on partnership sponsors and others who propose partnership combinations and reorganizations that fall within the definition of a limited partnership rollup and, thus, must comply with the rules of the SEC, the NASD, or otherwise comply with the provisions of the bill. The Committee notes that existing SEC rules impose a number of requirements that, in part, would be codified by this Act. Thus, with respect to these requirements, the additional burdens imposed by this Act would be small. In addition, the Committee notes that existing and pending NASD rules, in part, would be codified by this Act. Thus, with respect to these requirement, the additional burdens imposed by this Act would be small. However, because the Act extends many of these requirements to non-NASD members, the additional burdens imposed on non-NASD members involved in a rollup transaction may be great.

The Committee also notes that the SEC and NASD, as a result of final passage of this Act, may be required to make changes in existing and pending rules in order to comply with this Act. The Committee intends that these provisions be implemented with minimal overall increase in the regulatory burden.

The Committee believes the benefits of this Act outweigh the burdens of the regulation. The Committee notes that, by imposing

nation-wide standards for limited partnership rollup transactions, this legislation is intended to forestall additional and inconsistent state action that would impose substantial costs on business. Moreover, the Committee notes that, by protecting investors subject to limited partnership rollup transactions, this legislation will enhance investor confidence in the nation's securities market and enhance the capital formation function of limited partnerships.

CHANGES IN EXISTING LAW

In the opinion of the Committee, it is necessary to dispense with the requirement of subsection 12 of rule XXVI of the Standing Rules of the Senate in order to expedite the business of the Senate.

COST OF THE LEGISLATION

The Committee has requested a cost estimate of this legislation under the provisions of Section 403 of the Congressional Budget Act of 1974. The cost estimate of the Congressional Budget office follows.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, July 7, 1993.

Hon. DONALD W. RIEGLE, Jr.,
Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has reviewed S. 424, the Limited Partnership Rollup Reform Act of 1993, as ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs on June 29, 1993. CBO estimates that implementation of S. 424 would cost between $400,000 and $500,000 over the next three years, assuming appropriation of the necessary amounts. Enactment of S. 424 would not affect direct spending or receipts. Therefore, pay-as-you-go procedures would not apply to the bill.

S. 424 would amend the Securities Exchange Act of 1934 to curb abusive practices in limited partnership rollups and to provide enhanced protection to investors affected by partnership rollup transactions. The bill would prohibit any proxy solicitation or tender offer in connection with a partnership rollup transaction unless the transaction is conducted in accord with rules prescribed by the Securities and Exchange Commission (SEC). The bill would direct the SEC to initiate a rulemaking procedure to promulgate such rules. Finally, S. 424 would mandate that the rules of registered securities exchanges and of automated quotation systems include provisions that protect dissenters' rights in rollup transactions.

Based on information provided by the SEC, CBO estimates that promulgating and enforcing the various rules required and overseeing changes in the rules of registered securities exchanges and automated quotation systems would cost the federal government between $400,000 and $500,000 over the next three years. CBO estimates that enactment of this bill would result in no cost to state or local governments.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is John Webb.

Sincerely,

JAMES L. BLUM
(for Robert D. Reischauer, Director).

MINORITY VIEWS OF SENATOR WILLIAM V. ROTH, JR.

When abuses regarding limited partnership rollups were first considered by this Committee in 1991, the SEC subsequently responded with a number of provisions mandating that disclosures be made to limited partners in order to provide them with information to make investment decisions in their own best interest. (I understand that similar rules proposed by the NASD are currently pending awaiting approval by the SEC.) Of course, the rules would not reverse the financial impact of what were in essence risky investments, but the rules did provide some appropriate protections against misleading or inadequate disclosures regarding the rollup process.

Agency rules alone, however, were clearly not enough protection for some who argued that steps taken by the regulators to address separate and distinct problem areas still left gaps in investor-protection rules governing rollups. As a result, on June 29, S.424, the "Limited Partnership Rollup Reform Act" was marked up by the Banking Committee by an overwhelming vote.

Unfortunately S.424 not only codifies the SEC rules (with which this Senator has no argument) but also mandates federal listing standards on the national exchanges for limited partnerships rolled up into corporations, creating a dangerous precedent of federal intrusion into areas historically governed by the States.

The purpose of this dissent is not to challenge the disclosure provisions of S.424 which, in light of the abuses that were extensively reviewed and catalogued by Chairman Dodd's Subcommittee on Securities as well as the full committee, are an appropriate response in protecting investors.

Rather, my concern lies with the listing standards which interfere directly with the substantive rights of investors legitimately developed under State law by mandating federal listing procedures for the listing of any security issued after a limited partnership rollup transaction is conducted under State contract or partnership law.

Having said that, it should be pointed out that some of the current listing standards adopted by the exchanges and the self-regulatory organizations (SROs) do address substantive rights of investors (although the vast majority of those rules address disclosure issues for the investing public). The critical difference between the current listing standards and the one proposed by S.424 is that the current standards were independently developed by the exchanges and the SROs under a regulatory regime far different from what is being proposed in S.424. In other words, the exchanges and the SROs were free to develop listing standards dealing with matters of internal corporate governance subject only to the SEC's right to veto a proposed rule. To me, there is a world of difference between

freely choosing the terms on which one will do business with another and government edict.

With S.424 we are faced with an unprecedented federal interference of private substantive rights that have traditionally been under the jurisdiction of State law.

The scheme of delisting corporations is an enforcement mechanism that has arisen on previous occasions in corporate governance debates. But S.424 is significantly different from those proposals. While I oppose both categories of legislation on federalism grounds, S.424 is, in theory, the worse yet, in practice, the better. This is so because S.424 covers relatively few transactions. What is worse is that S.424 reaches individual contracts, a matter usually viewed as far removed from federal concern. Moreover, the legislation deputizes the exchanges to enforce federal standards of private contract which are, in my opinion, unrelated to the business of the exchanges.

Exchanges have no natural interest in the prior lives of those who solicit its services. To me, S.424 is as strained a legislative effort as it would be to require shopkeepers not to do business with customers who earned their spending money in a manner contrary to imagined federal standards. That Congress may regulate shopkeepers in the flow of interstate commerce is well settled. But that proposition does not in itself prove that Congress may regulate how individuals earn money to become the shopkeepers' customers. That must be judged independently. In making that judgment about S.424, the legitimacy of Congress' choice should receive no support from the fact the we can regulate exchanges. The standards legislated in S.424 have, in my opinion, no natural relationship to the business of the exchanges.

The doctrine of federalism is incorporated in the constitutional plan. The purpose of this doctrine is not to generate lawyer-like arguments about legislation but to empower individual citizens and to protect their freedom. The framers stretched the power of government over many discrete power centers by separating powers among three branches and dividing powers with the States. And when States further divided power internally, the grand design enabled individual citizens to know what different power centers were accountable for the decisions affecting their lives.

The suggestion that in modern times Congress be the only power center runs counter to the constitutional plan. When all relevant decisions for individual citizens are made in one place, the electorate has less choice, less leverage, in electing a government that suits it. In such circumstances each voter must weigh the good and the bad of just one power center—Congress—and vote. Under the constitutional plan, the voter makes similar judgments, but the greater number of power centers envisioned by the framers, including State and local governments, grant each voter more choices and more personal power over each voter's own destiny.

In the constitutional plan, it falls particularly to this institution to safeguard the interests of the States and, in turn, the people. The freedom of the people is neither won nor lost in a day. But it is lost with an attitude that federalism does not matter any more.

It is shame that that attitude is growing so prevalent in this body. It we don't care, who will?

WILLIAM V. ROTH, Jr.

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