Obstacles and Opportunities in the Establishment of a Secondary Market for Real Estate Limited Partnerships

by

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Bachelor of Architecture
Carnegie - Mellon University, 1988

Submitted to the Department of Architecture
in Partial Fulfillment of the Requirements for the Degree of

Master of Science
in Real Estate Development

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ABSTRACT

An informal secondary market for publicly syndicated limited partnerships has formed in response to a need of owners to sell their partnership interests and as a means for prospective buyers to exploit an investment opportunity. Sellers and buyers frequently meet on unequal terms. Original limited partners are often unsophisticated investors with an incomplete understanding of real estate securities. Limited partners who seek to liquidate their investment find they have suffered severe diminution in the value of their investments and severe restrictions on the saleability of the partnership interests.

This thesis attempts to document the obstacles in the establishment of an efficient secondary market for publicly syndicated limited partnership interests. The limited partnership investment structure is itself a major impediment to the development of an efficient market. Federal tax and securities regulations have a negative impact on the liquidity of limited partnership interests. General partners, acting in their own interest, create barriers to information and fair access to the informal secondary market.

Attempts to create more efficient markets have met with limited success. Inefficiency in the secondary market has produced windfalls for some new investors. Recent Internal Revenue Service rulings have reduced the possible level of efficiency in the secondary market. A proposed central exchange, expected to increase market efficiency, is not likely to receive the support of most secondary market participants. Finally, the diminishing pool of limited partnerships suggests a finite life for the secondary market.

Thesis Supervisor: Blake Eagle
Title: Chairman, MIT Center for Real Estate
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Chapter One

Introduction

An informal secondary market for publicly syndicated limited partnerships has formed in response to a need by current owners of partnership interests to sell their units and as a means for prospective buyers to exploit an investment opportunity. Prospective sellers and buyers are often not meeting on equal terms or in common interest. Each participant in the secondary market challenges the development of an efficient market. The limited partnership investment structure is itself a major impediment to the development of liquidity in the secondary market. Is it possible to develop an efficient secondary market for real estate limited partnerships, given the constraints inherent in this investment form?

Background

The real estate investment environment of today is significantly different than that of 15 years ago. Tax laws and capital market conditions in the 70’s and 80’s led to the development of the limited partnership as a means to raise equity for real estate. Public and private offerings were bought by private investors looking for tax shelter, inflation protection and profits. Many of the public offerings were promoted as a way for the small investor to participate in real estate, widely believed to be an inflation hedge, offering greater return and moderate risk as compared to stocks. The ability for an individual of modest net worth or income to invest in securitized real estate was viewed as a real benefit of public syndications. A demand for tax shelter opportunities was stimulated by inflation pushing incomes into higher tax brackets. It is estimated that over $90 billion in equity was raised by public syndications since the early seventies. The limited partnership syndication obviously filled a need and exploited the investment demand for its time.

The conditions that favored limited partnership syndications in the 1970’s and early 1980s disappeared. The 1986 Tax Reform Act all but eliminated the usefulness of real estate tax shelters for individual investors. In the aftermath of the tax act and significant over investment in real estate by banks, savings and loans, insurance companies, pension funds and foreign institutions, real estate values plummeted. It was the worst real estate
market since the Great Depression. These events dealt a crushing blow to the value of most real estate limited partnership interests.

The limited partners were sold their investments on the assumption that real estate was a safe, growing investment. Often these investors were unsophisticated in investment matters, and were more often swayed by aggressive brokerage salesmanship. The importance of liquidity became apparent to the investors only after substantial investment had already occurred. Liquidity was never promised for limited partnership securities and the partnership structure itself was designed to constrain liquidity. Following the real estate crash in the early 1990’s, holders of limited partnership units had no way of selling their units except at enormous discount to their asset values.

A small, informal, secondary market for limited partnership interests had always existed. This market was formed to dispose of partnership interests due to death, divorce or disaster to an investor. Often, the sales of the limited partnerships were conducted through the partnership’s general partner, who controlled the information and transaction processes. This internal mechanism broke down when the demand for transfers or sales of partnership units increased in the wake of the real estate market plunge.

The conflict between the original limited partners, the sellers in the secondary market, the general partners, and brokers, became evident. The general partner enjoyed significant inside information on the health and future of the partnership’s assets. The general partner’s interests lay with holding on to the asset. The general partner was the developer/manager of the asset, who earned fee income from this activity, whether or not the partnership made money. Limited partners were at the mercy of a general partner with opposite goals from their own, as well as the syndicators and brokers who sold syndicated partnerships.

Innovators in the brokerage and real estate finance industry have attempted to create a better alternative for the limited partners desiring liquidity. This private market remains an informal and decentralized collection of independent broker/dealers and securities firms’ internal matching services. Its existence is rarely known by the limited partners, who often rely on their general partners for information. A trade association, the Investment Program Association (IPA) is attempting to create a central limited partnership exchange, and promote the exchange to limited partners. The independent exchanges and dealers who
constitute the informal market have experienced recent growth in trading volume. These exchanges have developed their own strategies to meet the challenges of creating a market.

Growth of a secondary market for RELPs is limited by factors unique to the limited partnership structure. The real estate limited partnership structure produces unique tax obligations when selling partnership shares. IRS regulations place restrictions on limited partnership secondary market trading. SEC regulations and NASD standards of practice have also conflicted with the requirements of secondary market participants.

Research Methodology and Scope

The focus of the thesis has been the secondary market for Real Estate Limited Partnerships (RELPs). Real estate partnerships account for approximately half of the total limited partnership public syndications. Real estate syndicated partnerships make up a substantial portion of the secondary market as well. The focus on real estate is also a result of the greater understanding of this asset class and the general public interest in real estate. Equipment leasing and energy partnerships are the other types of partnerships traded on the secondary market.

Sources of information for this thesis is composed of the following:

- Primary Sources – Interviews of participants in the informal secondary market.
- Literature Survey – A description of the real estate limited partnership structure, the tax and regulatory restrictions and the history of the informal secondary markets available from real estate finance literature.
- Market Data – Trading and valuation data exists from private partnership valuation consultants, private exchange operators, and general partners.

The research has concentrated on examining publicly syndicated real estate limited partnerships marketed by the large syndicators and Wall Street firms. These public syndications constitute a large share of the RELP market. They are well documented and partnership interests have trading histories in the secondary market. Public information is
available on individual real estate partnership performance. The research reveals inherent conflicts of interest between investors and sponsors of partnerships.

Creating a more efficient market is important in meeting the needs of the unsophisticated limited partners who originally invested in the public syndications. Many of these investors suffered significant unexpected losses when the real estate market collapsed. They continue to be exploited as they try to sell their partnership units. The establishment of an efficient secondary market is required if sponsors expect to raise any more capital from small investors through limited partnerships.

Organization

The following chapters will be organized as follows:

Chapter 2 – Limited Partnership Syndication. A summary of the real estate limited partnership structure and its legal and regulatory requirements is presented. In addition, the public syndication process and structure is discussed, which includes a historical overview of the development of the market, its structure and participant relationships that evolved.

Chapter 3 – The Limited Partnership Secondary Market. A historical summary of the development of the informal secondary market exchanges, and the marketing and regulatory problems this market encountered.

Chapter 4 – An Inefficient Market. The secondary market for RELPs is a securities market which can be considered inefficient. The secondary market is constrained not only by tax and securities regulations, but also by unequal information among the participants. Pricing of partnership units is not standardized and the small size and trading volume result in uncertain valuation for the individual partnership units.

Chapter 5 – Limited and General Partners’ Motivations. The development of an efficient market is challenged by the conflicting interests of the participants in the secondary market. Manipulation by general partners, who seek to
capitalized on superior information, challenges efforts to create a more efficient market.

Chapter 6 – Efficient Market Perspectives. The prospects for a proposed central partnership exchange are presented. Even if the secondary market is successful in improving its efficiency and trading volume, the limited partnership secondary market could be a temporary phenomena. Few new partnerships are being organized, the existing partnerships’ assets are being liquidated, and the partnerships are being consolidated or transformed into other ownership forms.
Chapter Two

Historical Background of Real Estate Syndication

An examination of the structure and history of publicly syndicated real estate limited partnerships (RELPs) provides considerable insight into problems confronting the establishment of an efficient secondary market. Creating an opportunity for more investors to participate in real estate ownership led to the development of real estate limited partnerships. In the 1970s and 1980s, publicly syndicated partnerships became a major component in financing real estate activities, as well as energy and cable TV ventures. The size of these partnerships and the number of investors eventually created the need for the development of a secondary market.

"...We could see that the syndication process was a practical and cost-effective way to raise money for the purchase and development of property. We also knew that its profit potential for investors – considering the minimal risk involved – probably could not be matched. ... All that was needed from [an investor] was a small investment – perhaps only a few thousand dollars – and the general partner would use his expertise in choosing and managing the investment."

Public RELP Syndications


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The rapid expansion of syndication volume in the mid eighties was a result of several important factors. The involvement of large Wall Street firms, positive investor perceptions, and aggressive marketing were contributors to this growth. The most significant factor, however, was the encouragement of real estate investment through tax regulations. The Economic Recovery Act of 1981 allowed generous tax shelter opportunities through rapid depreciation of real estate. The tax shelter aspects of real estate fueled real estate investment demand by taxable investors, as individuals were driven into higher tax brackets by the rapid inflation of the 1970’s. Increased investment by banks, savings and loans, insurance companies, pension funds and foreign investors pushed up real estate values and construction levels.

The value of the tax shelter was derived from real estate income which was offset by interest and depreciation deductions. Taxable income in real estate could be negative, generating a tax loss, while actual cash income was positive. Prior to 1986, investors could apply a tax loss to offset personal income, thus reducing the individual’s federal income tax. Shorter depreciation periods were allowed, as well as accelerated depreciation methods, deferring taxes until the real estate was sold. The potential advantage of this system is demonstrated below.

### Calculation of Taxable Income (Loss) Prior to 1986 Tax Reform Act

<table>
<thead>
<tr>
<th></th>
<th>Prior to 1986 Tax Reform Act</th>
</tr>
</thead>
<tbody>
<tr>
<td>Project Development Cost</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Loan</td>
<td>$7,000,000</td>
</tr>
<tr>
<td>Equity</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Depreciable Basis (not including land)</td>
<td>$9,500,000</td>
</tr>
<tr>
<td>Net Operating Income (8.5% yield)</td>
<td>$850,000</td>
</tr>
<tr>
<td>Income after operating expenses</td>
<td>($700,000)</td>
</tr>
<tr>
<td>Interest a</td>
<td>($633,333)</td>
</tr>
<tr>
<td>Depreciation b</td>
<td>($483,333)</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>($483,333)</td>
</tr>
<tr>
<td>Cash Flow</td>
<td>$850,000</td>
</tr>
<tr>
<td>Debt Service</td>
<td>($763,308)</td>
</tr>
<tr>
<td>Cash Flow</td>
<td>$86,691</td>
</tr>
<tr>
<td>Tax Shelter at 50% Rate c</td>
<td>$241,667</td>
</tr>
<tr>
<td>After Tax Return</td>
<td>$328,358/year</td>
</tr>
</tbody>
</table>

a. $7,000,000 Mortgage, 25 year amortization, 10% interest  
b. $9,500,000 Basis, 15 year straight line depreciation  
c. Regular income reduction of 50% taxable income loss from real estate
In the peak years of 1985 and 1986, an average of $7 billion was raised each year. The decline in the popularity of RELP investment following that peak was an immediate, and direct result of the Tax Reform Act (TRA) of 1986. By 1988, when the act’s provisions became fully applicable, sales of publicly syndicated RELPs had fallen by 50%.

The Tax Reform Act of 1986 removed the great majority of previously available tax benefits for real estate. The ability to shelter regular income with real estate tax losses was eliminated. Depreciation schedules were lengthened, reducing the value of the tax deferral. For partnerships set up primarily as tax shelters, their attraction to investors was destroyed. Investors in existing partnerships were also affected, as their tax shelters were phased out. Deep tax shelter partnerships became rare. These partnerships were structured to generate large taxable income losses. Deep tax shelter partnerships were more commonly offered in private syndications, although many public partnerships relied on tax shelter for investment return. Elimination of tax benefits was a major contribution to the causes of the real estate crash which began in the late 1980s.

"...what most failed to realize was that good real estate tax shelters required bad real estate economics."  

The defining event in the recent history of real estate was the collapse of the national real estate markets in the late 1980s and early 1990s. From 1987 to 1993, the value of commercial real estate included in the NCREIF Index declined by 35-40%. The analysis of this crash has been the subject of much research, and will not be repeated here. The result for the investors of publicly syndicated RELPs was equally drastic: 1) As will be explained later, limited partners were ill equipped to understand the risks of investment in real estate, and 2) the illiquidity of real estate limited partnerships interests gave them little opportunity to escape from their investment.

The large number of limited partners inevitably led to the need for increased liquidity of real estate securities. An early innovation offering limited partners a tradable security was the application of Master Limited Partnerships (MLP) to real estate. MLPs are partnerships that are publicly traded on a national stock exchange. The formation of real estate MLPs

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often included the merger of multiple, smaller partnerships, into a single large partnership in a process called a “roll-up.”

Soon after the introduction of MLPs, the Treasury Department introduced rules which narrowed the ability for corporations to use the MLP form to escape corporate taxation; the Revenue Act of 1987 and IRS Revenue Ruling 88-75. The Treasury Department concern was that operating corporations would elect to become partnerships, thereby avoiding paying federal taxes at the entity level. The MLP growth was short-lived, although recognizing the unique situation of real estate partnerships, the IRS excluded real estate MLPs, a handful of which continue to exist. The marketability of MLPs was effected by the lack of institutional buyers; tax exempt investors could be taxed on income from the MLP deemed “unrelated business income,” and institutional investor concerns about the lack of investor control and sponsor compensation.

The demand for real estate investment in a securitized format was met by increases in the formation of Real Estate Investment Trusts (REITs). These entities are not taxed as a corporation if they meet strict requirements governing their operation. REITs issue stock equities which are traded on national exchanges, such as the New York Stock Exchange, and therefore offer the liquidity lacking in the public RELP syndications. Partnerships were transformed into REITs in the “roll-up” process. Abuses occurring in the roll-ups prompted Congress to enact regulations limiting roll-ups in 1993.

Public real estate securities have an appeal to investors seeking to participate in the ownership of commercial real estate. Tax laws and capital market conditions in the 1970s and 1980s made it possible for real estate companies to raise capital through syndications which funded their real estate acquisitions. The ability for an individual of modest net worth and income to invest in securitized real estate was the benefit promised by the public syndicators. Public syndications filled real estate ownership needs of many investors.

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**Limited Partnership Basics**

The investment form most suitable for securitized tax advantaged real estate investment in the 1980s was the limited partnership. Two major characteristics of limited partnerships made them attractive to real estate investors. The first is limitation of liability. A limited partnership has two categories of partners; general and limited. Limited partners are insulated from liability beyond their invested equity, the same as stockholders in a corporation. The general partner personally, or as an entity, bears the full liability of the partnership. The limited partnership is managed by the general partner. Limited partners are for all practical purposes passive investors.

The second advantage is a limited partnership is not taxed as an entity. All profits “flow through” to the partners, thereby avoiding the double taxation of corporate structures. The limited partnership allows tax losses to be passed on to the limited partners which creates “tax shelters.” The flexibility of the limited partnership form also allows for disproportionate allocation of the economic benefits. Tax losses can be allocated by partner agreement. Typical agreements allocate the tax benefits and a preferred cash return to the limited partners, with residual cash returns and a share of the sale proceeds to the general partner. Partnership agreements also specify general partners’ management fees, often determined as a percentage of operating income. Regulatory control of the limited partnership form is flexible enough to allow for large numbers of limited partners in a single partnership.

**Partnership Regulation**

Regulation of limited partnerships is governed by the Internal Revenue Service, the Securities Exchange Commission, and partnership law at the state level. State partnership laws are modeled after national partnerships acts; the Uniform Partnership Act (UPA – 1914), and the Uniform Limited Partnership Act (ULPA – 1916), Revised (RULPA – 1976, 1985). These acts set a national standard for the regulation of limited partnerships, and define the rights and responsibilities of the partners. Almost all states have adopted RULPA or ULPA.
Partnerships formed in states which have adopted ULPA or RULPA are required to file a partnership certificate with the state. The partnership certificate is a prerequisite for the marketing investment in a limited partnership. Partnerships can exist without a partnership certificate or a formal agreement (either written or oral), but those that do are classified as a general partnerships which means all partners have general liability. Obtaining a partnership certificate is critical to successfully sell limited partnership interests.

The partnership certificate, as required in RULPA, requires the following information be included: 1) the name of the partnership, 2) the address of the registered office and agent, 3) the name and address of each general partner and 4) the latest date of dissolution. Under ULPA, 14 items are required to be included in the partnership certificate, including: names of each partner, general and limited, location and character of partnership business, each partner’s capital contributions, time of return of partners’ contribution, distribution of profits and losses, or other compensation, rights of limited partners to assign their interests. The revisions in RULPA simplified the partnership certificate and encouraged the use of comprehensive limited partnership agreements.

ULPA requires that the partnership certificate be amended whenever a limited partner change occurs, either a new or substitute partner, or a change in a partner’s contribution. ULPA requires all partners to sign amended certificates. Limited partners typically are required in the partnership agreement to sign a power of attorney giving the general partner the right to update the amendments on their behalf. RULPA eliminates the need and expense of obtaining powers of attorney for each partner by requiring only the affected partners to sign the amendment.

Limited partners are passive investors, with little control in the management of the partnership. The rights of the limited partners with respect to the operation of the partnership is defined in ULPA, §10:

1. Access to Records and Accounting – the right at all times to inspect and copy any of the partnership books and full account of appropriate partnership events.
2. Distribution – a share of partnership profits and return of contribution.
3. Liquidation – the right to seek dissolution of the partnership.

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5 Jarchow, pp. 95-105.
6 Jarchow, p. 100.
Neither ULPA nor RULPA require preparation of financial statements or financial reports.

Qualifying for limited liability status under ULPA restricts the amount of operational control available to the limited partners. RULPA expanded the limited partners control. RULPA [§302, §303(b)(5)] defines rights of limited partners through voting about major events of the partnership, such as:

- Dissolution or winding up of the partnership.
- Sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership other than in the ordinary course of its business.
- Change in the nature of the business.
- Removal of a general partner.7

Limited partners have similar status as shareholders in a corporation. To ensure that corporations do not attempt to avoid corporate taxation by declaring themselves partnerships, the IRS scrutinizes partnerships for corporate characteristics. If the limited partnership exhibits more than two of four corporate characteristics defined by the IRS, it is considered a corporation, and subject to tax. The four characteristics are:

- Centralized Management: This characteristic is usually present in RELPs.
- Continuity of Life: Partnerships usually are not considered to have continuity of life because a partnership is dissolved in the event of the death or retirement of a general partner, or the liquidation of the partnership’s assets.
- Limited Liability: Partnerships escape this characteristic because the general partner is fully liable for partnership’s obligations. Further qualifications are required when the general partner is a corporation.
- Transferability of Interests – To avoid this corporate characteristic, the partnership agreement typically requires limited partners to receive the consent of the general partner before transferring a partnership interest.8

Additional qualifications under the tax codes includes a general partners’ minimum capital investment in the partnership, usually 1%.

The Syndication Process and Regulation

Syndication is a process by which a group of individuals cooperate for some business venture. In a typical real estate syndication, the limited partners contributed the capital, and

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7 Jarchow, p. 104.
the sponsor (the general partner) contributed the expertise. There are two distinct syndication markets for real estate limited partnerships; public and private. Private real estate syndications appeal to fewer, wealthier investors. Average per partner investment for small partnerships (fewer than 50 partners) is $204,000. Investment objectives focused almost exclusively on the tax shelter aspects of real estate. Public syndications, in contrast, appealed to larger numbers of smaller investors. The investment goal was less dependent on tax shelter benefits and more on income and growth. Public syndications are subject to considerably greater federal and state securities regulations.

The issues in private syndications are parallel in some respects to those of public syndications, but are sufficiently dissimilar to exclude from this study. Private syndications are typically organized to raise capital for a single project. Investors focused on “deep tax shelters” and did not rely on real estate performance to satisfy their investment goals. Deep tax shelters were created by generating large tax losses, often at the expense of actual operating income generation. Wealthy investors able to use real estate tax losses to reduce federal income tax were indifferent to small, or zero, cash returns. Following the Tax Reform Act of 1986, these investors’ perspectives changed.

Tax shelter elimination and poorly performing real estate destroyed the value of many private partnerships. Many limited partners in private partnerships desired an escape from their investments. Trading of privately syndicated partnerships is extraordinarily rare, however. Private partnership information is not publicly available. Securities purchased in exempted offerings, such as private partnerships, cannot be resold without registration or exemption, thus eliminating private syndications from the RELP secondary market.

Organization of a large real estate public syndication was, and is, a complex and lengthy process. The typical syndication of the 1980s was organized around a blind-pool investment approach. A sponsor/general partner would organize a RELP and then seek to raise capital by selling interests in the limited partnership. Either marketing directly, or more commonly through a Wall Street brokerage, the syndicated limited partnership interests would be offered to the public. After a sufficient number of investors had contributed capital, the general partner would acquire properties. The general partner was

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10 Arnold, pp. 6-14.
also responsible for coordinating the tax and regulatory compliance, financing, investment, legal, and managerial decisions. After the formation of the syndicate, the general partner (sponsor), would manage the partnership and usually operate the properties. The obligations of the general partners were further defined under federal and state securities regulations.

*Regulation of Public Syndication*

The Securities Act of 1933 and the Securities Exchange Act of 1934 apply to real estate syndications under certain conditions. Real estate offerings are considered securities if they meet the securities definition under the 1933 Act. A key defining element under the Act is if an investment contract exists. The concept of an investment contract was defined by the Howey case (SEC v. WJ Howey Co., 328 US 293, reh’g denied, 329 US 819 (1946)). Now referred to as the “Howey Test,” it is the primary determination for the existence of a security. The “Howey Test” has four distinct aspects: 1) The investment of money 2) In a common enterprise 3) With expectations of profits 4) Solely from the efforts of the promoter or a third party. Under this definition, courts have held that partnership interests are securities, subject to securities regulation.\(^\text{12}\)

Exemptions from securities regulations are possible for partnerships under specific conditions. There are four types of exemptions from federal securities regulations: 1) The private offering exemption. 2) The intrastate offering exemption. 3) The small offering exemption. 4) The accredited investors exemption. The exclusion most commonly applied in the formation of real estate partnerships is the private offering exemption, also referred to as “Regulation D.” SEC Regulation D exempts private offerings when the investors have sufficient wealth and sophistication on their own to gain information which would normally be disclosed in an offering prospectus. Private offerings are not exempted from antifraud or civil liabilities under federal securities or state partnership laws.\(^\text{13}\)

\(^{11}\) Arnold, pp. 6-22–6-26.

\(^{12}\) Jarchow, p. 332.

\(^{13}\) Jarchow, pp. 348–350.
Registration Requirements

Under the 1933 Securities Act, the registration process requires preparation of a registration statement for publicly offered securities. A prospectus is included as part of this registration, and this provided potential investors with information relating to the partnership. The SEC registers any securities offering if there has been full disclosure of all material information in a manner that is not misleading to the investor. The SEC provides guidelines for preparing the registration statement, and standard forms for its submittal. Form S-11 was typically used for real estate securities. The SEC prepared Guide 5 (1982), "Preparation of Registration Statements Relating to Interests in Real Estate Limited Partnerships," which provided disclosure requirements in the registration process.\(^\text{14}\)

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Commentary</th>
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<tbody>
<tr>
<td>Use of Proceeds</td>
<td>Explanation of the function of the offering, estimate of offering expenses, including underwriting commissions and organization costs, and all other fees and expenses, including amounts paid to general partners.</td>
</tr>
<tr>
<td>The Sponsor</td>
<td>Extensive description of the sponsor’s business experience, relevant financial information on recent prior syndications of the sponsor, a schedule of “all direct and indirect compensation that the general partners…will receive in connection with the offering,…partnership and property management fees, participation in cash flow distributions and commissions and fees to be received on sale or refinancing of properties.</td>
</tr>
<tr>
<td>Investments</td>
<td>The plans for the real estate investments and the type of properties, location and intended holding periods, as well as method of financing and investment policy as relating to income generation, capital gain or tax shelter focus.</td>
</tr>
<tr>
<td>Tax Considerations</td>
<td>Disclosure of the federal income tax aspects of the offering, including an opinion of tax counsel.</td>
</tr>
<tr>
<td>Distribution Approach</td>
<td>Disclosure of the price at which the securities are offered, the terms of the underwriting agreement and any relationships between the broker-dealers and the general partners.</td>
</tr>
<tr>
<td>Financial Information</td>
<td>Information relating to the financial condition of the partnership and the general partners, including an audited balance sheet, and income statements of the partnerships and general partner financial reports.</td>
</tr>
<tr>
<td>Additional Material</td>
<td>Disclosure of key areas of concern to the investor which include, “..risk factors inherent in the offering…the fiduciary duty owed by the general partners to the limited partners; potential and actual conflicts of interests among the partners…restrictions on the transferability of partnership interests.”</td>
</tr>
</tbody>
</table>


Periodic reporting is required by the SEC for public syndications. Periodic reports must be made to the SEC describing the ongoing business. Under the 1934 Securities Exchange Act, §15(d), real estate partnerships must file Form 10-Q quarterly reports and Form 10-K annual reports. Quarterly reports are unaudited financial statements of the operations for the quarter. Annual reports are audited financial statements with narrative information about the partnership’s business. Certain partnership events require filing Form 8-K, when events such as changes in the management of the issuer, bankruptcy filing, acquisitions, dispositions and/or refinancing occur.\textsuperscript{15}

States securities laws also govern public RELP syndications. State “Blue Sky Laws” require registration of offerings, even those which may be exempted from federal registration. Each state has adopted its own regulations, but typically included broker-dealer licensing and registration requirements. The North American Securities Administrators Association (NASAA), an organization comprised of state securities regulators, provides standards for state regulation of public real estate offerings. Most states have adopted this model regulation, though state requirements continue to vary. States which follow guidelines prepared by NASAA outline investor suitability standards, regulate conflicts of interest, limit the amount of sponsor compensation and set forth rights of limited partners.

The opportunities to make lots of money in real estate syndication attracted the attention of large numbers of real estate operators. Two groups emerged to dominate the industry during the eighties, Private real estate syndicators and Wall Street. During the peak period of RELP syndication, the top 20 sponsors were responsible for 84% of all money raised.\textsuperscript{16}

\textsuperscript{15} Jarchow. pp. 393–398.

All Time Top Money Raisers in Public Real Estate Limited Partnerships through 4th Quarter 1987.

<table>
<thead>
<tr>
<th>Fund</th>
<th>Total Amount Raised $ millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. JMB Realty</td>
<td>3,629</td>
</tr>
<tr>
<td>2. The Balcor Co.</td>
<td>3,220</td>
</tr>
<tr>
<td>3. Merrill Lynch Hubbard</td>
<td>1,813</td>
</tr>
<tr>
<td>4. Integrated Resources</td>
<td>1,715</td>
</tr>
<tr>
<td>5. The Fox Group</td>
<td>1,471</td>
</tr>
</tbody>
</table>
During the late 1970s and early 1980s, Wall Street brokerage houses and large real estate syndicators flooded the country with real estate partnership investment opportunities. The minimum suitability requirements, as promulgated by NASAA, opened the door for middle income individuals to invest in real estate syndications:

Suitability of Participants:
The sponsor is required to impose suitability requirements on investors, and provide in the prospectus the objectives and risks of the investment. Minimum annual gross income of $30,000; net worth of $30,000; or absent income, net worth of $75,000.19

The efforts of syndicators and agents to sell these investments to unsophisticated investors included targeting IRA investors by pricing partnership units at $1,000 or $2,000. An estimated 30% of limited partnerships were purchased as an IRA investment.20

Marketing of RELPs

Demand for real estate investment in the 1980s based on tax shelter and inflation hedges was the driving force for real estate ownership. Unsophisticated investors, the core of the public limited partnership market, were sold on these attributes.

Another aspect of marketing real estate syndications was to sell on the basis of earning superior returns in real estate. Rapidly increasing value of much of the country’s real estate in the 1970s and early 1980s, lent support to the belief that real estate values would always go up. A 1984 study of RELP performance reveals a strong case for claims of real estate as a superior asset. Through 1984, annual gains of 22% on equity were achieved on those properties sold. Using an internal rate of return calculation, average after-tax returns for investors in the 50% tax bracket was 14.3%.21 Comparing returns of other investments for the 10 years prior to 1985 supported claims of real estate’s superior performance, particularly during periods when inflation rates were above average.

Reliance on historic performance measures created unrealistic expectations in the minds of most investors. There was little adjustment for the likelihood of future adverse circumstances. Eventually, the oversupply of capital contributed to overbuilding and the now well documented real estate crash. Investors in RELP syndications failed to recognize, nor were they made aware of, the many ascertainable risks in real estate investment.

The income projections prepared for real estate limited partnerships were also susceptible to overly optimistic expectations. A study performed by the University of California School of Management in 1987, found that over 80% of the properties performed below expectations. The researchers studied privately syndicated partnerships with a sample of 39 properties acquired in 1983 and 1984. The study provides some insight into the reasons behind the discrepancy between projections and actual performance. These reasons appropriately explain publicly syndicated real estate experiences.

The study suggests that previous to the 1986 Tax Reform Act the favorable tax climate drove the growth of RELP syndications, and that the implications of that growth included the following:

The increase in monies raised relative to available property helped to bid up prices to levels that often could not be supported by current income. Only optimistic projections of the future could justify the property acquisitions...

In addition, the growth of the industry and the expectations of money to be made by syndicators, attracted more people to the field. The expectations of potential profits perhaps attracted marginal or less skilled persons to the business of real estate syndication. Thus, the selection and operation of properties may have been less than ideal during the period studied.

\[1983-1985\]22

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Contributing factors to under performance of RELP syndications was the high cost involved in forming syndications and the compensation and fee structures paid to general partners. Investor capital was used to cover expenses and fees in three phases of a syndication; formation, operation and termination. A summary of investment information for syndications from 1970 to 1984 demonstrates the effect on net investment compared to total capital raised. Of $10 billion raised through 1984 in the public market, only 63% made it into real estate assets.\(^{23}\)

![Industry Investment Structure as of December 31, 1984](image)

\(\text{Source: Roulac Syndication Yearbook, 1985}\)

Immediately after contributing capital, limited partners lost 30% to fees (excluding 7% for reserves, which is money not lost to fees, but is nevertheless unable to be used for additional property acquisitions.) Based on these numbers, property must appreciate by 30% net (after costs of sale) to return to the limited partners their original contribution. In

an analogous situation, a mutual fund with similar front end loads, under optimal conditions, would require three and a half years at an 8% yield to just break even.

State regulations governing fee structures failed to protect investors from poor use of their capital. Under NASAA policy, widely adopted by the states, sponsors could get away with investing only 67% of syndication proceeds into property acquisitions. Other compensation requirements allowed similar latitude in rewarding the sponsors. The fee structure, while meeting all securities regulations, was a severe handicap to future performance prospects.

<table>
<thead>
<tr>
<th>Program Fees</th>
<th>Total maximum all fees: complying with other securities offerings in state (typically about 15% of gross offering proceeds).</th>
</tr>
</thead>
<tbody>
<tr>
<td>Front End Fees:</td>
<td>Calculated as the minimum investment in the properties of investor capital that is the maximum of: 1) 80% of the capital contributions reduced by .1625% for each 1% of indebtedness 2) 67% of the capital contributions.</td>
</tr>
<tr>
<td>Property Management Fees</td>
<td>Lesser of competitive local fees or regulated maximums): Residential = 5% of gross revenues; Long term net leased industrial and commercial properties =1% gross revenues plus 3% initial leasing fee; other properties = 6% of gross revenues if leasing services are performed, 3% if no leasing services required.</td>
</tr>
<tr>
<td>Promotional or Residual Interests</td>
<td>1) 25% of cash distributed from net proceeds of sale or refinancing after 100% return of investors capital contribution plus cumulative return of 6% or 2) 10% of distributions from cash flow and 15% of cash distributed from net sale proceeds after return of investor capital contribution plus 6% cumulative return.</td>
</tr>
</tbody>
</table>


Organization fees and the compensation structure guaranteed certain behavior from sponsors. A study conducted in 1985 of sponsors’ income sources revealed that acquisition fees contributed 69% of total income. Operations fees accounted for 23% and termination fees (back end load) just 8%. 24 The goal of the sponsor was to earn as much up front and produce as many syndicated partnerships as possible.

The absolute cost of syndication is not the driving concern; rather, it is the use of the proceeds which raises questions. Real estate transaction costs, including costs of analysis and information, are substantial in comparison to stock equities or bonds; the expertise of the sponsor should be rewarded for undertaking the manager’s role. Unfortunately, too

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much money went into the promoters’ pockets. Commentary from 1988 underscores this point:

“Even the most casual critique of various real estate investment sponsors...lead to the inevitable conclusion that many pay more attention to the fee potential...than to the results required to deliver the projected investment return. Generally, sponsors fail to spend enough of the significant fees they generate on investment management services, thus extracting disproportionate profits irrespective of the investment results delivered. Of even greater concern, however, is the fact that expenditures actually made are misdirected, i.e., they are skewed in favor of marketing, promotion and compensation to the selling effort rather than toward the development of strategic investment policy, disciplined acquisition evaluation and conscientious portfolio monitoring.”

Liquidity

Real estate investment has long been recognized as illiquid. Illiquidity in real estate refers to the inability to quickly sell an asset. An individual building, or a portfolio of buildings, can require months to sell. Buying real estate requires substantial time and expense. Buyers must evaluate complex legal and financial issues and analyze markets, leases, and physical conditions. Because real estate limited partnerships own real estate, these interests are equally illiquid absent any secondary market.

In recognition of illiquidity, the SEC requires that a prospectus must state the intended holding period of real estate assets. Limited partners were given no expectation of holding a liquid investment. A time horizon of 7-10 years was not uncommon as a holding period. NASAA did require, however, that the general partner provide a structure for the transfer of a limited partner’s interests. Transfers were expected to occur very infrequently, only in situations such as a death or divorce of a partner.

Disclosure and Risk

A more sensitive issue in marketing limited partnerships was the disclosure of risk. Several lawsuits in the 1990s accused RELP promoters of misrepresenting risk in sales presentations and prospectus documents. Results of lawsuits against larger syndications

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provide insight into the marketing practices common in the sale of RELPs. The suits also illustrate that despite SEC disclosure requirements, investors were victimized by the incomplete disclosure of investment risks.

Prudential Securities, Merrill Lynch, Paine Webber, Smith Barney Shearson/Lehman and Dean Witter are or have been targets of class action lawsuits relating to their partnership activities. Prudential’s cases eventually resulted in the company establishing a reparations fund totaling $635 million. The Prudential case involved restitution to 50,000 investors whose claims were considered valid by an independent claims adjuster. Investors claimed that Prudential mislead investors about the risks of a variety of partnerships sold in the 1980s totaling $8.15 billion. Prudential’s settlement is the largest of the partnership cases, but included many private placement and energy partnerships. A better example demonstrating incomplete disclosure and misrepresentation of risk was the recent class action lawsuit brought against Merrill Lynch.

Merrill Lynch settled a class action lawsuit in 1993 brought by 16,500 limited partners in the Arvida/JMB partnerships. The Arvida partnerships were established to fund the development of planned housing communities, a particularly risky real estate venture. The performance of the second Arvida partnership was particularly bad. Arvida L.P.- II raised $234 million dollars in 1989. Unit size was $1,000 with a $5,000 minimum investment and 15,700 investors became limited partners. The settlement reached in 1993 offered $6 million dollars to the partners wishing to liquidate. After legal fees, the cash value to the partners equaled $4 million, translating to less than 2% of the original investment.

The class action complaint accused Merrill Lynch of having “...ignored the collapsing real estate market...” to sell the partnership, while receiving over $20 million in fees. Since the inception of the partnership only $20 per $1,000 unit had been distributed. Recent secondary market publications report the partnership is trading at just $1.56 per unit. The issue at the heart of the case is how Merrill Lynch represented the risks of the venture through its prospectus and its brokers’ marketing practices.

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29 Ibid.
“No one ever achieved RELP superstardom without recognizing, and using, the fact that the way you say what you say is more important than what you say.”

Merrill Lynch documents described the ventures as a “moderate risk.” Merrill Lynch’s internal presentations to its brokers projected cash returns between 13% – 20% annually for the two Arvida partnerships. In an Arvida II sales letter to potential investors, Merrill Lynch brokers claimed the Arvida I had: “generated greater than the 12% return projected...” The letter failed to mention that most of this “return” was a payback of capital. The Arvida partnerships lost $290 million in value from 1990 through 1992.

Equally troubling to the investors participating in the class action was the lack of suitability of the Arvida investment for substantial numbers of the Merrill Lynch clients. Many of the clients were retirees, looking for conservative, income producing investments. Instructions from Merrill Lynch to its brokers reinforced the minimum suitability standards allowed by NASAA policy: $30,000 income/$30,000 net worth or $75,000 net worth. Merrill Lynch maintains that the targeted investors were suitable for what in fact turned out to be a highly risky investment.

A similar discussion of Merrill Lynch marketing practices appeared recently in a business journal. A Merrill Lynch partnership formed in 1985, ‘MLH V’, raised $500 million from 80,000 individual investors, about 75% percent investing as an IRA contribution. Those investing as part of a retirement fund contributed an average investment of $3,700. The ability of the these clients to analyze the prospectus was limited.

For example, the prospectus touts that the general partner (Merrill Lynch) would receive a residual profit on the sale of the assets only after the limited partners earn their capital back plus a 10% annual return. The effect intended was to build confidence in the general partner’s performance and suggest the partnerships were expected to return at least 10% per year. The prospectus failed to reveal that the residual share given the sponsor was

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32 Ibid.
regulated by NASAA guidelines and had nothing to do with the good faith of the general partner. 33

In fact, Merrill Lynch as sponsor and securities broker, earned 19% in acquisition, sales and organization fees plus "custodial fees" on their brokerage accounts; all of which was disclosed, as required, in the prospectus. As general partner, Merrill Lynch also earned 10% per year on gross income from the properties it managed. The limited partners, in contrast, have earned approximately a 1% return annually. Charles Bennett, director of Corporate Finance at NASD explained why the majority of the investors were individuals: "Institutional investors looked at these transactions, but they rejected them because of the high upfront fees." 34

"The strategy for making money in a RELP will usually rest on a very small number of economic and tax issues. Never mind that the prospectus or offering memorandum rambles on for 200 stylized, legalistic and ultimately incomprehensible pages." 35

The legacy of the RELP syndication boom was millions of limited partners who purchased real estate securities without knowing a lot about them. As the value of their investments continued to decline they then realized that it was very difficult to escape. The opportunities to sell limited partnership interests are dependent on the informal secondary market. The secondary market generates unfortunate consequences for those same limited partners hurt by their original RELP investments.

35 Murray, Shared Perceptions, p. 17.
Chapter Three

Historical Background of RELP Secondary Market

The creation of real estate limited partnership syndications is a relatively recent event in comparison to other public securities. The development of a secondary market for limited partnership units is an even more recent occurrence. One of the first of the secondary market firms, The Liquidity Fund, was founded in 1980. The largest independent secondary market trading firm, The Chicago Partnership Board, was founded in 1988. Matching services within the larger Wall Street brokerage houses have existed since the early 80s but only serve clients of the brokerages.

Despite the short period that the limited partnership secondary market has existed, several significant regulatory and market developments have occurred. A brief description of the evolution of this market describes the changes that have affected the participants in the secondary market.

Investors in limited partnerships have always needed an exit strategy when personal events demanded. Investment in real estate limited partnerships was typically understood to be for a specified amount of time, usually not less than seven to ten years. At the end of the holding period the assets would be liquidated and the partnership terminated. Prior to that partnership termination, several reasons could exist for selling a partnership interest. The most common events have been described as the “three D’s”; death, divorce and disaster. Investors facing these situations required conversion of assets into cash.

Another situation creating a need to sell a partnership interest was declining tax shelter or diminished partnership value. Until the late 1980’s none of these reasons led to significant sales of limited partnership interests in the secondary market. Historical estimates for the volume of trading in the secondary market demonstrates the recent growth of the secondary market. Prior to the real estate crash in the late 1980’s, most partnership transfers were conducted through the general partners or the brokerage houses that originally sold the investment. With the increased numbers of investors looking to get out of their partnerships in the wake of the real estate crash, independent resale firms increased in number. Competition between the independent resale firms and the brokerage house
matching services reached a conflict in 1991. Following this transition period, the current secondary market characteristics evolved.

In perspective, the size of the current market is small; estimated transaction volume in 1995 is $160 million, less than 1% of the $90 billion in publicly syndicated RELPs. Furthermore, just 1/6 ($15 billion) of all public partnerships actively trade.\(^{36}\)

<table>
<thead>
<tr>
<th>RELP Secondary Market Trading Data</th>
<th>March/April 1995</th>
<th>Annualized Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Transactions</td>
<td>2,492</td>
<td>14,952</td>
</tr>
<tr>
<td>Total Units Traded</td>
<td>1,684,583</td>
<td>10,106,298</td>
</tr>
<tr>
<td>Volume</td>
<td>$21,028,668</td>
<td>$128,172,008</td>
</tr>
</tbody>
</table>

Transaction data for the period 2/1/95-3/31/95.

Historical trading data is scarce. Estimates from the last three years indicate large increases in trading volume between 1993 and 1994. This increase corresponds to the implementation of significant changes in secondary market trading regulations.

<table>
<thead>
<tr>
<th>Historical RELP Secondary Market Transactions</th>
<th>Bi-monthly Total</th>
<th>Annualized Total</th>
<th>%A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oct/Nov 1993</td>
<td>1,600*</td>
<td>9,600</td>
<td></td>
</tr>
<tr>
<td>Oct/Nov 1994</td>
<td>2,445</td>
<td>14,670</td>
<td>+53%</td>
</tr>
<tr>
<td>Mar/Apr 1995</td>
<td>2,492</td>
<td>14,952</td>
<td>+2%</td>
</tr>
</tbody>
</table>

*Includes 304 partnership no longer trading in the secondary market.

**Participants in the Secondary Market**

A summary of the participants in the secondary market provides an introduction to the working of this market. The mechanics of selling a partnership unit in the secondary market can be complex when compared to selling stocks or bonds.

\(^{36}\) Various sources
The market is comprised of seven distinct segments:

- **Sellers – Limited partners**
- **Buyers – Speculative investors (individuals and institutional), securities dealers, and general partners.**
- **Secondary Market Resale Firms – independent broker/dealers and brokerage house internal matching services. Broker firms facilitate the trading of limited partnership interests, compensated by commissions and fees. Dealers buy partnership units on their own account and mark-up the price before selling, earning a profit.**
- **General Partners – General partners control the partnership transfer process and most of the information to the market.**
- **Regulators – SEC, NASD and IRS.**
- **Industry Associations – The Investment Program Association (IPA), a non-profit limited partner advocacy group.**
- **Secondary Market Service Firms – Partnership valuation firms and industry publications.**

An owner can sell a partnership unit using the following options:

1) Directly through an independent broker/dealer that accepts retail customers, or through an independent securities broker who is familiar with the secondary market. The broker ultimately places the partnership unit in a secondary market resale firm.

2) Through a Wall Street brokerage matching service, which is only available to limited partners who originally purchased their units from these firms.

3) Through the partnership’s general partner.
Secondary Market Broker/Dealers

These firms buy and sell limited partnership units, as dealers for their own account, or facilitate in the trading of the limited partnership units as brokers. There are approximately 20 broker/dealer firms. Secondary market firms trade in about 1,400 of the estimated 2,000 public partnerships. Traded partnerships are valued at about $15 billion dollars. In this small market, the top three firms control 60% of the trading. A single firm, The Chicago Partnership Board, accounts for about half of all trades.\(^{37}\)

An early broker firm, the National Partnership Exchange (NAPEX), was formed in 1984, and organized an auction system which is composed of four major steps. First, a listing of available partnerships units is distributed to brokers and investors participating in the auction. Second, bids and asks are solicited. Partnerships units available for sale are phoned in and listed on the NAPEX computer system. Bids are recorded in the same manner. Buyers and sellers remain anonymous, but the computer system records and displays all bids received. A scheduled auction date arrives, and sales are awarded to the highest bidder. A lengthy closing period is then entered into as the required paperwork is completed.\(^{38}\)

The Chicago Partnership Exchange (CPB), the largest of the secondary market firms, is organized as an auction market. CPB estimates its performs 400 – 500 trades per month. Following the auction format described above, CPB publishes a weekly listing of all partnerships available for purchase. Approximately 1,200 partnerships are listed on the CPB “Units Available for Purchase” publication. A daily current listing is available to brokers and serious individual investors.


The CPB system operates as follows:

1. A potential seller offers a unit for sale. A CPB trader quotes a price based on recent market activity. Sellers may elect to list the price as firm, or subject to best purchase offer.

2. Sellers decide to proceed at the quoted price, and the trader accepts the sale order.

3. CPB adds an 8.75% commission on the sellers price. All trades are subject to a minimum transaction charge of $199.

4. Firm quote transactions are immediately executed. If the quote is subject to best offer, the units are auctioned.

5. CPB publishes a weekly listing of all partnership units available for purchase. A daily listing is available to brokers and qualified investors.

6. Units are listed pending ownership verification paperwork. Once the verification is established (usually within a couple of days), CPB mails a sale contract to the seller. The seller has 10 days to provide the signature guarantees and copy various documents.

7. CPB schedules an auction and notifies potential bidders of the auction. Auctions are held every business day at noon. An average of 95 trades per week were reported for the last 5 quarters.

8. Buyers place bids by phone or fax. If bids meet or exceed the seller’s price, CPB awards the sale to the highest bidder. If a unit is sold at a price above the 8.75% commission, the seller receives the difference. If the minimum limit price is not met, the seller is not obligated to sell.39

CPB prepares the paperwork, and notifies the partnership’s general partner of the pending sale. The general partner is then asked to approve the sale, subject to conditions stipulated in the partnership agreement. The time for this approval varies by partnership,

but ranges from a few days to several months. Only after the general partner approves can the sale be closed.

CPB has interdealer agreements with about 50 brokers. Transactions with the large wirehouses do not go through the auction system. Some of the large wirehouses require "firm bid" quotes. The CPB described their interdealer trading process as "similar to the interdealer quotation system on the NASDAQ exchange." Firm quote pricing is required by Merrill Lynch, and its partnerships are listed separately on the CPB "Units Available for Purchase" publication.

The Chicago Partnership Board will purchase partnership units for its own account. In an apparent conflict of interest, CPB will bid in their auction as a buyer. They prefer to function as a market facilitator, and not actively deal. They will buy and hold a partnership to collect distributions. These dealer functions occur rarely, according to the CPB’s Director of Communications.

The New York Partnership Exchange provides a matching service. The firm maintains its own database of partnerships. Their data base includes recent trading prices, partnership distributions, net asset values, and other events. The data is used for the firm’s matching functions, as well as offering valuation services outside the trading process. Typically dealing only through brokers or institutions (like trust departments), the firm matches sellers and buyers of partnership interests. The N.Y. Partnership Exchange, Inc. charges a flat fee for its matching services.

The American Partnership Service, Inc., serves sellers of limited partnerships. This firm relies on "word of mouth." Business is based on relationships with unaffiliated brokers. A bimonthly listing sheet with prices of available units is sent out to eight or nine brokers active in the secondary market. Bids are received for the units offered through the American Partnership Service, and the highest bids are awarded. The volume of these businesses may be a hundred transactions or fewer per month.

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41 Perez, phone interview, July 11, 1995.
Firms functioning as dealers buy and sell limited partnership interests for their own accounts. The firms operate by buying partnership units at a deep discount and later selling the units at substantial mark-ups. Mark-ups of 20%-30% were not uncommon. Until 1991, when the dealer firms’ activities were challenged by the NASD, these firms accounted for half of all partnership trades. The Partnership Securities Exchange, the Liquidity Fund and Mackenzie-Patterson were examples of firms involved in dealing.44

Wall Street Securities Firms’ Matching Services

Brokerage houses which originally packaged and marketed RELPs to retail investors operate matching services. These services are available only to original customers of the brokerage. Merrill Lynch has the most active matching service, a result of being the largest Wall Street firm in the sale of limited partnerships. Brokerages typically operate matching services as an accommodation to their existing investors. Fees are claimed to be minimal. Brokerages do not advertise their partnership matching services. Sellers must request, through an in-house broker, a sale of their partnership unit.

Smith Barney, a large Wall Street wirehouse, who inherited a base of limited partners following a merger with Shearson Lehman, operates a matching service. Working only for clients who bought partnership units through Smith Barney (or its predecessors), the firm established a partnership trading desk. Volume is estimated at 200 to 300 trades per month. The system has been operating for about a year. It was redesigned in response to regulatory and legal events of preceding periods. Smith Barney accepts both internal and external, interdealer, bids. To meet SEC regulations, Smith Barney operates the partnership system only as a “sell” desk. Three external bids are required to meet SEC “best execution” requirements.

Sellers’ brokers submit sales orders to the partnership sell desk. The desk prepares a price list of partnership units offered for sale. The list is faxed to secondary market

broker/dealers who have signed interdealer agreements, and distributed internally to Smith Barney brokers. The list is released to all participants at the same time. Bids are due within 48 hours and are done anonymously. An auction takes place once a month, usually the first Tuesday.

Smith Barney then matches buyers and sellers for another 48 hours. The units are awarding to the highest bids. An additional ten days for paperwork is required, not including the general partners’ transfer process. As with the other resale firms, the transfer is not complete until the general partner approves. Approval may take two weeks to several months. Money is not exchanged until the general partner completes the transfer process. Following the sale, Smith Barney does not maintain a relationship with the new limited partner.

Smith Barney tracks every partnership the firm sold. Data is collected using public information. Unlike the other Wall Street firms, Smith Barney did not act as a general partner for partnerships. Their involvement in partnerships is only as a service to the clients Smith Barney originally sold the RELPs.

General Partners

General partners (GPs) play a major role in the sale of limited partnerships interests. Prior to the development of the informal secondary market, limited partners would offer to sell their interests to, or through, the general partner. Partnership liquidity was satisfied in this manner when only small numbers of investors were involved. General partners’ rights to control transfer of partnership units were typically articulated in partnership agreements:

(c) No sale, transfer, assignment or substitution by a Limited Partner, which has otherwise been consented to by the General Partners, shall be effective as against the partnership until the purchaser, transferee, assignee, or substitute Limited Partner, and all the Partners, execute all such certificates and other documents and perform all such other acts which the General Partners deem necessary or appropriate to constitute such purchaser, transferee, or assignee as such or as a substitute Limited Partner and to preserve the limited liability status of the Limited Partners in the Partnership after the completion of such sale, transfer, assignment, or substitution under the laws of each jurisdiction in which the Partnership is doing business.45

The general partner is typically required by state regulations to provide a mechanism for transferring limited partners’ interests. The NASAA guidelines clearly describe general partners’ responsibilities:

**NASAA Guidelines**

| Exchange of Limited Partnership Interests | “1) A provision for such exchange must be set forth in the partnership agreement, and appropriate disclosure as to the tax effects of such exchange are set forth in the Prospectus;...4) Each limited partnership interest must be valued at no less than market value if there is a market or if there is no market, fair market value of the Program’s assets as determined by an independent appraiser;...6) No securities sales or underwriting commissions shall be paid in connection with such exchange.” |


The general partner has the responsibility to limit the number of transactions. The IRS determined a limit of units allowed to trade – the “safe harbor.” Trading outside the “safe harbor” results in the partnership being characterized as a corporation, subject to corporate taxation. Any transaction that occurs in the secondary market eventually must be approved by the general partner. The speed at which the general partner must process the transfer is not regulated.

The role of the general partner in the secondary market is also that of information source. General partners are required to provide periodic reports to the SEC, and to the limited partners. The quality of these financial reports vary among general partners, but must conform to minimum requirements established by the SEC. Minimum reporting requirements seldom provide adequate information for thorough investment analysis.

**Partnership Valuation Firms**

The market has created an opportunity for specialists in partnership valuations. For a fee, a valuation firm will provide an estimated value of an individual partnership interest. A handful of these valuation firms exist.
The demand for limited partnership valuation by third parties is seldom from secondary market participants, but mostly from the legal and accounting professions. Holders of trusts, estates, and other investment funds require periodic “market prices” and rely on valuation firms to provide current investment values. Valuation firms provide letters of appraisal, giving their opinion of the market price of the partnership interest. Valuation firms also provide independent pricing of partnership values for general partners. The firms are a good source of independent information on the secondary market. They are called upon as experts in legal proceedings. Broker/dealer firms may also provide partnership valuation services and legal expertise.

Estimating prices in the secondary market depends primarily on financial statement analysis. Required financial statements such as the 10K, 10Q, and 8K are prepared by general partners and filed with the SEC, as required under Section 15(d) of the 1934 Securities Exchange Act. Additional news releases are available for events not described in the filed statements.

RELP interests, like other real estate securities, have pricing components in both real estate property markets and the capital markets. Secondary market sales have unique tax complications which need to be calculated. The lack of standardized reporting from general partners makes this valuation process more complicated.

Two basic values are required to arrive at a meaningful value for a partnership unit. The first is the value of the assets reflecting its liquidation. This value is termed “Net Asset Value” or “Value per Unit” and is often reported in the secondary market publications. The net asset value is usually an appraised real estate value less liabilities. In contrast, annual reports typically report partnership assets at book value.
The second value is the price the seller could expect to receive by selling a partnership in the secondary market. This is termed the “Fair Market Value.” As defined under the IRS Revenue Ruling 59-60:

Fair market value is the price at which the interest would transact between willing and informed buyers and sellers, neither acting under duress or undue compulsion.

In the absence of a more specific valuation standard, Revenue Ruling 59-60 is used by a leading partnership valuation firm as a guideline. Preparing a complete analysis of the price in accordance with RR 59-60 is particularly important in the secondary market, where transaction prices do not provide meaningful unit values. An example of a methodology which produces a meaningful price is the model employed by The Valuations Group.

The Valuations Group model:

1. **Estimate Gross Asset Value** – defined as the “theoretical cash value which would be realized by the partnership in the event of an immediate disposition of its assets.” The availability of sufficient information, the asset type and accounting standards adjust the asset value.

2. **Net Asset Value per Limited Partnership Unit** – defined as “… the cash distribution which would be received by investors assuming a complete liquidation of a partnership’s assets as of the valuation date.” The cash distribution is adjusted for; transaction costs, indebtedness, joint venture shares, other assets and general partners share of liquidation proceeds.

3. **Fair Market Value of the Owner’s Interest** – adjusted by eleven factors relating to the partnership and its marketability:
   1) **Secondary Market Liquidity and Investment Control** – as discussed throughout this thesis.
   2) **Cash Flow and Distributions** – emphasis on current distributions from cash flows.
   3) **Asset Type and Quality** – an analysis typically from financial statement analysis of the properties comprising the partnership’s portfolio.
   4) **Management Capabilities and Fee Structure** – an evaluation of the quality of the management of the partnership, a particular concern in limited partnerships and discussed more fully in this thesis.
   5) **Market Capitalization** – a premium for larger scale partnerships which receive more attention from investors.
   6) **Portfolio Diversification** – an adjustment for the risks of a single asset or weakly diversified properties within the partnership’s portfolio.

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7) *Capital Structure (debt v. equity)* – a risk adjustment up for highly leveraged assets.
8) *Liquidation Time Horizon* – a discount is applied for partnership not anticipating liquidation in the near term.
9) *Goodwill* – an “intangible” relating to the perceived quality of the program.
10) *Recent Historical Performance* – adjustments for recent events at the asset level.
11) *Analytic Complexity* – complexity in the partnership structure lowers the value of the investment.\(^4\)

Assessing the tax implications in the sale of a partnership interest is also critical. Buyers assume the tax basis of sellers which is unique for each limited partner. The present value of future tax is discounted from the unit price. Partnerships with low basis are simply worth less to secondary market buyers and are priced accordingly. Complicating the valuation, however, is the uncertainty of the date of liquidation. Many partnerships intended to have been liquidated after seven or ten years continue to operate. The number of years to liquidation is estimated. Conservative figures are typically used, lowering the unit price.

Complication occurs when the partnership units become available as a result of owners’ deaths. After death the partners’ basis is “stepped-up” and the price must be revised to reflect lower taxes. Partnerships with a 754 election, however, can trade at the present value of the tax gain, as the partnership interest carries its own basis. Public partnerships with the 754 election are extremely rare, however. The result of the differing tax implications is that even with similar partnerships, buyer’s valuations must be conducted for each partnership unit intended for purchase. Unlike stocks or bonds, which are homogeneous within a company, limited partnership shares carry unique tax obligations to the buyer which must be considered for each purchase, increasing the complexity and cost of valuation.

\(^4\) Ibid. p. 22.
Secondary Market Publications

There are several companies that research and publish information about the secondary market:


The Stanger Co. has been publishing information on the real estate limited partnerships and secondary market activity since the early 1980s. The firm has been involved in the evolution of the real estate securities market. Its principals serve as expert witnesses and as advisors on syndication and REIT formations. *The Stanger Report* is published monthly, and supplies transaction data to the Bloomberg Financial Data System.

*Partnership Spectrum*, published by Partnership Profiles, Inc.

*Partnership Spectrum* is published bi-monthly and provides comprehensive coverage of news events and transaction data in the secondary market. *Partnership Profiles*, a compendium of partnership data for 800 individual partnerships, is published semi-annually.

*The Investment Advisor*, published by Dow Jones,

*Investment Advisor* publishes secondary market transaction data, available quarterly.

Disclosure, Inc.,

Disclosure, Inc. sells publicly filed SEC reports (10K, 10Q, 8-Ks) and prospectuses, including publicly registered limited partnerships.

Information about partnerships, secondary market activity, regulatory and financial matters are gathered and analyzed. Subscribers include brokers, trust and estate managers, accountants, and investors who participate in the secondary market. Few, if any, limited partners subscribe to the publications.
Industry Associations

The Investment Program Association (IPA) was established in 1985 by Robert Stanger. Its mandate is to represent the interests of investors in non-publicly traded securities, principally partnerships. Rationalizing the secondary market is its major goal; acting on behalf of investors in regulatory matters, roll-ups, and tender offers, as well as promoting a central exchange for trading limited partnership units. IPA has attempted to simplify the tax reporting system for the partners and the partnerships at both the state and federal levels. Securities regulations are also being targeted for simplification and standardization.

Members of IPA include the major wirehouses, such as Merrill Lynch and Paine Webber, and program sponsors of real estate, equipment and energy partnerships. Funding is from dues paid by general partners, selling organizations and vendors servicing the industry. Dues are based on the number of investors within members’ partnerships. The IPA’s mandate is to serve the investor, although funding and membership is from general partners and affiliates. Chris Davis, president of IPA, admits to a conflict, but stresses that the association works in the interest of the investors.

IPA has been attempting to form a central trading facility for limited partnerships in collaboration with Cantor Fitzgerald, a large securities brokerage. Unlike the current secondary market resale firms, Cantor would act as a neutral party facilitating transactions between buyers and sellers, never acting as a principal. Compensation to Cantor Fitzgerald would be on a commission basis. Transactions will be posted on the computerized trading screen, making the function of the market transparent to the participants. Bids and asks would be shown and trading histories maintained.48

48 Christopher Davis, President, Investment Program Association, phone interview, May 9, 1995.
The National Association of Securities Dealers proposes a central listing facility for limited partnership interests through their Over The Counter Bulletin Board (OTCBB). The OTCBB is a computer quotation system which allows brokers and dealers to advertise securities which are otherwise not traded on the national securities exchanges. Qualified participants would be brokers as well as market makers meeting certain criteria. The goal of the OTCBB listing is to provide greater information to the secondary market. Unlike the Cantor Fitzgerald proposal, the OTCBB will not be a trading vehicle. The NASD also applied to the IRS for a determination of whether the listing of partnership units on their system would result in characterization of partnerships as corporations. 49

Buyers

Buyers of limited partnerships usually have quite different motivations than the sellers. Buyers are for the most part sophisticated investors. They look for partnerships whose limited partnership units appear to be undervalued. Private investment funds familiar with the secondary market, such as Liquidity Fund, Equity Resources and Bigelow Management, are participants on the buy side. Larger investment organizations, such as Apollo Advisors, or The Koll Company, participate in tender offers. The goal of a tender offer is to take over the partnership and liquidate the assets or earn management fees. The tender offers occur outside the secondary market, but nevertheless compete with secondary market investors.

The advantages to savvy buyers in the secondary market are substantial. Liquidity Fund promotes the advantages to buyers as follows:

- Proven Performance – the units are backed by seasoned portfolios of assets with actual operating results on which to rely for analysis.
- Shorter holding periods – secondary units have shorter holding periods, having already gone through the organizational and acquisition phases, as well as several years of ownership.
- Potential tax benefits – the investment can be structured to meet and take advantage of specific tax needs.
- Low transaction cost – transaction fees do not have to subsidize the many organizational costs associated with new issues.
- Immediate investment returns – return on investment begins right away because the assets are already “up and running.”

• Excellent values – buyers perform an important service by “cashing out” sellers who otherwise would have to wait years to reap the fruits of their investment. Sellers are willing to accept a substantial discount from the actual “break-up” value of their units as a way of compensating buyers for this service. 50

The final point is at the center of the secondary market buying strategy, as this paper will attempt to demonstrate. Buyers attempt to arbitrage the difference between the sellers’ price and the underlying value of the partnerships’ assets. The risks for buyers are potential reversal of economic conditions and declines in partnership asset values. Secondary market investing in the last few years indicates that the advantages have outweighed the risks.

Regulatory Oversight

The SEC and NASD have regulatory oversight in the limited partnership secondary market as they do in other public securities markets. For any publicly registered partnership, periodic reporting and requirements are enforced by the SEC. NASD is the self-regulatory body of the nation’s securities dealers and provides “Rules of Fair Practice” which govern the securities industry. The IRS, through partnership tax regulations, plays a major role in the secondary market by in effect setting trading limits, thereby influencing prices.

NASD Mark-Up Policy

A major challenge to independent resale firms came from the securities firms and the NASD. Wall Street securities dealers concluded that independent resale firms were using “predatory practices,” by charging unusually high mark-ups on the transactions of partnership interests. 51 In 1991, the National Association of Securities Dealers issued a report which supported the securities dealers’ accusation. This report was a response to perceived violations of NASD’s standards of fair practice, which limit the amount of mark-ups and fees a dealer or broker can charge a customer. This action by the NASD had significant impact for some of the independent resale firms.

NASD has an established mark-up policy limiting allowable mark-ups to 5%. Article III, Section 4 of the NASD Manual – Rules of Fair Practice describes the NASD policy:

Sec. 4.... if a member buys for his own account from his customer, or sells for his own account to his customer, he shall buy or sell at a price which is fair... he shall not charge his customer more than a fair commission or service charge....

Subsequent interpretation of the mark-up policy set the “fair mark-up” at 5%, but allowed for adjustments based on relevant circumstances:

The Board stated that it would be impractical and unwise, if not impossible, to define specifically what constitutes a fair spread on each and every transaction because the fairness of a mark-up can be determined only after considering all of the relevant factors. Under certain conditions a mark-up in excess of 5 per cent may be justified...

NASD’s mark-up policy required that independent firms dealing in RELPs comply with this regulation.

The Partnership Securities Exchange, an independent resale firm, was censured and fined by the NASD. It was required to repay customers who were charged “excessive mark-ups,” which were estimated at between 16% and 360% on 36 transactions completed by the firm in 1989. The Liquidity Fund, another independent resale firm, was required to pay an even greater fine in 1989, on similar accusations of excessive mark-up. NASD subsequently ruled that an 8% mark-up was an appropriate limit, based on their analysis of RELP transaction costs.

Even at the 8% mark-up, independent resale firms claimed it was impossible to earn sufficient margins to stay in business. The response from the securities firms was contrary. As competitors of resale firms and to protect their trading control, Merrill Lynch supported the NASD ruling. Merrill Lynch asserted that 8% was “...certainly workable and appropriate in the market and gives plenty of flexibility to the people involved.”

The intent of the NASD action was to provide fairer charges to the buyers and sellers of the limited partnership market. However, the reduction in allowable mark-ups reduced liquidity by removing active trading firms from the marketplace. An appeal was made to the SEC, claiming that the NASD action was unfair to the resale firms, and ultimately, to those investors wishing to sell their partnership units. One year later, the SEC reversed the NASD action against The Partnership Security Exchange. The SEC ruled that the “NASD had ‘deviated’ from traditional approaches to analyzing security markups, and went on to state that ‘we cannot conclude that the prices charged by [PSX]...were unfair.’”56 Unfortunately, the reversal came to late for some resale firms, PSX and Liquidity Fund both withdrew from the resale business.

The matching services sponsored by the securities firms also experienced regulatory pressure from the SEC in 1991. The new regulations temporarily terminated their matching services. Prior to the 1991 ruling, the internal matching services had great latitude in setting prices. The partnership desks acted as buyers and sellers, setting prices for captive clients. Independent resale firms charged that prices were kept artificially high to maintain values of limited partners’ investments.57

The SEC ruled that firms provide up-to-date, “evergreen,” prospectuses, for every partnership the brokerage firms sold. The SEC viewed the resale of partnership interests in these situations as though they were original sales, subject to the prospectus disclosure requirements. The cost of keeping these prospectuses current would have been significant, as financial information and property data would need to be updated.

Further restriction on matching services was SEC’s enforcement of fairer transaction procedures. SEC required brokerage firms to act in the best interest of sellers and buyers, calling for “best execution” in reaching a sales price. This is achieved by receiving at least three bids for each partnership unit offered for sale. Internal matching was restricted. The SEC also effected a prohibition on solicitation of clients by brokers for the matching services. The ban on solicitation meant that a securities’ firm broker couldn’t recommend the sale or purchase of a partnership unit. A client must request a sale or purchase from the

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broker. Providing both sides of the sale became very difficult, particularly supplying buyers within matching services. Matching services were suspended for a year and a half, as the securities firms developed new partnership trading strategies. 58

In early 1993, the Wall Street Journal described the secondary market "...in turmoil, as participating firms grapple with regulatory pronouncements forcing major changes in the business." 59 The Journal estimated that prices of some partnerships fell as much as 20% following the NASD actions. The effect on a sample of limited partnership prices tracked by the Wall Street Journal was an average decline of 7%, due to reduced market activity. 60

The solution for matching services was to transfer RELP trading to the secondary market firms. Securities firms now act primarily on the sell side, offering their clients' units to the secondary market firms. Secondary market firms then provide the required three bids meeting the "best execution" requirement. Securities firms, however, keep considerable control of the process through interdealer agreements with the secondary market firms.

Transactions generated by the out-placing of the securities' firms trading gave the secondary market firms a large business increase. Merrill Lynch alone was estimated to have generated $30 million in partnership trades in 1992. 61 The reversal of fortunes for the secondary market firms was dramatic. Business generated from the securities firms currently constitute a significant business for many of the small resale firms and the Chicago Partnership Board.

**Anti-Rollup Legislation**

Congress passed legislation in 1993 to reduce abuses in limited partnership roll-ups and provide more protection for limited partners. A roll-up is a process in which one or more limited partnerships are consolidated or merged into a single new entity, in which the limited partners receive new securities. The new entities could be limited partnerships, Master Limited Partnerships, or more commonly, real estate investment trusts (REITs).

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59 Slater, "Market Isn't Kind", p. 22.
60 Ibid. p. C15.
61 Ibid. p. 58.
Legislation was introduced in reaction to events in the late 1980's when increasing numbers of sponsors chose to reorganize their partnerships with the intent of recapitalization. A limited partnership rolled-up into a REIT provides limited partners with new securities in what is intended to be a publicly traded entity, potentially offering greater liquidity than partnerships. Significant questions of fairness surfaced in these transformations.

Critics of the roll-up practices pointed to the devaluation of limited partners’ investments while general partners were enriched. Many roll-ups resulted in the newly created securities trading at a discount to their former value. When multiple partnerships were combined, stronger partnerships’ assets were devalued by weaker partnerships. The unequal combination resulted in the immediate devaluation of the stronger entities’ limited partners’ investment. In many situations the terms of the original partnership agreement had changed significantly; voting rights, term of life (finite to infinite-life entities), management compensation and investment objectives were altered. Rollups were conducted in many cases by simple ‘yes-no’ proxy votes. General partners received fees, reduction in debt, and equity stakes previously unavailable to them while in the partnership form.62

This most recent legislation passed by Congress and the rules adopted by the SEC, have reduced the opportunity for limited partner abuse. Improvements in disclosure was a key issue in writing the new rules. Under the new regulations, sponsors must describe the rollup’s impact to limited partners’ interests and reveal the risks. Descriptions of the changes to voting rights, investment objectives, and general partners’ compensation must be included. Proxy solicitation regulations were also implemented. The new rules require general partners to supply lists of limited partners, increasing investors’ ability to organize. Dissenting partners (those partners not wishing to participate in the roll-up) are required to be provided with securities with the same terms as the original investment, or cash for the pro-rata share of partnership assets. Certain transactions are excluded from the regulations, such as private (non-SEC registered) partnerships.63

The IRS Revenue Ruling 88/75 produces the biggest tax hurdle in the free trading of partnership units in the secondary market. The Treasury Department continues to be concerned about operating companies using the partnership form to escape corporate taxation. Following the development of Master Limited Partnerships in the mid 1980s, the IRS placed limits on the volume of trading permissible for a partnership. Realty and energy partnerships were excluded, but others had 10 years of life before having to terminate partnership status.

In 1988, the IRS laid out permissible levels of trading for partnerships, the "safe harbor." The secondary RELP market growth in the 1990s attracted the attention of the IRS. The IRS feared that closely held corporations, with low or no trading volume, would be tempted to become partnerships. The original safe harbor limit would provide liquidity for these transformed corporations in the emerging partnership secondary market. In the spring of 1993, IPA with Cantor Fitzgerald, applied for a no-action letter from the SEC for a more efficient securities exchange, raising the level of concern of the IRS. Private letter applications were submitted by Cantor Fitzgerald and NASD concurrently, for a ruling on their respective partnership trading proposals. In 1995, the Treasury Department, acting to protect the national corporate tax base from this perceived threat, proposed new partnership trading restrictions.64

The IRS notice restricted trading volumes; only up to 2% of limited partnership interests in a partnership would be allowed to trade in a secondary market. If safe harbor limits are exceeded, the IRS characterizes the partnership as having "freely traded securities." The partnership would be treated as a corporation, subject to corporate tax. The IRS proposal allows up to a 10% safe harbor limit for partnership units that trade in "qualified matching services."

2) Requirements. A matching service is a qualified matching service only if--
(i) The matching service consists of a computerized or printed listing system that lists customers' bid and/or ask prices in order to match partners who want to sell their interests in a partnership (the selling partner) with persons who want to buy those interests;

64 Christopher Davis, President, Investment Program Association, telephone interview, May 9, 1995.
(ii) Matching occurs either by matching the lists of interested buyers with the list of interested sellers or through a bid and ask process that allow interested buyers to bid on the listed interest;

(v) The matching service displays only quotes that do not commit any person to buy or sell a partnership interest without an accompanying price (nonbinding indications of interest) and does not display quotes at which any person is committed to buy or sell a partnership interest (firm quotes) or two-sided quotes;

The requirements of a qualified matching ensures a specific level of inefficiency be maintained, specifically intending to slow the transaction process:

2(iii) The selling partner cannot enter into a binding agreement to sell the interest until the 15th calendar day after the date information regarding the offering of the interest for sale is made available to potential buyer...

2(iv) The closing of the sale effected by virtue of the matching service does not occur prior to the 30th calendar day after the first day that the selling partner can enter into a binding agreement to sell the interest...

2(viii) The selling partner’s information is removed from the matching service within 120 days after the date information regarding the offering of the interest for sale is made available to potential buyers and, following any removal...of the selling partner’s information from the matching service, no interest in the partnership is entered into the matching service by the selling partner for at least 60 calendar days.65

The IRS will hold hearings on July 31, 1995 to decide on the final form of partnership trading regulations. Implementation of the proposed safe-harbor rules would add inefficiencies to the RELP secondary market. The secondary market already suffers from significant inefficiencies, as the following chapter will document.

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Chapter Four

Efficient Market Definition

A fundamental concept used in explaining the working of securities markets is The Efficient Market Theory. In an efficient market a securities trade results in zero net present value. This means that the buyer or the seller can only do as well as any other market participant. An efficient market is one where information is widely and cheaply available to all investors and all relevant and ascertainable information is already reflected in security prices.

Publicly traded stock prices are described as following a random walk. Each stock price change is independent; there is no relationship between the previous day’s stock price changes and the current day’s. Therefore, there is no way of predicting tomorrow’s price change.66

The result of an efficient market is fair pricing for all participants. The market will establish a fair price when the market is sufficiently competitive; properly conducted (no collusion among participants), there is no substantial cost in participating in the market, there a reasonable number of skilled participants involved who have access to all available market information. Competition among skilled participants will result in “true value.” True value means an “equilibrium price which incorporates all the information available to investors at that time.”

The efficient market is further subdivided into three categories; weak, semistrong and strong. The weak form exists when the market price reflects all information contained in past prices. The semi-strong form states that market prices reflect not just past prices but all other published information as well. The strong form is one where all relevant information is available through fundamental analysis. Under the strong form theory, prices always reflect the true value of the security and no participant would be able to predict future price changes.67

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67 Ibid. p. 294.
Information plays a crucial role in the concept of establishing efficient markets. The success of any market trading is dependent upon availability of information to the market’s participants. A persistent theme in the secondary market for real estate limited partnerships is an uneven information playing field. More often than not, this has been to the disadvantage of limited partners.

To demonstrate that the secondary market does not fairly price partnership units, several comparisons of pricing and return are presented. Increased securitization of real estate allows comparisons to other publicly syndicated real estate partnerships. Availability and cost of information is examined. The limited volume of the RELP secondary market is a contributor to inefficiency. A large number of transactions is required to arrive at a true market price.

**Historical Returns and Secondary Market Opportunities**

**Real Estate Investment Returns**  
**1980 – 1994**

<table>
<thead>
<tr>
<th>Investment Type</th>
<th>Average Annual Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Publicly Syndicated RELPs</td>
<td>1.5%&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td>Real Estate Limited Partners</td>
<td></td>
</tr>
<tr>
<td>Infinite Life REITs</td>
<td>15.2%&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
<tr>
<td>NCREIF Index</td>
<td>7%&lt;sup&gt;c&lt;/sup&gt;</td>
</tr>
<tr>
<td>Commercial Mortgages</td>
<td>8.5%&lt;sup&gt;d&lt;/sup&gt;</td>
</tr>
</tbody>
</table>

Sources:
- <sup>a</sup> "RELP Industry's Appraisal-Based Performance Report,"  
- <sup>b</sup> NAREIT
- <sup>c</sup> Russell-NCREIF
- <sup>d</sup> Giliberto-Levy Mortgage Index

The overall performance of publicly syndicated limited partnerships has been inferior compared to other forms of real estate investments. The RELP return was calculated in a study done by the Stanger Company, based on the actual performance of 22 sponsors and 159 real estate partnerships’ total return (appreciation and cash distributions). The return was calculated assuming the assets were liquidated at the time of the study. The study was performed using data supplied voluntarily by general partners. Results could be biased positively because poorer performing general partners were less willing to supply
information. The top half of partnerships studied returned an average of 6.7%, an inferior performance when compared to other real estate investments.68

The poor performance experienced by original RELP investors is not shared by investors in the secondary market. No continuous market performance measure is available. A market index is published by the Chicago Partnership Board (CPB). The CPB index reports total return on 100 partnerships traded through its exchange. This index began in June 1993. It helps to serve as a proxy for the secondary market as a whole. CPB claims its volume approaches half of all transactions in the secondary market and includes many smaller, retail trades. Total return includes distributions and price changes.

From June 1993 through June 1995, the Chicago Partnership Board Index increased 33.5%.69 The May 4, 1995 CPB Weekly Review reported:

"Over the past twenty-two months, a diversified portfolio of secondary partnership units might have been quite profitable..."70

Returns in the RELP secondary market have been greater than other forms of real estate investment during the same period.

<table>
<thead>
<tr>
<th>Real Estate Index Comparison</th>
<th>Total Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Index</td>
<td>1995 Q1</td>
</tr>
<tr>
<td>CPB 100a</td>
<td>6%</td>
</tr>
<tr>
<td>Wilshire Real Estate Securities Index</td>
<td>0.38%</td>
</tr>
<tr>
<td>NAREIT Indexc</td>
<td>1.11%</td>
</tr>
<tr>
<td>NCREIF Indexd</td>
<td>2.02%</td>
</tr>
<tr>
<td>Real Estate MLPs*</td>
<td>n/a</td>
</tr>
</tbody>
</table>

*2 year return annualized
a. The Chicago Partnership Board
b. Wilshire Associates
c. NAREIT, Inc.
d. NCREIF
e. Returns calculated from data in Realty Stock Review, April 24, 1995, for 8 Real Estate MLPs.

Disparities exist between long term RELP returns and recent returns earned by new investors participating in the secondary market. Comparative returns in other real estate securities reveal lower gains during the same period. The disparity strongly suggests market inefficiencies. Increased return may be partly attributable to the recovering real estate market, but this fails to account for the large gain. A survey of 95 public RELPs reported that during 1994 (the only full year of the index), the net asset values increased only 1.1%.

Additional evidence of inefficiency is provided by other disparities. Comparing investment performance in the RELP secondary market with performance of master limited partnerships traded on the AMEX and NYSE reveals dramatic differences. Master limited partnerships share many of the same features with non-traded publicly syndicated partnerships, except they are traded on a public stock market. Performance of master limited partnerships, measured by total return, is considerably poorer than the RELP secondary market for the same periods.

The CPB index fails to capture the performance of the entire secondary market. The CPB index measures only those units which have traded on its exchange. It does not include transactions made by other broker/dealer firms, transactions involving roll-ups and tender offers, or returns generated by liquidations. These transactions also reveal inequality in returns between original limited partners and recent investors. Attempting to measure these returns is much more difficult due to inadequate information. Anecdotal accounts published in the financial press and from publicly available documentation provide some insight into the returns earned by some investors.

Partnership sales through “tender offers” are increasingly more common. In tender offers, investors try to take over a partnership by buying out the limited partners. A well documented, and controversial, example was the Apollo/NPI tender offer. Apollo Advisors is a real estate investment fund, sometimes referred to as a “vulture” fund. Apollo bought a 1/3 stake in National Property Investors (NPI), a general partner. NPI then made a tender offer for a controlling share of partnership interests in 19 partnerships that it manages. The following table displays the comparative values for the tender offer, partnership units, and

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the price in the secondary market prior to the tender offer. Potential profits to NPI and secondary market investors are calculated as well.

**APOLLO/NPI Tender Offer Potential Returns**

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>NP II</td>
<td>$36</td>
<td>$55</td>
<td>$10-19</td>
<td>$5-35</td>
<td>53%</td>
<td>unidentified</td>
</tr>
<tr>
<td>NP III</td>
<td>$51</td>
<td>$50</td>
<td>11-35</td>
<td>27-46</td>
<td>0%</td>
<td>168-410%</td>
</tr>
<tr>
<td>NP IV</td>
<td>$102</td>
<td>$159</td>
<td>45-78</td>
<td>29-50</td>
<td>56%</td>
<td>122-278%</td>
</tr>
<tr>
<td>NP 5</td>
<td>$70</td>
<td>$58</td>
<td>5-43</td>
<td>143</td>
<td>(17%)</td>
<td>100-536%</td>
</tr>
<tr>
<td>NP 6</td>
<td>$152</td>
<td>$217</td>
<td>15-35</td>
<td>239</td>
<td>42%</td>
<td>94-237%</td>
</tr>
<tr>
<td>NP 7</td>
<td>$102</td>
<td>$122</td>
<td>25-50</td>
<td>143</td>
<td>40%</td>
<td>104-308%</td>
</tr>
<tr>
<td>NP 8</td>
<td>$132</td>
<td>$157</td>
<td>5-43</td>
<td>151</td>
<td>14%</td>
<td>207-2,500%</td>
</tr>
<tr>
<td>CPF XII</td>
<td>$126</td>
<td>$320</td>
<td>$-</td>
<td>243</td>
<td>93%</td>
<td>313-808%</td>
</tr>
<tr>
<td>CPF XIII</td>
<td>$227</td>
<td>$454</td>
<td>25-55</td>
<td>371</td>
<td>63%</td>
<td>144-234%</td>
</tr>
<tr>
<td>CPF XIV</td>
<td>$117</td>
<td>$234</td>
<td>35-48</td>
<td>192</td>
<td>64%</td>
<td>208-2,300%</td>
</tr>
<tr>
<td>CPF XV</td>
<td>$120</td>
<td>$231</td>
<td>5-39</td>
<td>15</td>
<td>14%</td>
<td>400-1,400%</td>
</tr>
<tr>
<td>CPF XVI</td>
<td>$15</td>
<td>$15</td>
<td>1-3</td>
<td>15</td>
<td>0%</td>
<td>171-660%</td>
</tr>
<tr>
<td>CPF XVII</td>
<td>$76</td>
<td>$99</td>
<td>10-28</td>
<td>148</td>
<td>95%</td>
<td>500-2,900%</td>
</tr>
<tr>
<td>CPF XVIII</td>
<td>$20</td>
<td>$22</td>
<td>14</td>
<td>10%</td>
<td>43%</td>
<td>105-344%</td>
</tr>
<tr>
<td>CPF XIX</td>
<td>$60</td>
<td>$117</td>
<td>2-10</td>
<td>$-</td>
<td>95%</td>
<td>89-430%</td>
</tr>
<tr>
<td>CPF XXII</td>
<td>$80</td>
<td>$135</td>
<td>18-39</td>
<td>137</td>
<td>71%</td>
<td>84-1,265%</td>
</tr>
<tr>
<td>MRI BP</td>
<td>$106</td>
<td>$140</td>
<td>20-56</td>
<td>347</td>
<td>227%</td>
<td>126-600%</td>
</tr>
<tr>
<td>MRI BP II</td>
<td>$232</td>
<td>$429</td>
<td>17-126</td>
<td>275</td>
<td>19%</td>
<td>89-430%</td>
</tr>
<tr>
<td>MRI BP III</td>
<td>$140</td>
<td>$299</td>
<td>20-62</td>
<td>$-</td>
<td>114%</td>
<td>126-600%</td>
</tr>
</tbody>
</table>

e. Calculated as the gross receipts from liquidation of partnership assets at latest date appraised value compared to tender offer price.
f. Calculated as the total return to a secondary market investor who invested in the partnership at the reported values published in June 1994, and sold at the tender offer price.

Potential profit to NPI secondary market investors is documented in the above table. The intention of the tender offer was to buy the limited partnership units at a price higher than could be received in the secondary market, yet in most cases at a substantial discount to net asset value. For lucky or well informed investors, buying a partnership interest just prior to the tender offer would have resulted in substantial profits. The secondary market prices listed in the table are the range of actual transaction prices, indicating that some third party investors were able to take advantage of both opportunities; buying cheap from the limited partners and then selling at a substantial profit to Apollo/NPI.

Original investors who sold at tender offer prices received higher prices than if they had sold in the secondary market. They failed to receive the most probable full value of their...
interests if the partnership had been liquidated. Limited partners who sold may also have faced unfavorable tax liabilities. Limited partners are often subject to capital gains on the sale of a partnership unit, even if sold at a discount to net asset value.

Selling limited partnership units in the secondary market can result in unexpected federal tax liabilities. Any gain or loss is the difference between the amount realized on sale and the partner’s adjusted cost basis of the investment. Incurring accounting losses through depreciation write-offs can reduce the basis to very low levels, that can result in large gains recognized when the partnership unit is sold. A complication exists in the sale because the selling partner must also recognize as a gain a proportionate share of the partnership’s liabilities. Gain is realized because the selling partner is deemed to be released from the partnership’s liability.72

Ordinary income may also occur if the partnership owns Section 751 property, which is property other than a capital asset.73 Section 751 property includes “‘unrealized receivables’ includes the entire allowable amount of ordinary income recapture of depreciation, computed as if the partnership’s property was sold for its fair market value at the time of the disposition of the partnership interest.” Selling partners would have ordinary income tax due on a proportionate share of the partnership’s Section 751 depreciation recapture.74 It is possible the sale of partnership interests will not produce enough cash to pay for the tax on the gain recognized by the IRS.

The disparity in return between the limited partners and secondary market investors demonstrates the inequality of the market. New investors were doing very well. This success comes at the expense of the selling limited partners. An efficient market would not allow such egregious exploitation of one group of investors by another. The limitations of the RELP secondary market explains how this exploitation is possible.

73 Lynn and Goldberg, p. 146.
74 Lynn and Goldberg, p. 144.
Size of Market

Securitized Real Estate Markets

<table>
<thead>
<tr>
<th>Security Type</th>
<th>Annual #Transactions</th>
<th>Annual $ Volume</th>
<th>Market Capitalization</th>
</tr>
</thead>
<tbody>
<tr>
<td>RELP Secondary Market</td>
<td>14,000</td>
<td>$156M</td>
<td>$90B</td>
</tr>
<tr>
<td>Real Estate MLPs</td>
<td>–</td>
<td>$116M</td>
<td>$296M</td>
</tr>
<tr>
<td>All REITs</td>
<td>–</td>
<td>$77B</td>
<td>$47B</td>
</tr>
</tbody>
</table>

New York Stock Exchange 49 Million $2.5 Trillion $4.7 Trillion

a. Stanger
b. Based on data for real estate MLPs from Realty Stock Review, April 24, 1995.
d. NYSE Fact Book 94. (New York Stock Exchange, Inc.: April 1995)

Estimation of the volume in the RELP secondary market indicates that less than 1% of the securities trade during the year. Other real estate securities trade in much higher proportional volumes. In comparison, the New York Stock Exchange trades more than half the value of the market’s capitalization.

Measuring the volume of the RELP secondary market is difficult. The market is fragmented, lacking any central institution or information source. Volume figures differ depending on the source. Market publications do not cover all the public partnerships, estimated to be at more than 2,000 at one time. Nor can they cover all those which are actually traded. Partnership Profiles provides coverage of about 700 partnerships and 80% of the most actively traded partnerships. Stanger reports on about the same proportion of partnerships and transactions.

A limitation of these tracking services is that they must rely on information supplied to them by the resale firms and program sponsors. In aggregate, the reported trading volume is probably lower than the actual volume. Some partnership trades are not reported to the publications. Private transfers between partners, which are not executed by secondary market firms, are also excluded. It is also possible that some transfers are not completed. In the absence of standardized reporting methods and more active publication of the data, estimates of the size of the market continue to be approximations.

75 Spencer Jefferies, Partnership Profiles, Sample Report Undated.
Small trading volume increases the difficulty of forming meaningful market prices from trading data. In the RELP secondary market, the range of prices for the same securities can be quite large, another example of the inefficiency of this market. Transaction data indicates the range between the high and low price can be as much as four times. The spread between the weighted average sales price and the difference between the high and low ranges up to 193%. The average number of transactions per partnership which reported secondary market trades is just five (5). The majority of the transactions involve just one or two trades per partnership. The lack of competition therefore is an additional contributor to the inefficiency of the secondary market.

Time, Cost and Complexity of Transaction

Long closing times common to the RELP secondary market increase the risk, expense and complexity of trades. State and federal securities regulations delay the transaction period. General partners’ approval can take several months to complete. Documentation requirements are substantial in partnership transfers. Documentation demanded by partnership agreements also burdens the transfer process.

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Verification of continuing partnership tax status is an important documentation requirement contained within a typical partnership agreement. Maintenance of the partnership’s status is critical to all the partners. Partnership agreements give general partners the responsibility to protect the tax and liability status of the partnership.

Notwithstanding anything contained in this Agreement to the contrary, no Unit may be assigned or transferred without an opinion of counsel in form and substance satisfactory to the Partnership that... (ii) such assignment or transfer does not violate any applicable Federal or state securities, real estate syndication, or comparable laws; and (iii) such assignment or transfer would not cause a termination of the Partnership for Federal income tax purposes. 77

Other documentation general partners require varies, but typically includes the following:

- Two copies of power of attorney (one to GP, one for resale firm).
- Signed purchase agreements from the seller and buyer.
- When a trust exists, copies of trust agreements are required, if more than one trustee, transfer documents signed by each trustee.
- If the seller is an estate, three additional forms of documentation are required; a certified copy of the death certificate, a letter of testamentary, and an affidavit of domicile. Obtaining these documents could take up to three months. 78

The general partner also has to satisfy state security laws and IRS regulations, the cost of which is included in the transaction fees:

- Under ULPA, changes to the partnership must be recorded as an amendment to the Certificate of Limited Partnership, and filed with the state within thirty days of the event.
- Certification of minimum income and net worth (“suitability”) is required by SEC securities regulations, and as otherwise limited by the partnership agreement.

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77 Lynn and Goldberg, p. 299.
Finally, approval from the general partner that the number of units in the transaction is within the “Safe-Harbor” trading limited is required. The general partner needs to monitor all the transactions occurring within the partnership. The general partner is the only party who can track the limited partnership transactions in the fragmented secondary market, and for those transfers (such as gifts) occurring privately.

General partners have broad rights to require documentation. The time in which a general partner may take to approve the transfer is not regulated. Delays of months are possible if the general partner is not motivated to execute the transfer. Many partnership agreements grant general partners “sole discretion to arbitrarily and capriciously refuse to grant...consent.” The cost and time required for the limited partner to assemble the required documentation is obvious. In addition to the accounting and legal fees payable by the seller, general partners charge a transfer fee between $10 and $150 dollars per transaction. These selling expenses do not include the actual commissions or sale fees charged by the resale firm.

Commissions and mark-ups add further expense to the secondary market transaction. Determining an average or typical fee is difficult. Many of the transactions are executed either by a bidding system or through a dealer purchase and resale. The Chicago Partnership Board charges a maximum of 8.75% as a commission, plus a minimum $199 transaction fee. The average secondary market transaction is $8,000, resulting in fees of $900. Many publicly syndicated partnerships allowed minimum investments of $2,000. Transaction fees on small investments results in costs that are a substantial proportion of the sales proceeds, or even considerably in excess of transaction proceeds. Several partnerships have units that trade for $10 or less.

During the interval between a sale and its closing a number of events can occur. Partnership events such as a large purchase of units by another buyer, or a tender offer, could collapse the value of the previous sale. Adverse impacts on the value of the assets in the partnership could occur during the transfer time. A buyer or seller may die, or similarly disastrous events, personal or financial, may also occur. More commonly, a cash distribution from operations or liquidation may occur after a sale, but before transfer of the

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79 Lynn and Goldberg, p. 298.
unit. The proceeds go to the seller, leaving the buyer holding a comparatively overpriced unit. Investors in the secondary market, including dealers, must price in the timing risk, lowering their offering prices.

**Cost and Inaccessibility of Information**

At the heart of the efficient market theory is the assumption that information is available to all participants in the market. In the real estate limited partnership secondary market information is not necessarily available, particularly for the sellers. An “information gap” exists in the secondary market.

The first gap is the lack of widespread knowledge by the limited partners about the existence of the secondary market. This is partially a result of the generally small size and youth of the secondary market. A more compelling explanation of the lack of information about the secondary market is that the general partners and securities firms, have done little to inform limited partners. For the relatively unsophisticated investor, with otherwise small exposure to the financial world, their information conduit is often clogged by the self interests of others, most often the general partner.

Information reaching the limited partners through the general partners are most often only in reaction to a request for selling an interest. Responses from general partners may include offers to buy the LP interest, usually at a steeply discounted price. General partners may provide names of secondary market resale firms, but may also add discouraging advice to the sellers. Often the advice has been “to wait until the real estate market improves.”

Securities firms are reluctant to advertise either the secondary market or their own matching services. Restricted by SEC trading regulations and hurt by recent lawsuits, securities firms are attempting to placate investors who demand a partnership sale, but without alerting other limited partners. Brokers cannot make any solicitations. Representatives from Paine Webber and Smith Barney emphasized their firms do not advertise partnership trading desks. Partnership trading is considered to be a public relations service, not a profit producing business. Limited partners must make a request to
their broker to sell a unit. Sellers may not realize the secondary market exists, apart from the in-house matching service. Names of secondary market broker/dealers are given out when requested by clients.

Recent financial journal articles have publicized the limited partnership secondary market. Occasional references to the secondary market appear in national business magazines, but with relatively narrow coverage. The Wall Street Journal has tracked 16 public partnerships since 1988 and published their secondary market prices on an irregular basis. The Journal’s coverage of the secondary market illuminated the poor performance and difficulty in resale of partnership interests, as well as identifying the resale firms. Few limited partners are likely to read the financial press regularly. Irregular coverage of secondary market prices and the small sample of partnerships that were covered provide little useful information to make a decision to sell. Furthermore, the Journal’s coverage is becoming less frequent. Karen Damato, a staff reporter at the Wall Street Journal who covers the secondary market, indicated that this is partly a result of the increased coverage by the secondary market publications.

Potential sellers need to know more than merely the existence of the secondary market. Participating sellers need to understand how limited partnership units are valued or priced and the most appropriate time to sell a unit. Limited partners are at a disadvantage for accessing this information. Market prices in an inefficient market fail to provide the casual investor with a realistic guideline for pricing.

Without meaningful market pricing, sellers can only turn to the handful of industry trade publications for trading information. The two leading publications, The Stanger Report and The Partnership Spectrum, report on recent developments in the secondary market; recent transaction prices, major announcements such as roll-ups or tender offers, and analysis and commentary on industry issues. These newsletters are the only widely distributed sources for much of the news affecting the secondary market. However, they only track a portion of publicly traded partnerships, usually the most actively traded.

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81 Stacey Miller, Assist. V.P. Direct Investments, Smith Barney, telephone interview, June 6, 1995.
Data on secondary market trading is reported monthly by *The Stanger Report* and bi-monthly by *Partnership Spectrum*. Even in a “slow” market, delays of one or two months fail to capture timely market information. News features in these publications do provide insight into major secondary market and partnership events, which would otherwise not be reported. Readership of these publications are individual investors, investment fund and trust managers, general partners and brokers. Few, if any, limited partners subscribe to the publications.

The SEC requires general partners to file annual reports, incidental reports when a major partnership event occurs, and unaudited quarterly reports. General partners are required to make these reports available to limited partners. Depending on the general partner and the partnership agreement, reports may be mailed out or available only by request. These reports seldom contain meaningful information other than operating financial schedules. Information required in these reports is minimal. The SEC and limited partners do not receive the most accurate, or more importantly, the most timely, information. General partners may have several months before publicly releasing significant partnership decisions.

General partners’ monopoly on information includes valuation data. General partners can supply asset values, but as the appraisal process is not an exact science, valuation can be corrupted. For example, in the Apollo/NPI tender offer, NPI used “extreme assumptions” to minimize their tender price. In pricing apartments, NPI used a 9.75% cap rate and a $400 per unit replacement reserve. Limited partners were probably not aware that the average cap rate was 8.8% (which would result in a higher property price), or the typical replacement reserve was $300 per unit. A more typical property valuation would have resulted in a per partnership unit price of $222, more than double the NPI figure of $99, and triple the offered price per unit of $76.83

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Incomplete disclosure on valuation methodology is demonstrated in another tender offer deal. The general partner of Oxford Residential Properties I, Oxford Realty, offered limited partners a price of $239 per unit, a price they claimed was equal to an independently estimated “fair market value.” What was not revealed about the fair market value estimate was that it was prepared for an unrelated party, not the general partner. A general partner could exercise greater control of the asset, reducing the discount for liquidation uncertainty. The net asset value would have been worth $460 per partnership unit if purchased by the general partner. Again, it’s unlikely that any of the individual investors would have been sophisticated enough to catch the difference.84

Investors in the secondary market, in contrast, have the ability to analyze the information coming out of the secondary market. Investors can afford to receive what information is available. An individual limited partner, whose total partnership interest may be as little as $2,000 cannot afford to maintain a subscription to secondary market publications. Single transactions of as little as $10 have been reported in the secondary market. The average RELP transaction price is only $8,400. The cost for the publications for an individual with a small investment is a large proportion of the total transaction cost. Buyers often buy in large volume compared to sellers, resulting in economies of scale for analysis and transaction costs.

<table>
<thead>
<tr>
<th>Sample Secondary Market Information Costs</th>
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<tbody>
<tr>
<td>The Stanger Report (monthly)</td>
</tr>
<tr>
<td>Investment Advisor (quarterly)</td>
</tr>
<tr>
<td>Partnership Spectrum (bi-monthly newsletter)</td>
</tr>
<tr>
<td>Disclosure, Inc. 10-K Annual Report</td>
</tr>
<tr>
<td>Partnership Profiles (semi-annual partnership summaries)</td>
</tr>
<tr>
<td>Independent Partnership Valuations</td>
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</table>

 Buyers can afford the cost of gathering marketplace information. Buyers in the secondary market are not naive investors as targeted in the original syndication marketing. They are sophisticated speculative investors, extremely knowledgeable about the

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partnerships in which they intend to invest. Furthermore, buyers are not dependent on the secondary market publications for their insight.

Many of the secondary market firms maintain their own database of partnership information. The New York Partnership Exchange, Inc., for example, maintains a database of 2,800 limited partnerships. Data on appraisal values, trading prices, distribution history and mergers since the early 1980s are at the disposal of these firms. This information is considered a competitive advantage, and is obviously not shared with the seller or other firms. Securities firms also maintain complete databases of the partnerships they sold. They serve as general partners or maintain close relationships with general partners. Individual investors either have the wealth to accumulate the information they need, or are able to team up with market insiders.

General partners are the best informed participants in the secondary market. Not only do they have the most immediate information about their partnerships, they also control the flow of information to the market. Inside information gives general partners the ability to make better informed decisions on price and investment timing in the secondary market, as well as preparing tender offers. General partners are motivated by factors sometimes opposed to the welfare of limited partners. This conflict creates obstacles to efficiency in the RELP secondary market.

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Chapter Five

Motivations of Limited and General Partners

Forming an efficient market requires competitive behavior among equally motivated participants. The Revenue Ruling 59-60 definition of “fair market price” is: “the price at which the interest would transact between willing and informed buyers and sellers, neither acting under duress or undue compulsion.” Sellers of limited partnerships in the secondary market can often be categorized as being under a compulsion to sell and not necessarily fully informed.

Limited Partners

The burden of holding a limited partnership interest for many investors is substantial. Every year, whether or not the partnership paid any distribution, made or lost money, the limited partner is required to file an additional tax form for each partnership investment. Filing tax form K-1 adds complexity and expense to the limited partners’ tax returns. The addition of a K-1 preparation to an otherwise basic return can add 20%-30% to the time and cost of preparing the tax return. An individual may hold a partnership interest worth only $100 and pay more than that each year in tax preparation.

Frustration is compounded when the general partner is late in preparing the partnership tax form #1065, from which schedule K-1 is derived. Delays in the general partner’s mailing of this information is not uncommon. The Investment Program Association estimated that more than half of the 10 million limited partners seek income tax filing extensions because of delays in receiving K-1 information from their general partners. Filing extensions delay receipt of tax refunds when due, and adds to the limited partner’s discontent with their investment.

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88 Ibid., p. 19.
Perhaps greater discontent, and motivation to sell, is generated by the abysmal investment performance of the great majority of public real estate partnerships. Negative return and continuing tax liability for undistributed partnership income drive many limited partners to sell at steeply discounted prices. Limited partners give up control of their partnerships in exchange for limited liability. Although harder to measure, having few investor rights, limited access to information and being helpless to organize themselves, incents many limited partners to sell. Thus, many limited partners are willing to sell at greatly reduced prices, even when well informed about the true asset value.

*General Partners*

General partners' intentions are often to prolong the limited partners' continued investment. General partners desire to prolong a partnership for two reasons; to perpetuate fee income and to capture as much back end residual share as possible. General partners discourage selling limited partnership units in the secondary market. Hiding the true value of limited partnership investments is one reason for discouragement. Another reason is to prepare limited partners for tender offers. General partners' control can be used to discourage limited partners from selling their interests in the secondary market. Despite general partners' fiduciary responsibility to act in the best interest of their limited partners, their actions often result in the opposite.

General partners are assumed to have a fiduciary responsibility to the limited partners. Courts have recognized the relationship of general partners to limited partners as being similar to that of corporate directors to shareholders. Application of corporate fiduciary duty principles would thus apply in the partnership context. Many of these duties are specified in the partnership agreement, but whether written or not, the general partner can be held to fiduciary standards as tested in court cases.\(^{89}\)

The most serious of the breaches of fiduciary responsibility is a general partner's involvement in a tender offer, according to Glen Bigelow, president of Bigelow Management, a real estate securities investment firm. The tender offer from the general partner is what Bigelow terms the "most egregious type of insider trading." General partners have full knowledge of partnership actions sometimes three months ahead of the

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\(^{89}\) Jarchow, p. 396.
investing public or limited partners. There is little opportunity in an inefficient market for participation by other investors. General partners are the only party that have complete lists of limited partners, whose cooperation is required to successfully complete a tender offer. General partners may also manipulate the information released to limited partners and the market.\textsuperscript{90}

A form of information manipulation is through biased calculation of net asset value. Net asset values are reported in annual reports as well as in secondary market publications. Until recently, a general partner's constraints on releasing secondary market prices was an effort to hide low partnership values. General partners didn't like pricing in the secondary market which typically reported low market prices for partnership units, increasing limited partner discontent, and possibly inviting litigation. Spencer Jefferies suggests that the general partners are now valuing the asset prices more conservatively (lower values per unit). The lower value deflates the limited partners' expectations for selling in the secondary market, and in turn makes a potential tender offer from the general partner look more attractive.\textsuperscript{91}

Bigelow describes general partner tender offers as extortion when general partners present their tender offer to desperate limited partners as the only way to get out. In this scenario, the general partner reveals that liquidation of the partnership, which may have been scheduled years previously, may not occur for a number a years to come. General partners create an opportunity for themselves, in effect, to purchase real estate in a recovering market at a price which may be at a 50\% discount. (See the NPI/Apollo returns shown in Chapter 4.) Some tender offers have been financed with short term debt. Rather than waiting many years for liquidation, as limited partners have been led to believe, the partnership would be required to liquidate within one or two years to pay off the debt. Partners selling in the tender offer would miss the opportunity to receive the liquidation proceeds, which are often considerably higher than the tender offer price. For example, the NPI/Apollo offer was financed in part by $55 million provided by a one year loan. The loan can be extended only twice, nevertheless the tender offer documents state the NPI has no plans to sell the partnership's properties.\textsuperscript{92}

\textsuperscript{90} Glen Bigelow, president, Bigelow Management, telephone interview, July 11, 1995.
At the other extreme, general partners’ reluctance to liquidate a partnership is common. Taxable gain due on the sale of partnerships with high accumulated depreciation is a legitimate concern for the partnership. General partners’ desire to stay in business obviously reduces the chance of liquidation. In the absence of new syndications from which sponsors can take large up-front fees, operating income becomes the principal income source. The recovering real estate market suggests that liquidation should be more profitable, enabling the return of limited partners’ contribution. Commentary from Spencer Jefferies describes the reluctance of a specific general partner to liquidate, but his comments could also apply generally:

Despite the strong market for apartments and the fact these partnerships are becoming virtual relics, Insignia says it has no plans to liquidate the partnerships. Unfortunately, tender offer documents do not reveal the precise planetary alignment required to actually begin liquidating any of these partnerships. 93 

General partner tender offers are not without risk. Failure to gain support of a large block of limited partnership interests is one hazard, but in practice a less likely event. Hostile tender offers have added more risk for general partners making tender offers. General partners are becoming scared of starting a tender offer in the fear of a third party launching a hostile counter offer. A hostile offer typically would raise the price for limited partnership interests, making it difficult for thinly financed general partners to compete. 94

The earlier strategy for take-over attempts, such as the Apollo bid for NPI, was to buy the general partner’s interest. More recently, third parties have stepped in to make an offer for a controlling share of the limited partnership interests, igniting proxy fights for ultimate control of the partnership.

Gordon Investment Company, general partner of Consolidated Capital Properties III and IV, offered $35 per unit in a tender offer. The Koll Co., a firm that owns and manages a large portfolio of real estate assets, recognized this offer as being particularly undervalued and providing an investment opportunity for itself. As Keith Allaire of the Stanger Co. pointed out, the partnership had almost half the value of the buyout offer in cash on its balance sheet. In effect, the tender offer could be partially paid for by the partnership’s own

94 Keith Allaire, Robert Stanger & Company, telephone interview, July 6, 1995
cash. Koll made a hostile bid for a majority of the limited partnership interests at $43.75 and $52.50 per unit (still a mere fraction of the $500 original investment).  

As the offer developed, Insignia Financial Group, another real estate owner and management firm, bought out Gordon’s general partnership position. Rather than fight a costly proxy battle, Insignia and Koll teamed up and made buy-out offers for the Con-Cap partnerships at $50 and $60. An even higher offer was made directly to Insignia by the Broe Companies, another real estate firm, to purchase the outstanding units of the two partnerships at $75 each. This offer was not disclosed to the limited partners until just prior to the time Insignia’s tender offer expired. Insignia and Koll were able to acquire 22.6% and 18.3% of Con Cap III and IV, respectively.

IPA has studied possible regulatory constraint on partnership offers, as was achieved with anti-roll up legislation. The focus of regulation would be to improve disclosure, extend the minimum offering period, and restrict the general partner’s ownership interest in limited partnerships. Opposition from general partners and partnership tenderors can be expected to be very strong.

Keith Allaire, editor of The Stanger Report, recently published an editorial articulating a view sympathetic to general partners in tender offers. Arguing against new regulations, this view promotes the tender offer as a positive exercise of the free market. Conflict between the general partner’s legitimate interest to stay in business and the limited partners’ desire to liquidate is mediated in unregulated tender offers. Allaire predicts that regulating tender offers to increase prices will produce fewer tender offers, denying limited partners liquidity. He argues that competition in the ‘free market’ has already produced higher price competing offers. Demand for real estate partnerships from investors will prevent “anyone from ‘stealing’ limited partnership interests...So, the free market will be preventing the general partner from raping and pillaging limited partners.”

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95 Allaire, telephone interview, June 29, 1995.
Fighting hostile tender offers and legal battles also wastes partnership resources. Money and time spent by general managers reduces their effectiveness in managing the partnership assets. Costs for failed general partner tender offers are in effect, charged to the partnership. The only recourse for limited partners in the majority of these tender offers has been litigation.

Legal actions challenging tender offers have not be effective. In the Apollo/NPI tender offer, at least four class action lawsuits were instituted by limited partners. Settlements resulted in increased tender offer prices and promises not to roll up the partnerships before 1999. The overall benefit to the limited partners is minimal; only certain limited partners are included and after considering legal fees and expenses, the higher tender offer prices are modest increases (7.5% and 15%), still substantially below net asset values. Glen Bigelow describes these settlements as “friendly class actions.” Unable to organize themselves, and unable to afford independent counsel, limited partners are primed to accept even obviously deficient settlements. Lawyers receive a 1/3 share of the proceeds, thousands of class action plaintiffs share the remaining 2/3, resulting in token recompense.

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Chapter Six

RELP Secondary Market Prospects

The prospects of creating an efficient market is poor, according to many participants in the secondary market. IRS “safe harbor” rules hobble any attempt to produce an efficient market. Getting past the “safe harbor” hurdle does not remove the structural limitations to liquidity in the RELP syndications, nor secondary market investors’ preferences for an inefficient market.

The IPA believes the potential volume in the secondary market following implementation of its central exchange could reach $1 billion. Real estate, energy and other publicly syndicated partnerships have a total capitalization estimated at $150 billion. Active trading would be less than 1% of outstanding equity, approximately the same proportion presently traded in the informal market. IPA’s estimate could be reached only if all of the secondary trading is done through their central exchange.

Many in the secondary market do not support the proposed central exchange. Some firms feel that their business is threatened by a more efficient market. Broker/dealers are unwilling to voluntarily surrender their business to a central exchange. Others view the effort as irrelevant given the current secondary market environment.

Efficient Market Perspectives

Secondary market firms enjoy the inefficiency of the market; this is how they make their money. As Angelo Ragone, president of the National Partnership Exchange, Inc. admitted, he prefers the status quo:

“I’m a trader, I like the illiquidity, I don’t want anything to be done.”

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Secondary market firms enjoy the ability to act as market makers in an informal, and lightly regulated, market. The information advantage many of these firms seek to exploit guarantees that sellers will not receive the best price. Lack of alternative mechanisms in secondary trading raises doubts about the potential for greater efficiency. An alternative such as the IPA/Cantor Fitzgerald central exchange, operating impartially, threatens the secondary market broker/dealers’ control of the market.

The current secondary market firms are concerned about the development of a more efficient, central exchange. Their interests remain with the status quo. An operator of one of the secondary market resale firm suggested that the current, decentralized market is preferable to the proposed central exchange. Competitive interests of many smaller firms is argued to provide greater service to limited partners than a central facility. The commitment of Cantor Fitzgerald to the RELP secondary market is questioned in this argument. Independent resale firms have had years of trading experience trading and collected substantial data on the RELP secondary market. Their business, in many cases, is devoted to limited partnership trading. In contrast, Cantor Fitzgerald would be providing services only as a small part of their business operations. Independent resale firms will be presenting their views to the IRS as it decides on implementing its proposed new safe-harbor limits.

Persons interviewed in the preparation of this paper gave negative assessments of the success of the IPA/Cantor Fitzgerald central exchange and of creating a more efficient market. The proposed IRS safe-harbor limitation was cited as a major impediment, but other limiting factors were also claimed. Self interest not withstanding, the interviewees brought up valid limitations on the creation of a true efficient market.

A major deficiency in the secondary market is the difficulty in assembling large blocks of securities. Average original investment size was less than $10,000, and many investments were as little as $2,000-$5,000. Purchasers in the secondary markets are required to complete agreements with each seller separately. The time lag while waiting for the paperwork to clear through general partners, receiving the appropriate signatures and certificates, adds cost and risks to purchasers. Large institutional investors seeking to invest millions of dollars at a single time, reject these cost and time constraints. Alternative

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100 Greg Paul, President, American Partnership Services, telephone interview, July 13, 1995.
real estate securities investments are more appropriate for institutional investors. Buyers in the secondary market are expected to be individuals or small investment funds.

Efficiency is not highly desired by buyers of limited partnerships. Recent improvements in volume and reductions in discounts have been reported in the secondary market publications.

"[The] influx of secondary market buyers has resulted in higher trading prices for units in most partnerships, especially in the real estate sector...resulting in unprecedented levels of trading volume in this market."\(^{101}\)

This apparent improvement in efficiency reduces buyers’ desire to invest in the secondary market. Eggert Dagbartsson of Equity Resources, a secondary market RELP investor, claimed a “speculative bubble” has been created. Dagbartsson curtailed his investments in limited partnerships because of the lower current discounts.\(^{102}\)

Buyers have the ability to withdraw from the secondary market until conditions are right for them; sellers often are compelled by powerful incentives to sell. Buyers also have the ability to pick and choose among a large pool of sellers. At present, less than 15% of all public partnerships have interests which are traded actively. Buyers with the appropriate resources, can and will, wait until conditions suit them. Creation of a central trading facility, which is assumed to increase efficiency, would not appeal to buyers looking for high profits.

Anthony Labozetta, who is developing the secondary market central exchange at Cantor Fitzgerald, refrained from stating that his firm will enter into this business. The decision to begin the exchange will be made purely as a “business decision.” The primary requirement is adequate volume to sustain profitability for Cantor Fitzgerald. The minimum volume Cantor-Fitzgerald requires is between $50 - $100 million per year. To meet this volume, Cantor Fitzgerald would need the major Wall Street securities firms to farm out their partnership trading to Cantor, transferring business from existing secondary market firms.\(^{103}\)

\(^{102}\) Eggert Dagbartsson, Principal, Equity Resources, Inc., telephone interview, April 25, 1995.
\(^{103}\) Anthony Labozzeta, Managing Director, Cantor Fitzgerald, telephone interview, June 29, 1995.
Stacey Miller of Smith Barney suggests that the proposed central exchange is too late to be attractive to the Wall Street firms. Following the 1991 SEC regulations, which forced the securities firms to end their partnership matching services, the partnership desks were unsure of how to accommodate their customers. A central exchange at that time would have been highly desirable. Securities firms adapted using the independent resale firms, and now have little motivation to switch to the IPA/Cantor Fitzgerald exchange.104

Securities firms are interested in putting the partnership era behind them. Legal battles continue to develop as investors claim improper marketing of the original investments by these firms. Securities firms continue to support limited partners in selling their partnership units with their matching services. Smith Barney's intention in establishing their partnership trading desk was to make a system that accommodates their sellers to a point, but under no circumstances to make it a business, nor to make any money in its implementation. Paine Webber's activities are conducted in a similar fashion. Smith Barney's representative described the feelings of these firms:

"We have had enough problems with partnerships The last thing they want to do is ...reopen any issue. They want [it] to go away."105

The matching service at Merrill Lynch is apparently operated under different motivations. Merrill Lynch refused to talk about their partnership activities. Glen Bigelow, president of Bigelow Management, is familiar with the Merrill Lynch system. He believes Merrill's new matching service artificially elevates partnership unit prices, despite the SEC regulations. Merrill Lynch's intent is to "let the air out slowly," softening the blow of depressed partnership unit values for its customers, and hoping to avoid further litigation. Their system accomplishes control of prices by careful timing of their scheduled auctions, and control of the volume of partnership units offered for sale.106

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104 Miller, telephone interview, June 6, 1995.
105 Miller, telephone interview, June 6, 1995.
106 Bigelow, telephone interview July 11, 1995
Merrill Lynch sellers and buyers list at the partnership desk separately for sales on different days. On Monday, faxes go out to the secondary market broker/dealers showing partnerships available as of Tuesday. Bids from the secondary market firms are then faxed back to Merrill Lynch for Tuesday’s auction. Offers to buy are exposed on Wednesday, closing on Thursday. The SEC matching service regulations are met, as three outside bids are received, and the internal buy and sell desks are independent.

Glen Bigelow suggests that this process allows the secondary market firms to “flip” the partnerships for Merrill. Buyers for the Tuesday partnership sale bid with the expectation that they can sell the units back to Merrill Lynch buyers on Thursday. The broker/dealers need only charge a small mark-up, reflecting the certainty of being able to sell the next day. Merrill Lynch controls the volume, buy and sell sides, to ensure the pricing is stable. The price is thus kept artificially higher than if sent out into the secondary market. Bigelow further suggests that Merrill churns commissions out of the process; Merrill brokers receive commissions on the buy and sell sides, and the secondary market firms receive a markup for the short time they warehouse the partnership unit.\(^{107}\)

Merrill Lynch is not expected to forgo this arrangement to support a more efficient secondary market, such as proposed by the IPA. Secondary market firms who profit in the Merrill Lynch transactions are similarly unlikely to support efficient market efforts.

Another limiting aspect of the partnership secondary market is absence of new partnerships to trade. Recent publicly syndicated real estate partnerships are based on the Section 42 Low Income Housing Tax Credit (LIHTC). Section 42 LIHTC is a program directed by the Treasury Department to produce affordable housing. The characteristics of these partnerships are significantly different than those RELPs common in the 1980s. The buyers of these syndications are corporations able to use tax credits. Further differentiating these new syndications, units are often sold in minimum blocks of a million dollars.

Tax credit partnerships do trade on the secondary market, often at small discounts, and occasionally at a premium. The advantage of the tax credit partnerships is that the value is calculated by the amount of tax credit remaining in the investment, which is visible to the

\(^{107}\) Bigelow, telephone interview July 11, 1995.
investor. The IRS requires bonding of buyers of traded LIHTC partnerships, ensuring buyers’ ability to pay taxes if recapture penalties occur. Bonding requirements limits the number and type of buyers in secondary purchases of LIHTC.\textsuperscript{108} The implication for the secondary market is that fewer new partnership units will be available for trading in the future.

Tender offers are competing with the secondary market for the purchase of limited partnership units. Tender offers provide liquidity for limited partners hoping to escape from their investments, although with some disadvantages. As the real estate market improves, however, fewer limited partners are expected to be motivated to sell, either through tender offers or the secondary market. After years of waiting for some return on their investments, the limited partners are beginning to receive distributions from their partnerships; a result of improvements in operating revenue or through asset sales. The secondary market publications indicate an increasing number of partnerships have improved distributions. In some cases, the distribution is equal to the partnership unit value in the secondary market just previous to the distribution.

The number of partnerships liquidating is also increasing. Four years ago, there were 2,100 publicly registered partnerships, the current total is about 1,600. This year, 40 partnerships are expected to be liquidated. Merrill Lynch is steadily selling assets in the partnerships in which they serve as general partner. The Merrill Lynch partnerships are some of the most actively traded partnerships. The major partnership sponsors on Wall Street are most eager to get out of their partnership obligations, ending the litigation and unfavorable press. All Merrill Lynch/Hubbard partnerships are expected to be liquidated in the next three years. What remains will be the smaller, poorer performing partnerships that have the least appeal to trade on the secondary market. Allaire suggests the poorly performing partnerships will have no option other than operate indefinitely.\textsuperscript{109}

\textsuperscript{109} Allaire, telephone interview, June 29, 1995.
Conclusion

This research has documented the evolution of the publicly syndicated real estate limited partnership secondary market. Regulatory and market forces have produced a market which operates inefficiently. Three basic causes of this inefficiency were revealed:

1) Real estate limited partnerships were designed to be illiquid.
2) Governmental regulations inhibit development of greater efficiency through limitations on liquidity and fail to protect limited partners from abuse.
3) General partners, securities firms, secondary market broker/dealers and sophisticated investors prefer inefficiency.

Attempts to alter the conditions causing inefficiency have been only partially successful. Transformations of limited partnerships into more liquid investment structures, such as Master Limited Partnerships and REITs, were attempted. Successful transformations were accomplished, but often at the economic expense of the unsophisticated limited partners. Regulatory reaction reduced the potential for tax law and limited partner abuse, but also reduced the ability to perform these transformations.

Regulatory efforts have not significantly improved the efficiency of the secondary market. IRS limitations on trading levels of partnership interests guarantee continuing inefficiencies. NASD and SEC regulation of secondary market trading attempted to reduce unfair pricing practices. As originally implemented, these regulations negatively impacted liquidity, arguably making the situation worse for limited partners. Current regulatory presence allows greater liquidity, but does not promote efficiency. Broker/dealers, securities firms, and general partners are still able to exercise control over most relevant information and therefore, of the secondary market itself.

The conflict between the economic interests of limited and general partners remains an unresolved condition of real estate partnerships. Introduction of regulations designed to protect limited partners from abuse such as a tender offer is being challenged. Limited partners are unable to organize opposition to self dealing interests seeking to maintain
secondary market inefficiency. A proposed central exchange, expected to increase market efficiency, is not likely to receive the support of secondary market participants.

Increases in trading volume and partnership prices has occurred recently in the secondary market. Some limited partners will benefit from the apparent increased efficiency. Efforts to create a more efficient market may be insufficient to reverse the economic reversal for many original RELP investors. However, the experience of the limited partnership secondary market can serve as an example for other small securities markets. Limited liquidity is already recognized with other real estate securities, such as Commercial Mortgage Backed Securities. Regulations which failed to protect RELP investors could help future regulations to be more appropriately designed and implemented in other inefficient securities markets.
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