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GOVERNMENT REGULATION

FEDERAL SECURITIES ASPECTS OF THE RESORT CONDOMINIUM†

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INTRODUCTION

This article attempts to explore and analyze the major pitfalls involved in the offer and sale of resort condominiums with specific rental arrangements. The myriad of problems involved with the sale of resort condominiums springs from the fact that the offer of a rental arrangement in conjunction with the sale of the unit may constitute a security as that term is defined in the Securities Act of 1933.¹ Consequently, the public offering of resort condominium units together with certain types of rental arrangements brings the traditional real estate promoter within the jurisdiction of the Securities and Exchange Commission (SEC) and the Board of Governors of the Federal Reserve System (FRB) when credit is arranged or extended by broker-dealers.

To avoid violation of the federal securities laws, the resort condominium promoter or developer must comply with the rules and regulations of the SEC and the FRB in order to market condominium securities, absent an available exemption. Paradoxically, it is the offer of the rental arrangement with the unit, to help meet the expenses of ownership, which opens a Pandora's Box revealing the morass of statutes, rules, and regulations of the SEC and FRB.

The condominium concept is not a new one. It was first used by the Romans in the days of the Empire to combat the scarcity and high cost of urban land. Condominiums also flourished in the walled cities of Western Europe in the Middle Ages.² However, condominiums are relatively new to the United States. In fact, it was not until 1961

† The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of any of the author's colleagues on the staff of the Commission.

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¹ 15 U.S.C. §§ 77a-aa (1970).

² A. GREZZO, U.S. DEPARTMENT OF HOUSING & URBAN DEVELOPMENT, OFFICE OF INTERNATIONAL AFFAIRS, CONDOMINIUMS, THEIR DEVELOPMENT AND MANAGEMENT (September 1972).

that Congress amended the National Housing Act³ to extend government insurance of mortgages to condominiums.

The rise of the resort condominium market is even more recent. The SEC and FRB are acutely aware of the problem facing the resort condominium industry. The FRB has deferred, for a period of six months, an amendment to Regulation T,⁴ which was to become effective on June 21, 1974 and would have precluded broker-dealers from selling condominium securities where the developer had prearranged financing for the unit. The SEC has also proposed a rule that would exempt condominium securities from the credit restrictions of the Securities Exchange Act of 1934⁵ provided certain conditions are met.⁶

REGISTRATION WITH THE SECURITIES AND EXCHANGE COMMISSION

Generally, the purchaser of a resort condominium unit is an absentee owner. Consequently, he must rely on the managerial efforts of the seller, or establish an agency relationship with a third party, to supervise the rental of his unit to others. The paramount attraction to the purchaser, therefore, is the offer of a rental pool or some other rental arrangement whereby the seller or promoter of the condominiums either undertakes or arranges for a third party to rent the unit on behalf of the owner during his absence. In a "pooling" arrangement the rents received and the expenses attributable to the rental of all the units in the project are combined and the individual owner receives his ratable share of the rental proceeds regardless of whether his individual unit was actually rented.

In its October 12, 1972 report to the Securities and Exchange Commission, the Real Estate Advisory Committee recommended registration with the SEC when a rental pool is combined with the sale of a condominium unit,⁷ since a security in the nature of an investment contract is deemed to exist. The Committee also recommended registration

[w]hether or not there is a pooling of income and/or expenses, if the purchaser is *required* to hold his unit available for rental for

³ 12 U.S.C. § 1715y (1970).

⁴ 12 C.F.R. § 220.6(1) (1974).

⁵ 15 U.S.C. §§ 78a-hh (1970).

⁶ SEC Securities Exchange Act Release No. 34-10,845 (June 7, 1974) (notice of proposal to adopt rule 3a12-5 under the Securities Exchange Act of 1934).

⁷ SEC, REAL ESTATE ADVISORY COMM., REPORT TO THE SEC 74 (1972). The committee's recommendations may be found in abbreviated form in 173 BNA SEC. REG. & L. REP. E-1 (1972).

any portion of the year, or to use the owner, developer, promoter or entity controlled by them as exclusive sale or rental agent. . . .⁸

On January 4, 1973, the Commission issued an advisory release⁹ noting that the offer and sale of condominium units coupled with an offer or agreement to perform or arrange certain rental or other services may constitute the offer of a security in the form of an investment contract within the meaning of the Securities Act of 1933 (the Act)¹⁰ and the Securities Exchange Act of 1934 (Exchange Act).¹¹ This release did not establish new law, but was merely a reminder of the existing state of the law as applied to the offer and sale of investment contracts which in this case were being offered with resort condominiums. The legal genesis of the Commission's release is found in two Supreme Court decisions.

In *SEC v. C.M. Joiner Leasing Corp.*,¹² a 1943 case, the defendant subdivided an oil lease and sold assignments of portions of the lease. The interests were sold to finance continued drilling. The Court found that without the promises of drilling by the seller, the leases would not have had any value. The Court went on to state that had the offers omitted the economic inducement of the promised exploration, the purchasers would have been buying real estate. In finding that the promise of future drilling in conjunction with the offer of the leases constituted a security, the Court looked to "what character the instrument is given in commerce by the terms of the offer, the plan of distribution and the economic inducements held out to the prospect."¹³

Three years later, in *SEC v. W.J. Howey Co.*,¹⁴ the Court set down what has generally become the accepted definition of an investment contract. In *Howey*, the defendant offered small parcels of planted citrus land for sale and also offered a management contract. Under the terms of the contract, the defendant obtained a 20-year lease on the land, undertaking to cultivate it and to harvest and market the crops, dividing the profits on the basis of the ratio of fruit for each parcel to the entire corporation. The Court found that an "investment contract" for the purpose of the Securities Act of 1933 means

a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely

⁸ 173 BNA SEC. REG. & L. REP. at E-3.

⁹ SEC Securities Act Release No. 5347 (Jan. 4, 1973).

¹⁰ 15 U.S.C. §§ 77a-aa (1970).

¹¹ 15 U.S.C. §§ 78a-hh (1970).

¹² 320 U.S. 344 (1943).

¹³ *Id.* at 352-53.

¹⁴ 328 U.S. 293 (1946).

from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.¹⁵

The purchasers of the citrus groves had "no desire to occupy the land or to develop it themselves; they [were] attracted solely by the prospects of a return of their investment."¹⁶ The common enterprise managed by the defendant or a third party was necessary to achieve the investors' "paramount aim" of obtaining a return on their investment.¹⁷

In its release, the SEC, relying on the legal conclusions of *Joiner* and *Howey*, went beyond the recommendations of the Real Estate Advisory Committee. The Commission stated that the following three basic arrangements would constitute securities offerings when offered in conjunction with condominiums:

1. The condominiums, with any rental arrangement or other similar service, are offered and sold with emphasis on the economic benefits to the purchaser to be derived from rental of the units due to the managerial efforts of the promoter, or a third party designated or arranged for by him;
2. The offering of participation in a rental pool arrangement; and,
3. The offering of a rental or similar arrangement whereby the purchaser must hold his unit available for rental for any part of the year, must use an exclusive rental agent or is otherwise materially restricted in his occupancy or rental of his unit.¹⁸

The offering of condominium units in conjunction with any one of the above will cause the offering to be viewed as an offering of securities in the form of investment contracts.¹⁹ Absent an available exemption,²⁰ registration under section 6²¹ of the Act would be required for

¹⁵ *Id.* at 298-99. In addition, recent decisions have indicated that the profits need not come solely from the efforts of third parties. A security may be found to exist even if the purchaser is not wholly inactive. See SEC Securities Act Release No. 5347 (Jan. 4, 1973).

¹⁶ 328 U.S. at 300.

¹⁷ *Id.*

¹⁸ SEC Securities Act Release No. 5347 (Jan. 4, 1973).

¹⁹ A security, as defined in section 2(1) of the Act, 15 U.S.C. § 77b(1) (1970), includes investment contracts. See text accompanying notes 14-17 *supra*.

²⁰ Securities Act § 4(2), 15 U.S.C. § 77d(2) (1970) (exempting from the registration requirements of the Act "transactions by an issuer not involving any public offering"). Securities Act § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1970) (providing an exemption for a wholly intrastate offering). Under this exemption, the issue must be offered and sold only to residents of a single state and the issuer must be a resident and doing business in that state. If the issuer is a corporation, it must be incorporated and doing business within the state. The Commission, in its discretion, may exempt from full registration securities whose aggregate amount does not exceed \$500,000. *Id.* § 3(b), 15 U.S.C. § 77c(b).

²¹ *Id.* § 6(a), 15 U.S.C. § 77f(a).

such a security. A registration statement filed with the SEC must meet the disclosure requirements of the Act and Schedule A.²² A discussion of those disclosure requirements, however, is too lengthy to be included within the scope of this article.

BROKER-DEALER REGISTRATION

Generally speaking, any person engaged in the business of selling securities must be registered as a broker-dealer²³ pursuant to section 15 of the Exchange Act.²⁴ For purposes of licensing broker-dealers, it is immaterial whether or not the security being sold is exempt from registration.²⁵ Accordingly, salesmen of condominium securities, unless specifically exempted, must nevertheless be registered as broker-dealers.

Two basic exemptions are available to salesmen of condominium securities. Section 15(a)(1) of the Exchange Act exempts from the registration requirements of the Act any broker or dealer whose business is "exclusively intrastate."²⁶ For the exemption to be available to a broker or dealer all of his business must be transacted within his state and the issuer must be a person resident and doing business within the state.²⁷ The broker or dealer may not effect transactions or otherwise do business for or with persons outside the state or advertise outside the state. The intrastate exemption from registration of broker-dealers under the Exchange Act, however, appears to be of little use to a promoter wishing to make an interstate public offering since such a transaction cannot be confined within one state.²⁸

The other available exemption from registration as a broker-dealer is the so-called "issuer exemption." Registration under the Exchange Act²⁹ applies only to salesmen falling within the definition of a broker

²² *Id.* Schedule A, 15 U.S.C. § 77aa.

²³ The term "broker" means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank. Exchange Act § 3(4), 15 U.S.C. § 78c(4) (1970). The term "dealer" means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business. *Id.* § 3(5), 15 U.S.C. § 78c(5).

²⁴ 15 U.S.C. § 78o (1970).

²⁵ *Id.* § 78o(a)(1). See note 20 *supra* regarding exemption of securities from registration.

²⁶ *Id.*

²⁷ *Id.*

²⁸ See SEC No-action letter, *Dart Industries, Inc.*, March 9, 1972, which implies that a promoter can hire a separate sales staff in each state, as long as they are registered with the SEC, and thereby obtain an intrastate exemption from registration for his salesmen in the state in which the securities are sold.

²⁹ Exchange Act § 15(b)(1), 15 U.S.C. § 78o(b)(1) (1970).

or a dealer.³⁰ The issuer exemption extends to bona fide employees of an issuer and is determined on a case by case basis. The basis for the exemption is that the issuer and his employees do not come within the statutory definition of broker or dealer. Factors affecting determination of such exemption include: whether the employee is compensated by salary or commission; the length of time the employee has been in the employ of the issuer and whether he will continue with that employment at the completion of the offering; whether the issuer withholds social security taxes and pays unemployment compensation premiums; whether the employee performs additional duties for the issuer other than the sale of securities; and the business background of the employee.³¹ The issuer exemption is available as long as the issuer is *not* "engaged in the business" of effecting securities transactions for the account of others, nor buying his own securities. Thus, he does not come within the statutory definitions of broker or dealer.³²

In the absence of either the intrastate or issuer exemption, registration of salesmen under section 15 of the Exchange Act is required in order to offer or sell condominium securities in the nature of investment contracts. Moreover, broker-dealers offering condominium securities are subject to the "margin requirements" of section 7 of the Exchange Act.³³

THE APPLICATION OF REGULATION T

One of the key elements of marketing a resort condominium is the availability of mortgage financing. This is due in part to the great outlay of cash that would otherwise be required to purchase a unit and the attractiveness of large interest deductions for federal income tax purposes.³⁴ Since most purchasers of resort condominiums are usually absentee owners, the individual procurement of permanent mortgage financing presents substantial problems which might impede a prospective purchaser from buying a unit. Consequently, the developer generally obtains a "take-out"³⁵ commitment from a local lend-

³⁰ See note 23 *supra*.

³¹ SEC No-action letter, *Arizona-Colorado Land & Cattle Co.*, avail. June 30, 1973.

³² See note 23 *supra*.

³³ 15 U.S.C. § 78g(c) (1970). Under this section, it is unlawful for a broker or dealer to extend or maintain, or arrange for the extension or maintenance of credit to a customer on a nonexempt security in violation of rules and regulations prescribed by the FRB.

³⁴ INT. REV. CODE OF 1954, § 163(a) allows a deduction for all interest paid or accrued on indebtedness.

³⁵ A "take-out" commitment refers to an arrangement by the developer with a lending institution to make permanent financing available to prospective purchasers of the condominium units.

ing institution in order to offer permanent financing to prospective purchasers.

Where a condominium security is offered for sale by a broker-dealer, the added arrangement of permanent financing by the developer invokes the application of sections 7³⁶ and 11(d)(1)³⁷ of the Exchange Act, and Regulation T of the FRB.³⁸ These sections impose certain restrictions on the extension of credit by broker-dealers thereby creating substantial marketing problems for developers and broker-dealers offering condominium securities with "take-out" financing.

The determination that a particular offering constitutes the offer or sale of securities³⁹ triggers the application of the statutory definitions of broker⁴⁰ or dealer⁴¹ to persons offering such securities for sale. Broker-dealers or any member of a national securities exchange are subject to the margin requirements of section 7 of the Exchange Act and Regulation T.

The House Committee on Interstate and Foreign Commerce stated that the main purpose of section 7 of the Exchange Act

is to give a Government credit agency an effective method of reducing the aggregate amount of the nation's credit resources which can be directed by speculation into the stock market and out of other more desirable uses of commerce and industry to prevent a recurrence of the precrash situation where funds which would otherwise have been available at normal interest rates for uses of local commerce, industry, and agriculture were drained by the higher rates into security loans and the New York call market.⁴²

The Senate Committee's view of the goals of section 7 was in accord with the House position:

These provisions are intended to protect the margin purchaser by making it impossible for him to buy securities on too thin a margin, thereby adding depth and stability to the market, and to vest a Government credit agency with power to reduce the aggregate amount of the Nation's resources which can be directed by speculation into the stock market and away from commerce and industry.⁴³

³⁶ Exchange Act § 7, 15 U.S.C. § 78g (1970).

³⁷ *Id.* § 11(d)(1), 15 U.S.C. § 78k(d)(1).

³⁸ Credit by Brokers and Dealers, 12 C.F.R. § 220 (1974).

³⁹ Securities Act § 2(1), 15 U.S.C. § 77b(1) (1970) defines generally a "security" while SEC Securities Act Release No. 5347 (Jan. 4, 1973), provides guidelines, *inter alia*, as to the applicability of the federal securities laws to offers and sales of condominiums. See text accompanying notes 9-11 *supra*.

⁴⁰ See note 23 *supra*.

⁴¹ *Id.*

⁴² H.R. REP. No. 1383, 73d Cong., 2d Sess. 8 (1934).

⁴³ S. REP. No. 1455, 73d Cong., 2d Sess. 11 (1934).

It is apparent from the legislative history that the primary thrust of section 7 was to prevent highly margined speculation leading to a recurrence of unstable market conditions.⁴⁴

Congress did not specifically consider the investment contract security in its deliberations that led to the adoption of section 7 because the evaluation of the investment contract security did not culminate until the Supreme Court's 1946 decision in *SEC v. W.J. Howey Co.*⁴⁵ But the speculative and risk characteristics that Congress criticized in the corporate security market also exist, directly or by analogy, in the case of the investment contract security.

Section 7 is also the source of the FRB's authority to regulate the extension of credit by brokers and dealers "[f]or the purpose of preventing excessive use of credit for the purchase or carrying of securities"⁴⁶ Consistent with that authority, the FRB promulgated Regulation T to regulate all extensions of credit by brokers and dealers which includes those not registered under section 15 of the Exchange Act.⁴⁷

The FRB's authority to determine the loan value of securities sold by broker-dealers is also found under section 7.⁴⁸ Section 7(c) provides that it shall be unlawful for any "broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer"⁴⁹ on any nonexempt security in contravention of the Board's rules and regulations. Section 7 does not apply either to those securities exempted from the credit provisions of the Exchange Act by the SEC⁵⁰ or to an exempted security.

⁴⁴ Section 7 was also enacted to maintain the availability of credit for financing local commerce and industry, to prevent undue market volatility by exerting a positive, stabilizing effect on the market and to protect investors from purchasing securities on too thin a margin. See H.R. REP. NO. 1383, 73d Cong., 2d Sess. 8 (1934); S. REP. NO. 792, 73d Cong., 2d Sess. 3, 8 (1934); S. REP. NO. 1453, 73d Cong., 2d Sess. 11 (1934). See generally 2 L. LOSS, SECURITIES REGULATION 1242 (2d ed. 1961).

⁴⁵ 328 U.S. 293 (1946). See text accompanying notes 13-16 *supra*.

⁴⁶ 15 U.S.C. § 78g(a) (1970).

⁴⁷ "This part . . . applies to every broker or dealer, including every member of a national securities exchange." 12 C.F.R. § 220.1 (1974) (emphasis added).

⁴⁸ Section 7(a) of the Exchange Act, 15 U.S.C. § 78g(a) (1970), provides that the Board shall "prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security)." Section 7(b) allows the Board to raise or lower the margin requirements prescribed in section 7(a) for the initial extension or maintenance of credit. 15 U.S.C. § 78g(b).

⁴⁹ 15 U.S.C. § 78g(c) (1970).

⁵⁰ The SEC may, by rules and regulations, either unconditionally or upon specified terms and conditions or for stated periods, exempt specified securities from the operation of any one or more provisions of the Exchange Act which by their terms do not apply to an "exempted security." Exchange Act § 3(12), 15 U.S.C. § 78c(12) (1970).

In its March 24, 1972, interpretation of Regulation T, the FRB stated that

for the purpose of purchasing or carrying securities, section 220.8 of the regulation . . . does not permit any loan value to be given securities that are not registered on a national securities exchange, included on the Board's OTC Margin List, or exempted by statute from the regulation.⁵¹

Loan value may be assigned only to either a "margin security"⁵² or an "exempted security."⁵³

Condominium securities are neither registered on a national securities exchange nor listed on the OTC margin stock list. They, therefore, do not meet the definitional requirements of a "margin security," and can be assigned no loan value under section 220.8 of Regulation T. The SEC has not exempted condominium securities from the provisions of section 7 of the Exchange Act. Since no loan value can be assigned to them, Regulation T precludes brokers or dealers from extending or arranging for the extension of any credit to any customer on the sale of a condominium security.

Section 220.7(a) of Regulation T⁵⁴ provides that a broker or dealer cannot "arrange" for a third party to extend credit on terms other than he could have provided. The Regulation thus precludes a broker or dealer from doing indirectly what he could not do directly. The staff of the FRB has construed "arranging" to include "the broker-dealer's activities in seeking out the investor and delivering a prospectus which makes previously arranged credit available to the investor. . . ."⁵⁵ In other words, a broker-dealer would not be able to offer a condominium security for sale where credit has been arranged by the developer or promoter if providing such credit himself would be in contravention of Regulation T. To do so would be a violation of section 7(c) of the Exchange Act.

Until recently, however, the FRB staff had taken the position, based on an opinion letter issued on May 25, 1971, that credit extended in conjunction with the sale of real estate was separable from any col-

⁵¹ 12 C.F.R. § 220.124(d) (1974).

⁵² "Margin security" is defined as a security registered on a national exchange or an over-the-counter margin stock. *Id.* § 220.2(f). Not all over-the-counter stocks are margin stocks. The FRB must determine whether a stock should be marginable based on such factors as degree of national investor interest, depth and breadth of market, etc. *Id.* § 220.2(e)(1).

⁵³ See note 50 *supra*.

⁵⁴ 12 C.F.R. § 220.7(a) (1974).

⁵⁵ Letter from the Staff of the Board of Governors of the Federal Reserve System, Aug. 2, 1973.

lateral investment contract.⁵⁶ The FRB's May 25th letter stated that brokers and dealers would not be violating section 220.7(a) of Regulation T if they participated in arranging for credit in the sale of real estate investment contracts secured by mortgages on the land where the credit is extended solely in connection with the sale of real estate. The May 25th letter dealt with the sale of citrus grove tracts offered in conjunction with a management contract in a situation not at all unlike that described in *SEC v. W.J. Howey Co.*⁵⁷ The *Howey* Court held that such real estate programs constituted securities in the form of an investment contract, the test being "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."⁵⁸ The SEC has continuously viewed the security as consisting of both the real estate and the management contract.⁵⁹

The staff of the FRB, on the other hand, held a different view of what constituted a security. It took the position that the offer of condominium securities with a mortgage financing commitment arranged by the issuer or developer did not constitute an extension of credit in violation of section 7(c) of the Exchange Act and Regulation T,⁶⁰ where the units were offered by a broker-dealer. The theory was that the mortgage on the real estate was a separate item from the offer of the collateral management agreement.⁶¹ Thus, the FRB's interpretation of what constituted a security for purposes of extending credit by broker-dealers differed from the SEC position.⁶²

However, on December 21, 1973, the FRB adopted an amendment to Regulation T.⁶³ The latter abandons the FRB's previous "separability" position and treats the offer of real estate with any part of an investment contract as a security. In pertinent part, the amendment states:

⁵⁶ Letter of interpretation from the Board of Governors of the Federal Reserve System, May 25, 1971.

⁵⁷ 328 U.S. 293 (1946).

⁵⁸ *Id.* at 301.

⁵⁹ See note 9 and accompanying text *supra*.

⁶⁰ It should also be pointed out that the recipient of credit in violation of Regulation T may incur liability. Section 7(f) of the Exchange Act, 15 U.S.C. § 78g(f) (1970), extends sanctions to the borrower also. Under Regulation X, 12 C.F.R. § 224 (1974), promulgated pursuant to section 7(f), both the broker and the investor are in violation of the regulation.

⁶¹ However, under the relevant Supreme Court decisions, for purposes of determining whether such an arrangement would constitute a security in the form of an investment contract under section 2(1) of the Securities Act, 15 U.S.C. § 77b(1) (1970), there is no separation of the sale of the real property from the collateral management agreement. See notes 12-17 and accompanying text *supra*.

⁶² See note 9 and accompanying text *supra*.

⁶³ 12 C.F.R. § 220.6(l) (1974).

credit for the purpose of purchasing or carrying any part of an investment contract security (for example, . . . the condominium ownership part of a program to own and rent a unit through a rental pool) shall be deemed to be credit on the entire security.⁶⁴

The FRB's adoption of the amendment to Regulation T brings it into line with the SEC's position that investment contracts are not separable, but registerable securities under section 6 of the Securities Act of 1933.⁶⁵ On the effective date of the amendment, barring an exemption⁶⁶ by the SEC or the FRB from the margin requirements of section 7 of the Exchange Act, broker-dealers will be precluded from selling condominium securities with prearranged "take-out" financing. Thus, broker-dealers would be restricted to selling condominiums involving investment contracts to those instances where sales are on a cash basis or the investor procures his own financing.

In the meantime, notwithstanding the apparent period of grace pending implementation, the offer of condominium securities with prearranged financing by broker-dealers still triggers the credit restriction provisions of section 11(d)(1) of the Exchange Act.

RESTRICTIONS ON THE EXTENSION OF CREDIT UNDER
SECTION 11(d)(1) OF THE SECURITIES EXCHANGE
ACT OF 1934

Section 11(d)(1) of the Exchange Act provides that a person who, "both as a broker and a dealer transacts a business in securities," cannot, directly or indirectly, extend, maintain or arrange for the extension or maintenance of credit to or for a customer on any security which is part of a new issue in which he participates within thirty days prior to the transaction in question.⁶⁷

Thus, any person who transacts business as both a broker *and* a dealer is prohibited from extending credit on new issues which he distributes. The prohibition is by its terms applicable if the participant engages in the transactions of a general broker-dealer business. The particular capacity of the broker-dealer in the offering is immaterial. A person who has previously transacted a business both as a broker and

⁶⁴ *Id.*

⁶⁵ 15 U.S.C. § 77f(a) (1970).

⁶⁶ See note 50 *supra*. Exemption by the SEC of salesmen of condominium securities from the provisions of sections 7(c) and 11(d)(1) of the Exchange Act would also provide a method for allowing the extension of credit on the sale of condominium securities without violating the margin requirements of the above sections of the Exchange Act or Regulation T. However, no such proposal for exempting condominium salesmen from those provisions of the Exchange Act is currently before the SEC.

⁶⁷ 15 U.S.C. § 78k(d)(1) (1970).

as a dealer cannot satisfy the terms of section 11(d)(1) merely by ceasing to act in one capacity during the duration of a particular offering. Such an individual would continue to "transact a business" in both capacities as a broker *and* a dealer, thereby falling within the purview of section 11(d)(1).

Consequently, where condominium securities are offered or sold by individuals transacting business both as brokers and dealers, regardless of the applicability of Regulation T, the direct or indirect extension, maintenance or arrangement of credit in conjunction with the sale of the unit could result in a violation of section 11(d)(1). It is only where a participant in a distribution has limited its *total* business to either brokerage *or* dealer activities, that section 11(d)(1) might not apply. Such a limitation on either brokerage or dealer activities is not likely among the larger broker-dealer firms. Notwithstanding a limitation on a participant's activities to either brokerage or dealer activities, section 7(c) of the Exchange Act, which also applies to a broker *or* dealer, would still prohibit the extension of credit by the participant who did not comply with Regulation T.

SEC PROPOSAL TO ADOPT RULE 3a12-5

By way of release on June 7, 1974, the SEC issued notice of a proposal to adopt rule 3a12-5 under the Exchange Act.⁶⁸ The rule, if adopted, would be in the nature of an experiment and subject to close scrutiny by the Commission. The proposed rule would exempt certain investment contract securities, offered by broker-dealers, from sections 7 and 11(d)(1) of the Exchange Act. Subject to certain conditions, "condominium securities"⁶⁹ will qualify for exemption from the credit restrictions of these sections.

In the release, the Commission expressed its preliminary view that "investment contract securities involving the direct ownership of specified residential real property,"⁷⁰ where the traditional modes of financing real property are utilized and there is no secondary market for trading in the securities, make unlikely the concerns addressed by sections 7 and 11(d)(1).⁷¹

The proposed rule exempts a security from the provisions of sec-

⁶⁸ SEC Securities Exchange Act Release No. 34-10,845 (June 7, 1974).

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ Section 11(d)(1) was enacted by Congress to prevent "one of the greatest potential evils attributable to the combination of the broker and dealer functions in the same person—the extension of credit on new issues by underwriter-brokers." H.R. REP. NO. 1383, 73d Cong., 2d Sess. 22 (1934).

tions 7(c)⁷² and 11(d)(1) with respect to any transaction by a broker or dealer who, directly or indirectly, arranges for the extension or maintenance of credit on the security to or for a customer provided certain conditions are met.⁷³ Credit extended for the purchase of a resort condominium must be secured by a lien, mortgage, deed of trust or other security interest on specified real property. The loan must be reasonably related to the value of the realty while principal and interest must be repaid pursuant to a regular amortization schedule. The proposed rule also provides that the lender not be in a control⁷⁴ relationship with the broker-dealer or the issuer.

In conjunction with the arrangement of financing, the proposed rule would require the broker-dealer to perform certain suitability functions including a determination that the investment is suitable for the purchaser. This must be supported by a written statement by the broker-dealer setting forth the basis for the determination. Prior to consummation of the transaction, the broker-dealer must also deliver a written statement setting forth the exact nature and extent of the purchaser's obligation under the loan arrangement; the purchaser's risk in the transaction, and a statement of all commissions, discounts or other remuneration which the broker-dealer⁷⁵ will receive or has received in connection with the transaction. Lastly, based on information regarding the purchaser's financial situation, the broker-dealer must reasonably determine that the entire transaction, including the loan arrangement, is suitable for the purchaser.

While the proposed rule places the burden of examining the purchaser's financial situation and the suitability of the transaction squarely on the shoulders of the broker-dealer, if adhered to, it will alleviate the problems of sections 7(c) and 11(d)(1) which preclude a broker-dealer from selling condominium securities where the developer has secured financing commitments for prospective purchasers.

REFLECTIONS

Since this article is intended primarily to describe the various problems involved in the sale and purchase of resort condominiums

⁷² Section 7(c) of the Exchange Act precludes a broker-dealer, directly or indirectly, from extending, maintaining or arranging for the extension or maintenance of credit to or for any customer on any security in contravention of the rules and regulations of the FRB. 15 U.S.C. § 78g(c) (1970).

⁷³ SEC Securities Exchange Act Release No. 34-10845 (June 7, 1974).

⁷⁴ The term "control" means the "possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 230.405(f) (1974).

⁷⁵ The proposed rule would include remuneration received or to be received by any person in a control relationship with the broker-dealer in connection with the transaction. See notes 6 & 74 *supra*.

with certain types of rental arrangements,⁷⁶ there are no general conclusions to be drawn, only some cautionary reflections. A clear understanding of the rules and policies of the SEC and FRB is of paramount importance if one is to avoid being trapped in a web of government regulations which in turn can spell financial disaster to the best intentioned developer.

A developer must first determine whether his project is a security which must be registered with the SEC.⁷⁷ If it is, absent an exemption,⁷⁸ salesmen must also register as broker-dealers with the SEC. The use of broker-dealers in turn triggers sections 7 and 11(d)(1) of the Exchange Act and Regulation T where credit, in the form of a mortgage, is arranged in conjunction with the sale of condominium securities. The FRB's prospective restriction⁷⁹ on the offer of mortgage financing will also raise important marketing problems which a developer should carefully consider prior to forming a sales staff. Moreover, the "energy crisis" and excessively high interest rates might even ring the "death knell" of the resort condominium industry before the effective date of the FRB's amendment⁸⁰ to Regulation T, thereby rendering moot the controversy over whether margin requirements under section 7 of the Exchange Act should be applicable to resort condominium securities.

The SEC's proposed rule 3a12-5, if adopted, would give broker-dealers selling condominium securities relief from the restrictions of sections 7 and 11(d)(1) of the Exchange Act and Regulation T. However, the Commission has cautioned that the proposed rule is in the nature of an experiment and that persons availing themselves of the exemption "will be carefully scrutinized to assure that such activities are not inconsistent with the public interest and are not subject to abuse."⁸¹

Since the proposed rule is premised on the absence of a secondary market, if a secondary trading market in condominium securities developed or the proposed rule were otherwise abused, the Commission would reconsider its appropriateness. This could again leave the resort condominium developer in the position of being unable to market condominium securities registered with the SEC due to credit restrictions under the Exchange Act.

⁷⁶ See text accompanying note 18 *supra*.

⁷⁷ See note 21 *supra*.

⁷⁸ See text accompanying notes 26-28 *supra*.

⁷⁹ See note 63 *supra*.

⁸⁰ *Id.*

⁸¹ SEC Securities Exchange Act Release No. 34-10845 (June 7, 1974).