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## Proposed Rule 3A12-5 - A High Price for an Exemption from Regulation T for Condominium Securities

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PROPOSED RULE 3a12-5—A HIGH PRICE FOR AN  
EXEMPTION FROM REGULATION T FOR  
CONDOMINIUM SECURITIES

BRUCE S. GOLDSTEIN\* AND ROBERT J. VAN DER WALL\*

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I. INTRODUCTION

The Securities and Exchange Commission<sup>1</sup> has indicated that under certain circumstances condominiums may be deemed to be securities.<sup>2</sup> Projects which involve securities are subject to numerous comprehensive federal securities laws plus a plethora of complex SEC rules and regulations. These laws were written and have usually been construed to deal with the characteristics that are peculiar to ordinary stocks and bonds, not to real estate. Condominiums, however, remain essentially a real estate commodity that must be marketed and financed as real estate, that is, with conventional mortgage loans furnished by local lending institutions. The imposition of securities laws into this traditional setting can have severe results for the securities bar, condominium developers and purchasers.

For example, triggering of the securities laws requires that the developer prepare and file with the Commission a costly, time consuming registration statement,<sup>3</sup> unless an exemption is available.<sup>4</sup> But even if an exemption is available, the broad anti-fraud provisions of

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1. Hereinafter referred to as the Commission or the SEC.

2. See section III *infra*.

3. Registration costs are known to vary, but have ranged upwards to \$125,000 for an 81 unit registration. Ellsworth, *Condominiums are Securities?* 2 REAL ESTATE L.J. 694 (1974) [hereinafter cited as Ellsworth]. For a comprehensive checklist for the contents of a condominium registration statement, see Klein, *Preparation of an SEC Registration Statement for an Offering of Condominium Units*, 2 REAL ESTATES L.J. 461 (1974).

4. Exempted securities and exempted transactions are described in sections 3 and 4, respectively, of the Securities Act of 1933, 15 U.S.C. §§ 77c, d (1970).

the laws still apply.<sup>5</sup> In addition, the laws provide severe restrictions on the means and content of advertising.<sup>6</sup> The cost of compliance with these laws will, of course, eventually pass to the consumer, whose protection is the object of securities regulation.<sup>7</sup>

Perhaps the most complex and perplexing ramifications that may arise from the inclusion of this field under the securities umbrella stem from the possible determination that condominium developers and sales people may be securities brokers and dealers. This result invokes myriad regulations<sup>8</sup> concerning broker-dealer conduct and brings into play the Federal Reserve Board's Regulation T,<sup>9</sup> which establishes margin requirements. Fortunately, the Commission has recognized this problem and has proposed a new rule<sup>10</sup> that would under certain conditions suspend the operation of the margin requirements and section 11(d)(1) of the Securities Exchange Act of 1934,<sup>11</sup> which regulates the extension of credit in purchase of certain real estate securities, in return for specified regulatory and disclosure requirements.

The thrust of this comment is to examine this SEC proposal in the light of the pre-existing statutory framework,<sup>12</sup> taking into account the legislative purposes of the appropriate provisions of the statutes and the applicability of these provisions to the unique character of condominium securities. As a prelude, the evolution of the definition of a security to include condominiums is first explored.

## II. DEFINITION OF A SECURITY

The federal securities laws were enacted in the 1930's partially as a result of the calamitous stock market crash of 1929 and the subsequent depression, but these laws had been presaged by substantial state regulation of securities and centuries of English regulatory law.<sup>13</sup> The Securities Act of 1933<sup>14</sup> was the first federal enactment and

5. See, e.g., section 77q(c) the 1933 Act, which states that "[t]he exemptions provided in section 77c of this title shall not apply to the [antifraud] provisions of this section." 15 U.S.C. § 77q(c) (1970).

6. 15 U.S.C. § 77e (1970).

7. H.R. REP. NO. 85, 73d Cong., 1st Sess. 1 (1933). In his March 29, 1933 message to the Congress, President Franklin Delano Roosevelt said:

There is . . . an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public . . . .

. . . . The purpose of the legislation I suggest is to protect the public . . . .

*Id.* at 2.

8. See, e.g., 17 C.F.R. § 240 (1974).

9. 12 C.F.R. §§ 220.1-8 (1974) [hereinafter referred to as Regulation T].

10. Proposed Rule 3a12-5, 2 CCH FED. SEC. L. REP. ¶ 21,195 (June 7, 1974).

11. 15 U.S.C. § 78k(d) (1) (1970).

12. Only federal securities laws and the appropriate SEC rules and regulations promulgated thereunder are discussed. The effects of "Blue Sky" laws, enacted in every state and which regulate securities transactions within the states, are not considered.

13. See generally 1 LOSS, SECURITIES REGULATION, ch. 1 (2d ed. 1961).

14. 15 U.S.C. §§ 77a-aa (1970).

adopted a broad catchall definition of a security<sup>15</sup> that was largely obtained from the existing statutes.<sup>16</sup> This definition was often cited in the early cases without elaboration<sup>17</sup> or was construed broadly<sup>18</sup> merely because it was remedial legislation.<sup>19</sup> Subsequent federal decisions determined the meaning of such ambiguous terms as an "investment contract" in the statute.<sup>20</sup>

The landmark definitional case is *SEC V. W.J. Howey Co.*, which construed an investment contract as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of [others]."<sup>21</sup> *Howey* was significant because, among other things, it explicitly broadened the definition of a security to embody a concept "capable of adaptation to meet the countless and variable schemes devised by those who seek the use of money of others on the promise of profits."<sup>22</sup> The case arose from the efforts of the W.J. Howey Co. and its affiliate, Howey-in-the-Hills Service, Inc., to sell to the general public narrow strips of citrus grove acreage in conjunction with a cultivation and marketing service contract. Profits from the harvest were to be allocated among the purchasers based upon a check made at the time of picking. The United States Supreme Court held that the promotion constituted an illegal offer of a security and the defendants were enjoined from using interstate facilities for the scheme.

It should be noted that the *Howey* definition of a security is really a statement of the economic relationship existing between the investor and the promoter.<sup>23</sup> The funds from a number of investors are pooled

15. As amended in 1934, the term "security" is now defined as: [A]ny note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest of participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b (1970).

16. Mofsky, *Some Comments on The Expanding Definition of a Security*, 27 U. MIAMI L. REV. 395 (1973) [hereinafter cited as Mofsky].

17. *Id.* at 398.

18. *SEC v. Starmont*, 31 F. Supp. 264 (E.D. Wash. 1940). See also *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943). The *Joiner* court stated:

[T]he reach of the [1933 Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts", or as "any interest or instrument commonly known as a 'security.'"

*Id.* at 351.

19. *SEC v. Starmont*, 31 F. Supp. 264 (E.D. Wash. 1940).

20. 15 U.S.C. § 77b (1970).

21. 328 U.S. 293, 298-99 (1946). This concept will hereinafter be referred to as the *Howey* test.

22. *Id.* at 299.

23. Tew & Freedman, *In Support of SEC v. W.J. Howey Co.: A Critical Analysis of the Parameters of the Economic Relationship Between an Issuer of Securities and the Securities Purchaser*, 27 U. MIAMI L. REV. 407 (1973) [hereinafter cited as Tew & Freedman].

to produce a profit from a business venture which is controlled not by the investor, but by the promoter. This concept provided a relatively stable framework that post-*Howey* courts used for some years to cut through form to the substance of numerous imaginative schemes, without significant change in the definition of a security.<sup>24</sup> Such promotions ranged all the way from the sale of trust deeds or mortgages<sup>25</sup> to beavers,<sup>26</sup> and were usually tested against the precise language of *Howey*.

Despite the widespread use of the *Howey* test, there have been numerous difficulties in applying it to different schemes that have managed to evade its express terms but should have been subject to securities regulation. For example, where the investor gives value in the form of his labor as well as (or in place of) money, the promotion is not a pure investment of *money*, nor does it involve an expectation of profits *solely* from the efforts of others.<sup>27</sup> Similarly, there have been difficulties in applying the term "common enterprise"<sup>28</sup> and determining what is an "expectation of profit."<sup>29</sup> Some courts and legal commentators have also raised the element of risk as a necessary part of the definition of a security.<sup>30</sup>

Consequently, a marked uncertainty in the definition of a security has been generated, making it extremely difficult for securities attorneys to advise clients when registration of an offering is required. In addition, the proliferation of definitions of a security will naturally result in a significant increase in the number of enterprises which will be subject to the burden of federal securities regulation.<sup>31</sup>

24. See generally Mofsky, *The Expanding Definition of "Security" under the Blue Sky Laws*, 1 SEC. REG. L.J. 217 (1973).

25. *Los Angeles Trust Deed & Mtg. Exch. v. SEC*, 285 F.2d 162 (9th Cir. 1960).

26. *Continental Mkt. Corp. v. SEC*, 387 F.2d 466 (10th Cir. 1967).

27. *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir. 1973).

28. *Los Angeles Trust Deed & Mtg. Exch. v. SEC*, 285 F.2d 162 (9th Cir. 1960). The court in *Trust Deed* suggested that a common enterprise is present where the economic welfare of the investor is "inextricably woven" into the business fortunes and skill of the promoter. *Id.* at 172.

29. See Tew & Freedman, *supra* note 23.

30. The element risk was seen as the essential ingredient in the definition of a security in the well known case of *Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961). The decision in *Silver Hills* arose under the California Blue Sky law definition of a security and involved the sale of memberships in an unfinished country club. The proceeds of the sale were to be used to complete the facilities and the purchasers were to have no right to the income or assets of the club, thus eliminating any profit expectation. The court held that the California statute was designed to protect the public against spurious schemes of whatever forms that were intended to obtain "risk capital." The *Silver Hills* court never defined the term, but "risk capital" was clearly intended not only to circumvent the expectation of profit element of the *Howey* test (which was absent from the promotion *sub judice*), but also to recognize that risk of loss is an essential attribute of security.

Others courts subsequently seized upon and extended the risk capital theory as a means of expanding the definition of a security to meet the exigencies of multilevel distributorships and from clauses that probably would not have been securities under the *Howey* test. Unfortunately, these courts have reached differing conclusions as to what constitutes a security, although the risk capital concept is generally used in some form. See generally Tew & Freedman, *supra* note 23; Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367, 381-82 (1967).

31. See Mofsky, *supra* note 16.

### III. A CONDOMINIUM AS A SECURITY

The expansion in the definition of a security spilled over into the resort condominium<sup>32</sup> industry in the mid-60's, when the Commission first advised a resort condominium developer that he was selling securities<sup>33</sup> and that he would have to comply with the registration provisions<sup>34</sup> of the Securities Act of 1933.<sup>35</sup>

Although subsequently the SEC issued a release<sup>36</sup> dealing with the sale of joint or profit sharing ventures, or limited partnership interests, in real estate four months after the effective date of an early condominium prospectus,<sup>37</sup> no explicit mention was made of condominiums. Of course, such forms of ownership had been commonly used since the early 1950's by real estate syndicates to construct primary residences,<sup>38</sup> but the release did not directly tie in this fact. Moreover, there appears to have been few reported SEC rulings on whether a condominium constituted a security until 1971, when the Commission released correspondence dealing with a number of requests for no action letters.<sup>39</sup> In response to one such request by an attorney for an undisclosed client, the Commission staff replied that under the facts given, the offering would have to comply with the federal securities laws. The proposal was for a public sale of condominiums built in the Grand Bahama Islands on terms which required a 20 year leaseback to a subsidiary of the vendor. The offering envisioned only vacation usage by the owners, with rental agent services to the owners to produce income, maintenance service and automobile transportation service provided by the subsidiary. The rental income was expected only to cover maintenance costs and reduce the mortgage debt, but the SEC staff apparently felt the scheme was

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32. Of course, condominiums sold for non-resort purposes are usually not securities since they are not primarily purchased for investment purposes, and fail to meet other aspects of the risk capital and *Howey* tests. Nevertheless, they are subject to real estate regulation. *See, e.g., Florida Condominium Act, FLA. STAT. ch. 711 (1973).*

33. When the SEC intervened, the Hale Kaanapali Apartment Hotel Development Co. had sold 152 of 253 condominium units in a resort structure that was to be operated as a hotel on the island of Maui in Hawaii. The plan envisioned rental of the unoccupied units for the owners by the developer, who offered to act as agent for the owners. The SEC intervention resulted in the return of over \$200,000 to owners who elected to rescind their purchases, in addition to substantial additional expense. Rohan, *The Securities Law Implications Of Condominium Marketing Programs Which Feature A Rental Agency Or Rental Pool*, 2 CONN. L. REV. 1 (1969) [hereinafter cited as Rohan].

34. 15 U.S.C. § 77f (1970).

35. 15 U.S.C. §§ 77a-aa (1970).

36. SEC Securities Act Release No. 33-4877, [1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,462 (Aug. 8, 1967).

37. Prospectus of the "Hale Kaanapali Apartment Hotel Development Co." dated April 13, 1967. *See Rohan, supra* note 33.

38. Clurman, *Are Condominiums Securities?*, 65 PLI CONDOMINIUM DEVELOPMENT (SECOND) 103, 104 (1972).

39. A no action letter is a response by the staff of the Commission to a written request by counsel as to whether a proposed course of conduct would, in the staff's opinion, require compliance with the federal securities laws. It name comes from the fact that if the proposed conduct was in fact adhered to, the staff would recommend to the Commission that *no action* of an enforcement nature be taken against the party inquiring.

sufficiently close to the definition of a security to warrant investor protection.<sup>40</sup>

However, in a second request at about the same time, the staff reached the opposite conclusion and issued a no action letter to the inquiring party.<sup>41</sup> The case involved a plan to build condominiums next to a resort hotel owned by an affiliate developer. The condominiums were to have their own recreational facilities. Sales were to be made by a registered real estate broker, but no representations were to be made to prospective purchasers regarding rental possibilities, even though they were conceded to exist if action was initiated by the owner after purchase. Significantly, no rental services were offered.<sup>42</sup>

Despite the release of a number of requests for no action letters, the Commission appears to have taken little formal action to promulgate its views on the necessity of federal securities regulation of resort condominium sales until 1972, when the SEC established the Real Estate Advisory Committee.<sup>43</sup> The REAC made its report to the Commission on October 12, 1972, recommending, *inter alia*, that the Commission "continue to regulate real estate securities pursuant to the 1933 and 1934 Acts' disclosure approach, intensifying disclosure and increasing policing and reporting standards."<sup>44</sup> The REAC also attempted to better define the circumstances under which a condominium is a security.<sup>45</sup>

Certain of the REAC recommendations were adopted by the SEC on January 4, 1973, when the Commission issued its Release No. 33-5347<sup>46</sup> under the 1933 Securities Act. The release was issued as a warning that compliance with the federal securities acts would be

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40. Edward S. Jaffry, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,395 (1971).

41. Surfides Condominiums, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,686 (1972).

42. In addition to these requests, the Commission staff, in 1971, indicated in response to two other inquiries that registration as broker-dealers under the Securities Exchange Act of 1934, 15 U.S.C. § 78c *et seq.* (1970) would be required of real estate salesmen dealing with resort condominiums. Haystack Hotel Ass'n, Inc., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,049 (1971); San Diego-Maui Group, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,444 (1971). See text accompanying notes 87-121 *infra*.

43. The Real Estate Advisory Committee [hereinafter referred to as REAC] was appointed by then Commission Chairman William J. Casey, on May 3, 1972, for the purposes of assisting "the Commission in the review of its disclosure procedures and policy objectives in the area of real estate security interests." Ellsworth, *supra* note 3, at 695-96.

44. Report of the SEC Real Estate Advisory Committee, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,265, at 82,773 (Oct. 12, 1973). The applicable sections are, respectively, 15 U.S.C. §§ 77a-aa, and 78a *et seq.* (1970).

45. The definition proposed by the REAC included a condominium as security (1) when it is offered with a rental pool, (2) when the purchaser is required to rent his unit for part of the year, (3) when the purchaser is obligated to employ the developer as an exclusive rental agent, or (4) when the developer provides management services with an unusually long term contract. Report of the SEC Real Estate Advisory Committee, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,265, at 82,775 (Oct. 12, 1972).

46. Guidelines as to the Applicability of the Federal Securities Law to Offers and Sales of Condominiums or Units in Real Estate Development, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,163 (Jan. 4, 1973).

required under certain circumstances, which were defined in the release. The Commission pointed out that it was aware that there was uncertainty about when condominium offerings were securities, and that the release was intended to provide guidelines as to when securities law compliance would be necessary to businessmen engaged in building and selling condominium units.<sup>47</sup>

The release explained that an offer to sell a condominium in conjunction with certain services could constitute an offer of an investment contract,<sup>48</sup> as defined by the *Howey* test,<sup>49</sup> thus requiring securities law compliance. The Commission emphasized that condominiums will be deemed to be securities if they are offered and sold through promotions which emphasize economic benefits to the purchaser.<sup>50</sup> The release summarized the circumstances which would cause an offering to be deemed a security:

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 the managerial efforts of the promoter, or a third party designated or arranged for by the promoter, from rental of the units.
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.

In all of the above situations, investor protection requires the application of the federal securities laws.<sup>51</sup>

Unfortunately, Release No. 33-5347 apparently did not provide as much guidance to condominium developers as might have been hoped; the Commission staff, in the eight months following issuance of the release, found itself dealing with a significant number of requests for no action letters.<sup>52</sup> While strict compliance with the release's guidelines resulted in the sought after no action letters,<sup>53</sup> many staff responses

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47. *Id.* at 82,536.

48. *Id.*

49. See text accompanying note 21 *supra*.

50. Guidelines to the Applicability of the Federal Securities Laws to Offers and Sales of Condominiums or Units in Real Estate Development, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,163, at 82,539-40 (Jan. 4, 1973).

51. *Id.*

52. BNA SEC. REG. & L. REP. No. 219, C-2 (1973).

53. See, e.g., K.A.C. of Vail, Colo., *Id.* at C-3. The developer planned to sell condominium units through a licensed real estate broker, who would offer them as second homes, not investments. Care of the condominium common elements would be achieved and paid for through an association of all owners. Inquiries from prospective purchasers regarding rentals were to be answered with the statement that owners would have to make their own arrangements.



apparently turned on fine points, not really covered by the release itself.

For example, in *Spring Realty Co., Inc.*,<sup>54</sup> the Commission staff indicated that it was unable to express an opinion upon whether securities law compliance was necessary, leaving the developer and his attorney to make the decision. In that case, the developer offered the condominiums to prospective buyers as both residential and investment property and offered to act as a rental agent for owners who chose not to live there all year.<sup>55</sup> In contrast, the case of *North Shore Project*<sup>56</sup> resulted in a denial of a no action letter. The Commission stated that although "mere notice of the existence of rental services . . . does not make a condominium offering one of securities,"<sup>57</sup> reference to rental income and consequential tax benefits might constitute the "economic benefits" emphasis that Release No. 33-5347 included in the definition of a security. In this case, the staff concluded that even though rental income was only to be used to offset costs, it could still be the "economic benefit" that would render the offering a security.<sup>58</sup> But in *Kaanapali Properties*,<sup>59</sup> a no action letter was forthcoming despite the fact that the developer advertised the tax advantage of condominium ownership. Perhaps significantly, this representation was not coupled with offers of rental services, nor was there prospective data regarding rental income.

An examination of numerous requests for no action letters and the staff responses to them does not result in any clear picture of when securities law compliance is necessary. It would appear that the decisions may partly be based on the manner of presentation,<sup>60</sup> but, regardless, the circumstances under which a condominium may be a security are not well defined. Moreover, the SEC has recently indicated that it will no longer issue no action letters in the condominium area and that it does not wish prior no action letters to be relied upon as indications of future Commission action.<sup>61</sup>

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54. *Id.* at C-4.

55. *Id.*

56. *Id.*

57. *Id.*, quoting the SEC response.

58. *Id.*

59. *Id.* at C-5.

60. *Id.* at C-7.

61. BNA SEC. REG. & L. REP. No. 252, C-1 (1974). The BNA report stated, in part, that

[w]hether or not the offering of a security is involved depends upon all the facts of a particular case, and variations in the facts of the cases might lead to different results. While no-action letters are limited to the facts presented, the staff said, and do not represent an interpretation of the law even as to these, the Commission is concerned that inferences might be drawn from the issuance of no-action letters in this rapidly evolving area. Such inferences could lead to misunderstanding as to the Commission's position, and to contentions in future situations that the Commission had taken a position that it in fact had not taken. The Commission has consequently directed the staff not to issue no-action letters in this area, and to advise that no-action letters issued in the past in this general field do not extend beyond the particular issuer involved and should not be relied upon by any other person or by the persons receiving the prior letters for any other offerings.

The consequent lack of certainty in the definition of condominium security renders the task of securities attorneys extremely troublesome. The probable result is that responsible counsel will be forced to recommend the expensive course of securities law compliance in any case that even remotely approaches the parameters suggested by the release and published staff responses.<sup>62</sup> Businessmen will then have to make the unsatisfactory choice of costly compliance or risky noncompliance in an atmosphere of uncertainty. The end result is a needless increase in the cost of doing business, which will be passed on to the consumer without demonstrable regulatory benefit or investor protection. It thus becomes obvious that further definitive action is incumbent upon the Commission. No useful purpose is served by leaving this area of law in an amorphous state.

#### IV. STATUTORY FRAMEWORK

##### A. Section 11(d)(1)

Despite the numerous ingredients necessary to develop a condominium project, the success or failure of the venture will ultimately depend on the developer's ability to sell the individual units at a profit. However, the dual nature of the condominium, which would result from its being deemed a security, can significantly complicate the sales function. First, the condominium is real estate<sup>63</sup> and, as with the sale of other real estate, sales people must be licensed by the state as real estate salesmen or brokers.<sup>64</sup> Where the condominium is also a security, however, the sales person may fall within the 1934 Securities Exchange Act<sup>65</sup> definition of a securities broker or dealer<sup>66</sup> and become subject to the numerous requirements under the securities laws.<sup>67</sup>

If the sales person is deemed to be a broker or dealer, section

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62. One writer has suggested: [T]he following tests [to determine the existence of a security] may be applied by one who is considering the development of condominiums or resort property:

(1) Does the developer offer the property primarily as a permanent residence or as a vacation spot with investment potential?

(2) Does the developer emphasize the potential that the property has for appreciation, or does he specifically instruct his salesmen not to mention growth potential of the property?

(3) Does the developer present a plan or arrangement under which he or another entity (related or unrelated) will manage and rent the property for the direct or indirect benefit of the purchaser?

(4) Does the developer's plan affirmatively deny any interest or intent in managing the project?

(5) Does the purchaser have complete freedom to occupy or rent his unit according to his own desires?

63. See, e.g., FLA. STAT. § 711.04(1) (1973).

64. See, e.g., FLA. STAT. ch. 475 (1973).

65. 15 U.S.C. §§ 78a *et seq.* (1970).

66. 15 U.S.C. §§ 78c(a)(4),(5) (1970).

67. See text accompanying notes 87-121 *infra*.

11(d)(1) of the 1934 Act<sup>68</sup> and the margin requirements<sup>69</sup> are triggered.<sup>70</sup> Section 11(d)(1) makes it unlawful for anyone who transacts business as both a broker and dealer to extend or arrange for the extension of credit to a customer on a non-exempt security "which was a part of a new issue in the distribution of which he participated as a member of a selling syndicate or group within thirty days prior to such transaction. . . ."<sup>71</sup> Thus, arrangement of mortgage financing by a sales person deemed to be a broker-dealer would be barred by section 11(d)(1), although this is routinely done by developers or their sales people as part of a condominium sales effort.

### B. Section 7 and Regulation T

Developers or their sales personnel deemed to be securities brokers or dealers will also be subject to the margin requirement, a method by which Congress controls the extension of credit for the purchase of securities.<sup>72</sup> The term margin is generally used to refer to the minimum percentage of the total purchase price that must be paid in cash by the purchaser of a security. For example, if the margin requirement is 75 percent, the purchaser of a security which costs \$100 must pay \$75 in cash. Credit may then be extended on the remaining \$25 of the purchase price. Thus, by raising or lowering the margin requirements, the relative ease or difficulty by which a security may be purchased on credit may be controlled.

Under section 7(a) of the Securities Exchange Act of 1934,<sup>73</sup> Congress established the initial margin requirements.<sup>74</sup> Realizing the need for flexibility, however, section 7(b) provides the Federal Reserve Board with the authority to raise or lower the margin "as it deems necessary or appropriate for the accommodation of commerce and industry. . . ."<sup>75</sup>

Section 7(c)<sup>76</sup> makes it "unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend . . . or arrange for the extension . . . of credit" on a non-exempt security<sup>77</sup> in contravention to the rules prescribed by the Federal Reserve Board. Pursuant to the authority given by this statute, the

68. 15 U.S.C. § 78k(d) (1) (1970).

69. 15 U.S.C. § 78g (1970).

70. The requirements of § 15(a) of the Securities Exchange Act of 1934 are applicable as well. These are discussed in the text accompanying note 89 *infra*.

71. 15 U.S.C. § 78k(d)(1) (1970).

72. 12 C.F.R. §§ 220.1-8 (1974).

73. 15 U.S.C. § 78g(a) (1970).

74. The initial margin requirements intended as a guide for the Federal Reserve Board, were the higher of (1) 55 percent of the current market price of the security, or (2) 100 percent of the lowest market price of the security during the preceding 36 calendar months, but not more than 75 percent of the current market price. H.R. REP. NO. 1383, 73d Cong., 2d Sess. 8 (1934).

75. 15 U.S.C. § 78g(b) (1970).

76. 15 U.S.C. § 78g(c) (1970).

77. See section 3(a)(12) of the Securities Act of 1934 for the definition of an exempted security. 15 U.S.C. § 78c(a)(12) (1970).

Federal Reserve Board adopted Regulation T<sup>78</sup> which controls the extension of credit by brokers and dealers.

The Federal Reserve Board has manifested a clear intention to include the condominium security within the scope of Regulation T by proposing an amendment to section 220.6 of the regulation. This amendment would read as follows:

Credit for the purpose of purchasing or carrying any part of an investment contract security (for example, but not limited to . . . the condominium ownership part of a program to own and rent a unit through a rental pool or otherwise) shall be deemed to be credit on the entire security.<sup>79</sup>

This amendment was proposed to negate a view previously held by the Federal Reserve Board that Regulation T would not be violated where the investment was divisible into a real estate component and a security component and the credit was extended solely to finance the real estate portion in the form of a conventional mortgage.<sup>80</sup>

The impact of applying Regulation T to the condominium developer (assuming that he is a securities broker or dealer) is quite significant since a large portion of condominium sales are dependent upon the arrangement of suitable financing. The effect of Regulation T is to completely bar the developer from extending credit or even arranging mortgage financing for the purchase of a condominium unit. The reason for this is that the broker or dealer is only permitted to extend credit on certain categories of securities prescribed by the Federal Reserve Board.<sup>81</sup> These categories include securities registered on a national securities exchange,<sup>82</sup> stocks on the Federal Reserve Board's over-the-counter trading list,<sup>83</sup> and exempted securities.<sup>84</sup> Since condominiums do not fall within any of these categories, no credit can be extended by the broker or dealer to finance the purchase.<sup>85</sup> Likewise, the developer is prohibited from arranging for mortgage financing since a securities broker is permitted to arrange for financing only on the same terms that he could employ in extending credit to others.<sup>86</sup> The developer who is classified as a broker-dealer is thereby faced with the unpleasant alternative of leaving the purchaser to arrange for his own financing.

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78. 12 C.F.R. §§ 220.1-.8 (1974).

79. Proposed F.R.B. Reg. § 220.6(1), 38 Fed. Reg. 34988 (1973).

80. 38 Fed. Reg. 34988 (1973).

81. See 12 C.F.R. § 220.8 (1974).

82. 12 C.F.R. § 220.2(d) (1974).

83. 12 C.F.R. § 220.2(e) (1974).

84. 12 C.F.R. § 220.2(g) (1974).

85. The Federal Reserve Board has already decided that Regulation T completely bars the extension of credit for the purchase of tax shelter securities, usually in the form of a limited partnership. 12 C.F.R. § 220.124 (1974). Presumably, Regulation T would be applied to condominium securities in the same manner.

86. 12 C.F.R. § 220.7(a) (1974).

### C. Brokers and Dealers

In planning the sales aspects of his project, a condominium developer can elect either to contract with an outside agency to provide sales personnel or perform the selling function himself. If he elects to utilize the services of an outside agency, the developer will be faced with Regulation T and section 11(d)(1) problems since the outside agency will almost certainly fall within the statutory definition of a broker or a dealer.<sup>87</sup>

If the developer chooses to perform the selling function himself, then he may either form a separate sales company, or he may simply hire sales personnel to sell his units. In either case, it is possible that those selling the condominiums may be deemed securities brokers or dealers and thus, in addition to the credit extension provisions, the developer will be subject to section 15 of the Securities Exchange Act.<sup>88</sup>

Section 15(a)<sup>89</sup> requires that every broker and dealer register with the Securities and Exchange Commission,<sup>90</sup> unless exempt.<sup>91</sup> Registered brokers and dealers are also subject to net capital requirements,<sup>92</sup> special bookkeeping and reporting requirements<sup>93</sup> and special anti-fraud provisions.<sup>94</sup> In addition, a broker or dealer must either become a member of the National Association of Securities Dealers (NASD),<sup>95</sup> an organization which imposes additional standards and reporting requirements, or become subject to a similar set of rules and requirements administered by the Commission.<sup>96</sup> In both cases, the rules are geared toward the more traditional securities broker or dealer who deals in stocks and bonds, including a require-

87. 15 U.S.C. §§ 78c(a)(4),(5) (1970).

88. 15 U.S.C. § 780 (1970). For more detail on the broker-dealer requirements, see Augustine & Fass, *Broker-Dealer Licensing in the Field of Real Estate Syndication*, 29 *Bus. Lawyer* 369 (1974) [hereinafter cited as Augustine & Fass].

89. 15 U.S.C. § 780(a) (1970).

90. The Real Estate Advisory Committee of the Securities and Exchange Commission has suggested that brokers and dealers of condominium securities be required to register only through a short form examination focusing on those portions of the 1933 and 1934 Acts relating to fraud.

[L]icensed real estate brokers and sales persons . . . should be exempt from the broker-dealer reporting and regulatory requirements under the 1934 Act where their sales of real estate securities are limited to . . . condominiums and cooperatives.

[1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,265, at 82,775 (Oct. 12, 1972). The Commission is now considering such an exemption.

91. 15 U.S.C. § 780(a)(2) (1970). Section 15(a)(2) gives the SEC the authority to make exemptions from the registration requirements.

92. 17 C.F.R. § 240.15c3-1 (1974).

93. 17 C.F.R. §§ 240.17a-3 through -5 (1974).

94. 15 U.S.C. § 780(c) (1970).

95. The National Association of Securities Dealers [hereinafter referred to as NASD] plans to offer an examination for real estate salesmen who are currently selling real estate securities, which will lead to a limited license to sell condominium securities and limited partnerships. This test will eventually become a prerequisite to NASD membership. BNA SEC. REG. & L. REP. No. 268, A-24 (1974).

96. 15 U.S.C. § 780(b)(8) (1970). Persons subject to such rules are brokers or dealers [hereinafter referred to as SECO].

ment that all salesmen complete a general securities examination.<sup>97</sup> This makes the task of finding personnel qualified to sell the condominium unit especially difficult, since salesmen must become knowledgeable in the more traditional securities markets as well as in real estate.<sup>98</sup>

In addition, brokers and dealers are subject to rule 15c2-5<sup>99</sup> whether or not they are registered with the Commission.<sup>100</sup> This rule makes it a fraudulent practice to extend or arrange credit unless the broker or dealer delivers to the purchaser a written statement setting forth the risks, disadvantages, obligations and all discounts under the loan.<sup>101</sup> The broker or dealer must also obtain from the purchaser information concerning his financial situation and needs, and from this make a determination

that the entire transaction, including the loan arrangement, is *suitable* for such person, and deliver[s] to such person a written statement setting forth the basis upon which the broker or dealer made such determination.<sup>102</sup>

These rules do not apply, however, to a broker or dealer who arranges for or extends credit subject to and in compliance with the requirements of Regulation T.<sup>103</sup>

The condominium developer may, however, be able to obtain relief from these laws by qualifying for either the issuer exemption or the intrastate exemption. An issuer<sup>104</sup> selling his own securities qualifies for the issuer exemption when he does not fall within the Securities Exchange Act definition of a broker or dealer.<sup>105</sup>

The Securities Exchange Act defines the term dealer as:

any person engaged in the business of buying and selling securities for his own account . . . but does not include . . . any person insofar as he buys or sells securities for his own

97. 17 C.F.R. § 240.15b8-1(a) (1974).

98. See note 95 *supra*.

99. 17 C.F.R. § 240.15c2-5 (1974) [hereinafter referred to as rule 15c2-5].

100. State of Ohio Dep't of Commerce, Div. of Securities, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,558, at 83,523 (1973).

101. 17 C.F.R. § 240.15c2-5(a)(1) (1974).

102. 17 C.F.R. § 240.15c2-5(a)(2) (1974) (emphasis added).

103. 17 C.F.R. § 240.15c2-5(b) (1974).

104. See 15 U.S.C. § 78c(a)(8) (1970).

105. While Augustine & Fass, correctly point out that "a broker-dealer who is exempt from registration will not necessarily be exempt from regulation, while an issuer who is not a broker-dealer to begin with, will be exempt from both registration and regulation," Augustine & Fass, *supra* note 88, at 370 n.4, they are perhaps stretching a point in their contention that the term "issuer exemption" is not really accurate. They assert that since the issuer is not deemed to be a broker-dealer in the first instance, he cannot be considered "exempt" from regulations governing brokers and dealers. Not wishing to belabor a question of semantics, we find the importance of this distinction overemphasized, as in their explanation of the inaccuracy of the term "exemption," the authors themselves point out that the issuer who is not a broker or dealer is indeed "exempt from both registration and regulation."

account, individually or in some fiduciary capacity, but not as a part of a regular business.<sup>106</sup>

Notably, in order to be a dealer under this definition, a person must be in the business of both *buying* and selling securities. The condominium developer, as an issuer, only sells securities and thus would not be a dealer within the above statutory definition. Moreover, since one must be both a broker and a dealer in order to be subject to the section 11(d)(1) prohibition against the extension of or arrangement for the extension of credit,<sup>107</sup> and since the developer generally sells only condominium securities, he is not subject to section 11(d)(1).

It is not necessary to buy as well as sell in order to be deemed a broker, which is defined as "any person engaged in the business of effecting transactions . . . for the account of others . . ." <sup>108</sup> The Commission has maintained, however, that an issuer and its bona fide employees who sell their own securities on a non-recurring basis<sup>109</sup> are not required to register as brokers.<sup>110</sup> Consequently, a condominium developer and his bona fide employees would be neither brokers nor dealers.

The possibility still remains that the personnel actually selling the units may not be bona fide employees, and thus may themselves be brokers. Whether a person is actually a bona fide employee will, of course, depend upon the facts of each individual case, the considerations being much the same as those that were used at common law to distinguish between the servant and the independent contractor.<sup>111</sup> Factors that have been suggested<sup>112</sup> for making this determination include: (1) the employee must be compensated by salary, not commission; (2) the employer must assume the responsibility of withholding and social security taxes; and (3) the salesman must be employed with the issuer both before and after the conclusion of the offering. Additional criteria used by the Commission are that the employees have no significant background in the securities business and that the salesman must not be primarily engaged in the activity of selling securities.<sup>113</sup>

The "intrastate exemption" encompasses two distinct concepts in securities law. First, an issuer who offers and sells securities within a single state is exempt from registering his securities under section

106. 15 U.S.C. § 78c(a)(5) (1970).

107. See text accompanying note 71 *supra*.

108. 15 U.S.C. § 78c(a)(4) (1970).

109. See SEC No Action Letter, Inland Realty Inv., Inc., BNA SEC. REG. & L. REP. No. 232, C-3 (1973).

110. The Woodmoor Corp., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,653 (1973). See also Landcom, Inc., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,176 (1971).

111. 2 L. LOSS, SECURITIES REGULATION 1298 (2d ed. 1961).

112. See Augustine & Fass, *supra* note 88, at 371.

113. The Woodmoor Corp., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,653 (1972).

3(a)(11) of the Securities Act of 1933.<sup>114</sup> This idea must be kept separate from the exemption from registration under section 15(a) of the 1934 Act of the broker or dealer "whose business is exclusively intrastate."<sup>115</sup>

The two exemptions have not been construed identically by the Securities and Exchange Commission, with the section 15(a) exemption apparently being much narrower in scope. While the primary concern of the 3(a)(11) exemption is that the securities be offered and sold only to bona fide residents of the state, in order to qualify for the section 15(a) exemption, the broker's or dealer's entire business must also be transacted solely within the state.<sup>116</sup> It is thus possible that a broker or dealer may be required to register under section 15(a), even though he only sells securities exempt from registration under section 3(a)(11).<sup>117</sup>

Both the intrastate exemption from registration of securities under section 3(a)(11) and the intrastate exemption from registration of brokers and dealers under section 15(a) have an effect (or at least may have an effect) on the credit and other broker-dealer requirements. The effects of the section 3(a)(11) exemption on the necessity to comply with Regulation T is not certain at this time. While no clear statement has yet been issued by the Federal Reserve Board,<sup>118</sup> there is some indication that securities exempt from registration under this section do not "have the impact on the securities market of the kind with which the Board was directed to concern itself under Section 7 of the Securities Exchange Act of 1934."<sup>119</sup>

If the Federal Reserve Board does eventually determine that securities sold under the section 3(a)(11) exemption are subject to Regulation T, brokers and dealers will, of course, be completely barred from extending or arranging for the extension of credit for the purchase of the condominium security sold under this exemption. In addition, the Commission, assuming this to be the case, has held that a broker or dealer who extends credit for the purchase of a security exempt under section 3(a)(11) will also be in violation of rule 15c2-5.<sup>120</sup> Even though this rule is excluded from application where credit is arranged in compliance with Regulation T, "[i]f the credit transaction is not permissible under Regulation T, this exclusion is unavailable."<sup>121</sup> It should be noted that even if the securities sold

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114. 15 U.S.C. § 77c(a)(11) (1970).

115. 15 U.S.C. § 780(a) (1970).

116. See Augustine & Fass, *supra* note 88, at 372.

117. See SEC No Action Letter, D.L. Burlage, BNA SEC. REG. & L. REP. No. 130, C-3 (1971).

118. See Letter from Federal Reserve Board to Mark E. Perrin, May 18, 1973, in 2 REAL ESTATE SECURITIES 453 (1974).

119. Letter from Michael A. Greenspan, Assistant Secretary of the Federal Reserve Board, in 2 REAL ESTATE SECURITIES 473 (1974).

120. State of Ohio, Dep't of Commerce, Div. of Securities, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,558, at 83,523 (1973).

121. *Id.* at 83,523.



under the section 3(a)(11) exemption are not subject to Regulation T, the transaction would still be subject to the requirements of rule 15c2-5.

The exemption from registration of securities under section 3(a)(11) will, of course, have no effect upon the requirement of the broker or dealer who sells these securities to register with the Commission under section 15. In addition, as the tests that determine whether one qualifies for the intrastate exemption from registration of securities under section 3(a)(11) are not identical to the tests employed for the intrastate exemption from registration of brokers and dealers under section 15(a), qualification for the former does not necessarily imply qualification for the latter. Likewise, a broker-dealer who arranges for credit on a security exempt from registration under section 3(a)(11) will still be affected by section 11(d)(1).

Qualification for the intrastate exemption of section 15(a) will not effect the necessity to comply with Regulation T or section 11(d)(1), since the latter apply to any broker-dealer whether registered or not. In addition, since the broker or dealer is precluded from extending or arranging for credit on the purchase of a condominium security, he would still be subject to rule 15c2-5. However, the intrastate exemption under section 15(a) will, of course, preclude the necessity of the broker or dealer registering with the Commission, as well as with the other requirements of registered brokers and dealers.

## V. STATUTORY ANALYSIS

### A. Section 11(d)(1)<sup>122</sup>

Rule 3a12-5<sup>123</sup> was proposed by the Commission because of its view that section 11(d)(1) and the margin requirements authorized by section 7 of the Securities Exchange Act were too restrictive to condominium developers in light of the problems these sections were designed to alleviate.<sup>124</sup> The proposed rule will, under certain conditions,<sup>125</sup> provide an exemption from the margin requirements and section 11(d)(1) for condominium securities. In order to determine whether the view of the Commission is correct, the legislative history of these two sections must be examined.

Section 11(d)(1) was not enacted for the purpose of controlling credit. Rather, it was designed to be a partial remedy to the general problem of conflict of interest inherent when the functions of a broker and dealer are combined within a single person.<sup>126</sup> The broker, as one

122. 15 U.S.C. § 78k(d)(1) (1970).

123. Proposed Rule 3a12-5, 2 CCH FED. SEC. L. REP. ¶ 21,195 (June 7, 1974). This rule is analyzed in section VI *infra*.

124. SEC Securities Exchange Act Release No. 34-10845, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,809 (June 7, 1974) [hereinafter cited as Release No. 10845].

125. See text accompanying notes 151-54 *infra*.

126. S. REP. NO. 792, 73d Cong., 2d Sess. 12 (1934) [hereinafter cited as S. REP. NO. 792].

who effects transactions for the account of others,<sup>127</sup> enters into a fiduciary relationship with his client and is therefore bound to render disinterested advice that is in his client's best interest. This responsibility is, however, incompatible with the function of a dealer, who buys and sells securities for his own accounts.<sup>128</sup>

In enacting the statute, Congress believed that one of the greatest dangers inherent in the combination of the broker and dealer functions in one individual arose where credit to purchase a security was extended by one who participated in the distribution of the security.<sup>129</sup> Thus, the enactment of section 11(d)(1) insured that one who is a broker and a dealer "will not induce his customers to buy on credit securities which he has undertaken to distribute to the public."<sup>130</sup>

It is readily apparent, however, that the rationale behind the passage of section 11(d)(1) is not applicable to the sales of condominium securities, in light of the manner in which the purchase of a condominium is traditionally financed. The seller of the condominium, whether he is an outside broker or the developer, rarely extends credit himself. While the developer usually has a commitment from a lending institution, this generally amounts to no more than a promise by the lender to examine the credit-worthiness of a prospective purchaser. The decision whether to grant the loan is entirely within the discretion of the lender.

This is in contrast to the manner in which credit is extended for the purchase of the more traditional forms of securities. For this type of transaction, the credit is extended by a broker-dealer himself. In addition, the decision whether to grant the loan does not depend so much upon the credit-worthiness of the purchaser, as it does upon the riskiness and the liquidity of the security sold.

### B. Section 7<sup>131</sup> and Margin Requirements

Because excessive use of credit tends to exaggerate fluctuations in the stock market, it was believed that the lack of control over margin requirements was a major cause of the stock market crash of 1929.<sup>132</sup> Designed to reduce the possibility of another such disaster, section 7 is essentially concerned with three problems:<sup>133</sup> (1) Preventing excessive

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127. 15 U.S.C. § 78c(a)(4) (1970).

128. At the time that the Securities Exchange Act was being considered for passage, critics of the stockbrokerage business argued that this potential conflict of interest was so great that the functions of the broker and dealer should be completely separated. S. REP. NO. 792, *supra* note 126, at 11. Congress felt, however, that such drastic action was unnecessary at that time, and instead in section 11(e) directed the Commission to investigate the feasibility of the complete segregation of the functions of brokers and dealers. See SEC, STUDY OF THE FEASIBILITY AND ADVISABILITY OF THE COMPLETE SEGREGATION OF THE FUNCTIONS OF DEALERS AND BROKERS, (1936).

129. S. REP. NO. 792, *supra* note 126, at 12.

130. H.R. REP. NO. 1383, 73d Cong., 2d Sess. 22 (1934).

131. 15 U.S.C. § 78g (1970).

132. S. REP. NO. 792, *supra* note 126, at 3.

133. See 2 L. LOSS, SECURITIES REGULATION 1242 (2d ed. 1961). *But see* Moore, *Stock*

use of credit for the purchase of securities;<sup>134</sup> (2) reducing exaggerated fluctuations in the stock market;<sup>135</sup> (3) protecting "the margin purchaser by making it impossible for him to buy securities on too thin a margin."<sup>136</sup>

Although to a certain extent, the concerns of section 7 may be somewhat applicable to condominium securities, the section was actually written with the more traditional type security in mind, *i.e.*, stocks and bonds. Thus, because the nature of the condominium security is sufficiently different from the traditional security (for example, the lack of a secondary trading market), the problems section 7 was designed to alleviate are for the most part inapplicable.

#### 1. PREVENTING THE EXCESSIVE USE OF CREDIT

A House Report which accompanied the Securities Exchange Bill of 1934 provides some insight into the possible consequences of permitting excessive use of credit for the purchase of securities. The report states:

The main purpose [of the margin provisions] is to give a government credit agency an effective method of reducing the aggregate amount of credit which can be directed by speculation into the stock market and out of the more desirable uses of commerce and industry . . . .<sup>137</sup>

The argument that margin requirements are necessary because credit is diverted from business in the aggregate into non-productive, speculative uses was often suggested by those who opposed allowing the use of credit for the purchase of securities.<sup>138</sup> This argument, however, is fallacious, and, in any case, is not applicable to the condominium security. The funds created by loans to buy securities are eventually directed to the sellers. These sellers are either issuers of the securities who use the money for various business purposes, or previous owners of the securities who use the money for consumption or other investments. In both cases, the money is being used productively in the economy.<sup>139</sup>

Where credit is extended for the purchase of a condominium security, the proceeds of the loan are channeled into the hands of the developers who use them to finance the actual construction of the condominium. The argument that the credit has been diverted into a nonproductive and speculative use is, thus, especially inappropriate

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*Market Margin Requirements*, 74 J. POL. ECON. 158 (1966) (empirical study indicating that margin requirements have not actually accomplished any of these purposes).

134. 15 U.S.C. 78g(a) (1970). *See also* H.R. REP. NO. 1383, 73d Cong., 2d Sess. 7 (1934).

135. 2 L. LOSS, *SECURITIES REGULATION* 1242-43 (2d ed. 1961).

136. S. REP. NO. 1455, 73d Cong., 2d Sess. 11 (1934).

137. H.R. REP. NO. 1383, 73d Cong., 2d Sess. 8 (1934).

138. *See* E. A. GOLDENWEISER, *AMERICAN MONETARY POLICY* 150-51 (1951) [hereinafter cited as GOLDENWEISER].

139. *Id.*

where the condominium security is concerned, as the credit has enabled the construction of a useful commodity.

The House Report goes on to state that the purpose of the margin provisions is also

to prevent a recurrence of the pre-crash situation where funds which would otherwise have been available at normal interest rates for uses of local commerce, industry, and agriculture, were drained by far higher rates into security loans and the New York call market.<sup>140</sup>

This argument does have some merit, at least when applied to the extension of credit for the purchase of stocks and bonds. Where credit is diverted into security loans, it becomes more difficult for other local concerns in the area to obtain credit which otherwise would have been available for local business or consumption. The money created by the security loans is channeled to the issuers or the previous owners of the securities who are not likely to be situated within the local community. Thus, while security credit does not divert credit or money away from business in the aggregate, it may have the result of making it more difficult for particular local concerns to borrow.<sup>141</sup>

This argument is not applicable, however, when credit is being extended for the purchase of a condominium security. The purchase of the individual unit is generally financed by a lending institution in the area in which the condominium is being built. The proceeds of the loan are, therefore, being used to finance construction of the condominium development and the credit is being used for local commerce and business.

There is, however, a more fundamental reason for preventing the excessive use of credit for the purchase of securities, based upon the function of the Federal Reserve Board. The primary objective of the Federal Reserve Board is to promote a healthy, growing economy through regulation of the money supply. The bulk of the money supply in the United States consists of demand deposits which are primarily created by loans from commercial banks.<sup>142</sup> Through the regulation of bank credit, the Federal Reserve Board increases or decreases the supply of money, depending upon the particular needs of the economy at any given time. This is generally accomplished by controlling the total volume rather than trying to control selected types of credit, since an attempt to restrict credit in one area will only divert it into another area. The total amount of credit, and, hence, the money supply, will remain unchanged.

When economic conditions are such that it appears security prices will be on the rise, and many buyers may thus be willing to borrow at high interest rates to take advantage of projected appreciation, general

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

141. See GOLDENWEISER, *supra* note 138, at 151.

142. See G. BACH, *ECONOMICS* 133 (6th ed. 1968).

credit controls will not effectively prevent the expansion of credit used to purchase securities. Margin requirements are thereby needed by the Federal Reserve Board to fill the gap in monetary policy when general controls are rendered ineffective.<sup>143</sup>

This argument does have a great deal of merit and could be used to support the contention that margin requirements should be applied to condominium securities. With the rapid advance of real estate prices, borrowers may be willing to pay higher interest rates because of the significant capital appreciation that is to be achieved. This could have the effect of diverting large amounts of credit to the sale of real estate during a period in which the Federal Reserve Board is attempting to restrict the expansion of credit.

The argument is somewhat mitigated, however, because mortgage credit has historically been shown to be very sensitive to general credit controls, thus eliminating the major justification for selective controls in this area. General controls can be quite effective because small increases in the interest rate have a significant impact upon the monthly mortgage payment.<sup>144</sup> Even the prospective capital appreciation together with the investment characteristics of the condominium security would probably not be great enough to induce the prospective buyer to purchase the condominium where there is a large increase in mortgage payments.

In addition, because of the lack of a secondary trading market, the speculator is less likely to divert his spending to condominium securities than if such a market were in existence. The efficient secondary trading for stocks and bonds makes immediate liquidation possible and provides prompt access to information—two very important factors to the speculator. In contrast, because no real secondary trading market exists for it, real estate has always been a much less liquid investment, with the purchase and sale traditionally being a slow and cautious process involving title examinations and credit checks. The possibility of quick profits from “in and out” transactions, the objective of every speculator, is substantially eliminated.

## 2. PREVENTING UNDUE MARKET FLUCTUATIONS

Because unrestricted use of credit can cause severe fluctuations in the prices of securities, a second function of margin requirements is “to prevent undue market volatility by exerting a positive stabilizing effect on the market.”<sup>145</sup> In the case of more traditional securities where there exists a secondary trading market, these fluctuations can become even more pronounced because of what is termed the pyramiding and anti-pyramiding effect.

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143. See J. BOGEN & H. KROOS, SECURITY CREDIT 47 (1960) [hereinafter cited as BOGEN & KROOS].

144. See P. HORVITZ, MONETARY POLICY AND THE FINANCIAL SYSTEM 366-67 (2d ed. 1969).

145. Release No. 10845, *supra* note 124.

The pyramiding effect causes a pronounced rise in stock prices; the price of a security rises, providing more collateral, which enables the purchaser to borrow more money, thus increasing his ability to purchase more securities, which causes the price to rise even higher.<sup>146</sup> While the pyramiding effect can occur for all types of securities, it is even more prevalent where there exists a secondary trading market because investors are promptly made aware that they have more collateral upon which to borrow.<sup>147</sup> As there is no secondary trading market for real estate, condominium securities are not significantly affected by pyramiding.

Perhaps an even more important factor in market fluctuations is the anti-pyramiding effect. When stock prices decline, impairing collateral for the loan, the broker will issue a margin call, *i.e.*, he will require additional collateral. If the purchaser is unwilling or unable to comply, the broker will then sell the securities which will cause further downward pressure on the stock market, thus leading to more margin calls.<sup>148</sup> Because there are no margin calls in the real estate market, the anti-pyramiding effect would not cause a decline in condominium security prices.

The need to prevent undue market fluctuations caused by the unrestricted use of credit which section 7 was designed to accomplish is, therefore, not applicable to the condominium security. The lack of a secondary trading market and the non-existence of margin calls makes the condominium security sufficiently different to justify its exemption from credit rules applied to the traditional security.

### 3. PROTECTING THE MARGIN PURCHASER FROM HIMSELF

The third purpose of the margin requirements is "to protect the margin purchaser by making it impossible for him to buy on too thin a margin."<sup>149</sup> When a purchaser buys stock on too thin a margin and there is a sudden drop in the market price, his equity is quickly eroded and his broker will issue a margin call. If he is unable to meet the margin call, he may be forced to sell at a loss.

Again, this concern is basically inapplicable to the condominium security since there are no margin calls for real estate and the real estate market generally does not fluctuate so drastically.

## VI. PROPOSED RULE 3a12-5<sup>150</sup>

Proposed rule 3a12-5 is entitled "Exemption of Certain Investment Contract Securities from Sections 7(c) and 11(d)(1)."<sup>151</sup> This rule

146. See BOGEN & KROSS *supra* note 143, at 42.

147. *Id.* at 49.

148. *Id.* at 43.

149. Release No. 10845, *supra* note 124.

150. 2 CCH FED. SEC. L. REP. ¶ 21,195 (June 7, 1974) [hereinafter referred to as proposed rule 3a12-5].

151. The full text of proposed rule 3a12-5 reads as follows:

will, under certain conditions, provide an exemption from the margin requirements and section 11(d)(1) for condominium securities.

In order to qualify for the exemption, the transaction must involve a statutory broker or dealer<sup>152</sup> who, directly or indirectly, arranges for the extension of credit to or for a customer. The security must involve an investment contract<sup>153</sup> security dealing with direct ownership of designated residential real property coupled with management services.<sup>154</sup>

The proposed rule then provides the following mandatory conditions in order for the exemption to apply:

- (1) The credit must be accompanied by a security interest, such as a mortgage, lien, or deed of trust.
- (2) The security interest must be solely in relation to the real property.
- (3) The amount of credit extended must be reasonably related to the fair market value of the real property at the time the credit is extended.

A security shall be exempted from the provisions of Sections 7 (c) 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, if—

(a) The security is an investment contract security involving the direct ownership of specified residential real property and related management services, and the credit:

(1) is secured by a lien, mortgage, deed of trust, or other security interest which is related only to such real property;

(2) is reasonably related to the current market value of real property at the time the credit is extended; and is to be repaid by regular payments of principal and interest pursuant to an amortization schedule established by the governing instruments; and

(3) is extended by a lender which is not directly or indirectly controlling, controlled by, or under common control with the broker or dealer or the issuer of the securities; and

(b) such broker or dealer, before any purchase, loan or other related element of the transaction is entered into:

(1) delivers to the customer a written statement setting forth the exact nature and extent of (a) the customer's obligation under the particular loan arrangement, including, among other things, the specified charges which he will incur under such loan in each period during which the loan may continue to be extended, (b) the risks which he will incur in the entire transaction, including the loan arrangement, and (c) all commissions, discounts and other remuneration received and to be received in connection with the entire transaction, including the loan arrangement, by the broker or dealer, and by any person controlling, controlled by, or under common control with the broker or dealer:

*Provided, however,* That the broker or dealer shall be deemed to be in compliance with this subparagraph if the customer, before any purchase, loan or other related element of the transaction is entered into in a manner legally binding upon the customer, receives a statement from the lender, or receives a prospectus or offering circular from the broker or dealer, which statement, prospectus or offering circular contains the information required by this subparagraph; and

(2) obtains from the customer information concerning his financial situation, reasonably determines that the entire transaction, including the loan arrangement, is suitable for him, and delivers to him a written statement setting forth the basis upon which the broker or dealer made such determination.

152. See text accompanying notes 106-08 *supra*.

153. See text accompanying notes 13-31 *supra*.

154. This language appears to relate to the terms of Release No. 33-5347, which attempted to define the circumstances under which a condominium would be a security. See text accompanying notes 46-51 *supra*.

- (4) The credit extension contract must include a regular amortization schedule of payments.
- (5) The payments must include installments of both principal and interest on the loan.
- (6) The party extending the credit is not permitted to have any type of management or ownership control relationship with either the broker or dealer, or the issuer of the securities.
- (7) Before the purchase or credit aspects of the transaction are executed, the broker or dealer must make a full written disclosure to the prospective purchaser. This disclosure may either be in the form of a prospectus (or "offering circular") or it may be simply a written statement containing the following items:
  - (a) the exact nature and extent of the customer's loan obligations;
  - (b) the credit charges for which the customer is responsible during the entire term for which the loan may be extended;
  - (c) the risks to which the customer is subject, both with regard to the loan, and with regard to the purchased security itself; and
  - (d) all commissions, discounts and other payments in connection with either the purchase itself or the loan, which are received by brokers, dealers, or those in a control relationship with them.
- (8) The broker or dealer must obtain from the prospective purchaser his current financial status.
- (9) The broker or dealer must reasonably determine that the entire transaction, including the loan arrangement, is suitable for the prospective purchaser in the light of his current financial status.
- (10) The broker or dealer must deliver to the prospective customer a written statement detailing the basis upon which he made his suitability determination.

#### A. *Analysis of Proposed Rule 3a12-5 Suitability*

While the proposed rule's exemption from the margin requirements is a welcome relief to the condominium developer, and is certainly justified in light of the purposes of these provisions, the conditions for the exemption imposed by the rule are quite troublesome, and, in fact, may cause as many problems as the rule was designed to alleviate. One of the most vexatious conditions is the required suitability disclosure. The suitability requirements under proposed rule 3a12-5 undoubtedly had as their genesis the "suitability



rules" promulgated by the NASD<sup>155</sup> or others<sup>156</sup> which were originally intended as ethical standards designed to promote fair dealing with the public.<sup>157</sup> While, in the past, the Commission has brought several disciplinary actions against broker-dealers under the suitability rules, they primarily involved themselves with excessive trading or "churning" of a customer's account,<sup>158</sup> blatant examples of a broker recommending high risk securities to customers of modest means and little market experience,<sup>159</sup> or high pressure tactics.<sup>160</sup> These earlier cases primarily dealt with the extreme, almost fraudulent situation which went well beyond a mere violation of an ethical standard.

There had been an awareness of the need for suitability responsibility on the part of brokers and dealers since at least the 1930's,<sup>161</sup> but pressure rose for greater professional responsibility in 1963 with the publication of an SEC Special Study<sup>162</sup> which concluded that there were serious gaps in the standards applied to brokers and dealers.<sup>163</sup>

Following this study,<sup>164</sup> which had been prompted by the excesses in the speculative securities market of the late 1950's and early 1960's,<sup>165</sup> the suitability doctrine underwent intensive discussion to

155. CCH NASD MANUAL ¶ 2152, art. III (Rules of Fair Practice) § 2 (1968). Section 2 provides:

In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

156. The Commission (SECO) rule applicable to nonmembers of the NASD, 17 C.F.R. § 240.15b10-3 (1974) reads:

Every nonmember broker or dealer and every associated person who recommends to a customer the purchase, sale or exchange of any security shall have reasonable grounds to believe that the recommendation is not unsuitable for the customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by such broker or dealer or associated persons.

New York Stock Exchange Rule 405, found at CCH NYSE GUIDE ¶ 2405 (1974), provides: "Every member organization is required . . . [to] use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted . . ." American Stock Exchange Rule 411 is to the same effect.

157. See Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445, 464 [hereinafter cited as Mundheim]; cf. Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), *aff'd*, 430 F.2d 1202 (9th Cir. 1970).

158. *E.g.*, R.H. Johnson & Co., 33 S.E.C. 180 (1952); C.H. Rollins & Sons, Inc., 18 S.E.C. 347 (1945).

159. *E.g.*, Phillips & Co., 37 S.E.C. 66 (1956).

160. *E.g.*, Gerald M. Greenberg, 40 S.E.C. 133 (1960).

161. The NASD Rules of Fair Practice have included suitability requirements since that organization was founded in 1938. Mundheim, *supra* note 157, at 450-51.

162. SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess. (1963) [hereinafter cited as SPECIAL STUDY].

163. Mundheim, *supra* note 157, at 445. The suitability rule is based on a reasonable basis test, *i.e.*, the broker-dealer must have a reasonable basis for making a recommendation to a customer. This reasonable basis test evolved from common law concepts of fraud and misrepresentation. Rice, *Recommendations by a Broker-Dealer: The Requirement for a Reasonable Basis*, 25 MERCER L. REV. 537 (1974).

164. SPECIAL STUDY, *supra* note 162.

165. Mundheim, *supra* note 157, at 459.

define its meaning and limitations.<sup>166</sup> The SEC urged strengthening its protection for investors,<sup>167</sup> while the NASD membership feared that publication of a statement<sup>168</sup> defining the content of the suitability doctrine would help convert an ethical standard into a rule of law.<sup>169</sup> The effect of that would be to subject a broker-dealer to a civil suit in which a dissatisfied customer might make a broker-dealer a guarantor of successful investment.

Indeed, the fears of the NASD membership turned out to be somewhat warranted, for a number of civil actions for damages were brought against broker-dealers for violation of the suitability rules. Fortunately for the broker-dealers, however, the courts have been reluctant to recognize a private remedy not expressly afforded by the securities laws.<sup>170</sup> While not expressly ruling on the issue because the plaintiff was barred by estoppel, the court in *Hecht v. Harris, Upham & Co.*<sup>171</sup> stated:

As to the N.A.S.D. "suitability" rule . . . upon which plaintiff relies in part in this case, the question arises whether it is the kind of rule upon which a civil action for damages . . . can be based. Conceivably, a broker might honestly think that his "ground" for believing his recommendation "suitable" is "reasonable" only to find himself overruled in a law suit and found guilty of fraud notwithstanding his good faith . . . . [T]he practical consequences of allowing private federal damage suits based on rules of this kind, and involving judicial review of market judgments, would be considerable.<sup>172</sup>

Based upon the reasoning in the *Hecht* case, several courts have since held that a violation of the NASD suitability rule does not per se give rise to civil liability.<sup>173</sup> Only in one California decision has a court adopted the position that "[g]ood ethics should not be ignored by the

166. *Id.* at 460.

167. The SEC position was outlined in the SPECIAL STUDY in these words:

Greater emphasis should be given by the Commission and the self-regulatory bodies to the concept of suitability of particular customers. The NASD, which has taken leadership in this respect by adopting a general suitability rule, should provide further definition of content and more effective surveillance and enforcement.

SPECIAL STUDY, *supra* note 162, at 329.

168. Actually, such a statement was published by the NASD on October 9, 1964. It was called *Guideline on Fair Dealing with Customers*, CCH NASD MANUAL G-7 to G-9, but was ineffective in defining the scope of the suitability doctrine, since it consisted primarily of five examples of conduct that would fail to meet the suitability standard.

169. Mundheim, *supra* note 157, at 463.

170. *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178, 181 (2d Cir. 1965).

171. 283 F. Supp. 417 (N.D. Cal. 1968), *aff'd*, 430 F.2d 1202 (9th Cir. 1970).

172. 283 F. Supp. at 431.

173. *Wells v. Blythe & Co., Inc.*, 351 F. Supp. 999 (N.D. Cal. 1972); *Mercury Inv. Co. v. A.G. Edwards & Sons*, 295 F. Supp. 1160 (S.D. Tex. 1969).

law," and allowed the plaintiff to recover in part, based upon suitability standards.<sup>174</sup>

The question of whether the suitability requirement under proposed rule 3a12-5 will give rise to a civil action for damages is, of course, evident. But now, the broker-dealer's fear of being sued by a dissatisfied customer becomes even more justified since the basis upon which the suit can be brought is elevated from a mere ethical standard to a Commission rule. It is questionable, however, whether this elevation to rule of law status is appropriate to the condominium security in light of its peculiar nature. The purchase of what essentially remains real estate is dependent upon far more intangible factors than is the purchase of a "conventional" security. For example, the offeree's personal tastes in appearance, construction type and quality, appliances, recreational facilities, location, view, etc., all have an effect on the suitability for the prospective purchaser. Obviously, these components cannot possibly be made by a broker-dealer.<sup>175</sup>

In addition, it is questionable whether it is appropriate to impose the burden of suitability determination on the broker-dealer in light of the traditional manner in which the condominium is financed. The purchaser generally obtains conventional mortgage financing from a local lending institution which is in the practice of making daily credit investigations that insure the "suitability" of each loan made.<sup>176</sup> Such institutions are already regulated by state and federal agencies<sup>177</sup> and are historically conservative in their suitability determinations.<sup>178</sup> Moreover, a purchaser of a condominium is probably conditioned to giving a bank or savings and loan institution confidential financial data that he would be loathe to give to a broker-dealer appearing in the guise of a real estate salesman.<sup>179</sup> In any case, the latter is certainly less well equipped to make realistic credit "suitability" determinations than are the lenders.<sup>180</sup>

A further difficulty with the suitability portion of the proposed rule is the total absence of standards. That is, it suggests no criteria by which to judge whether an offering is suitable to an offeree.<sup>181</sup> In addition, the proposed rule gives no indication of the specificity in the

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174. *Twomey v. Mitchum, Jones & Templeton, Inc.*, 269 Cal. App. 2d 690, 69 Cal. Rptr. 222, 244 (1st Dist. 1968).

175. See letter from Roger G. Galloway, Vice President of Kaiser Aetna, Oakland, California to SEC, July 12, 1974.

176. See letter from John M. Collette, partner in the San Francisco firm of Collette & Ziegler to SEC, August 14, 1974.

177. See letter from Peter M. Gunnar of the Portland, Oregon firm of Gunnar, Burkhart, Armstrong & Associates to SEC, August 2, 1974.

178. See letter from Cades, Shutte, Flemming & Wright of Honolulu, Hawaii to SEC, August 9, 1974.

179. See letter from Peter M. Gunnar of the Portland, Oregon firm of Gunnar, Burkhart, Armstrong & Associates to SEC, August 2, 1974.

180. *Id.*

181. See letter from Cades, Shutte, Flemming & Wright of Honolulu, Hawaii to SEC, August 9, 1974.

written statement required to be given to the offeree setting forth the basis of the suitability determination.<sup>182</sup>

Although the suitability requirement is not really appropriate at all to the condominium security, the issue only becomes critical where suitability becomes a basis for civil liability. Certainly there is little objection to holding the broker-dealer to a high ethical standard which would prevent him from using high pressure techniques on unsophisticated buyers. It would perhaps be preferable, therefore, to delete the suitability requirement from the proposed rule and leave the broker-dealer subject to the ethical standards of the NASD and SECO.<sup>183</sup>

Simple deletion of this requirement is, however, insufficient since the broker-dealer will still be subject to rule 15c2-5.<sup>184</sup> This rule requires the broker-dealer to make suitability disclosures much the same as are required in proposed rule 3a12-5 when he extends or arranges for credit not subject to the provisions of Regulation T. Since proposed rule 3a12-5 would exempt the broker-dealer who sells condominium securities from Regulation T, he would then become subject to the suitability requirements of rule 15c2-5. In order to obviate the problem, the proposed rule would have to specifically exempt condominium securities from rule 15c2-5. In any event, this points up the redundancy of the proposed rule 3a12-5 suitability requirement, since essentially the same disclosure requirements would already be made mandatory by rule 15c2-5.

### B. *Other Conditions of the Rule*

The proposed rule imposes a number of conditions for exemption from the margin and section 11(d)(1) requirements other than suitability that are not without difficulty. The first of these is that security must involve direct ownership of residential real property. An immediate question that arises is why the exemption is limited to residential property. Many condominiums are sold for industrial and commercial purposes and there does not seem to be any reason why the exemption should not extend to this type of property.<sup>185</sup> Indeed, one can argue that the proposed rule does not even exempt most condominium securities sold as vacation retreat investments. This is either because many of these condominiums are not lived in long enough each year in order properly to define them as residences, or because the units sold are really not large enough to constitute a true residence.<sup>186</sup>

In addition, the exemption appears to be limited by the "direct ownership" language in the rule to fee simple ownership. But there are

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182. *Id.*

183. See text accompanying notes 95, 96 *supra*.

184. See text accompanying notes 99-103 *supra*.

185. See letter from John M. Collette, partner in the San Francisco firm of Collette & Ziegler to SEC, August 14, 1974.

186. See letter from Cades, Shutte, Flemming & Wright of Honolulu, Hawaii to SEC, August 9, 1974.

many condominiums in Hawaii, Mexico and elsewhere that are sold only with long term leasehold interests. The denial of an exemption to these securities would seem to be neither consistent nor purposeful.<sup>187</sup>

The proposed rule hinges receipt of the exemption from sections 7 and 11(d)(1) for real property securities on "related management services." This language suggests that the Commission desired the exemption to cover the type of real estate arrangement that was defined as a security in Release No. 33-5347.<sup>188</sup> But examination of the Release No. 33-5347 guidelines shows that a condominium could be deemed to be a security even if management services were not offered in conjunction with it. For example, the owner could simply be materially restricted in his occupancy or the rental of his unit.<sup>189</sup> The difficulty with the language in the proposed rule, therefore, is that it does not appear to cover all real estate arrangements defined in Release No. 33-5347 as securities, and there would seem to be no good reason for not doing so.<sup>190</sup>

The proposed rule can, nevertheless, be construed to imply that any investment in an arrangement consisting of "residential real property and related management services" may be deemed to be a security. Release No. 33-5347 makes it clear that this is not the case, but the release is not a rule and is not incorporated by reference into proposed rule 3a12-5. On this ground, some courts may elect not to employ the Release No. 33-5347 standards,<sup>191</sup> the net effect of which may be to include in the definition of a security certain arrangements that even the Commission itself did not see fit to call a security.

Subparagraph (1)(a) of the proposed rule limits the exemption to credit secured by an interest which relates only to the real property.<sup>192</sup> This limitation is likely to pose difficulties for purchasers seeking mortgage financing from lenders who quite reasonably might wish to obtain additional protection for their security interests in the property. For example, a lender may wish to take an assignment of rental income from the purchaser, but the language of the rule appears to prohibit this in an exempted transaction. Yet, there would seem to be no useful purpose subserved by such a restriction.<sup>193</sup>

As to subparagraph (a)(3) of the proposed rule,<sup>194</sup> a further difficulty emerges. This provision would limit the exemption to situa-

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187. *Id.*

188. [1972-1973 Transfer Binder] CCH FED. SEC. L. REP ¶ 79,163 (Jan. 4, 1973) [hereinafter referred to as Release No. 33-5347].

189. *Id.* at 82,540.

190. See letter from Stephen J. Weiss and Howell J. Reeves of the Washington firm of Arent, Fox, Kintner, Plotkin & Kahn to SEC, August 15, 1974.

191. See letter from Cades, Schutte, Fleming & Wright of Honolulu, Hawaii to SEC, August 9, 1974.

192. See note 151 *supra*.

193. See letter from Stephen J. Weiss and Howell J. Reeves of the Washington firm of Arent, Fox, Kintner, Plotkin & Kahn to SEC, August 15, 1974.

194. See note 151 *supra*.

tions where credit "is extended by a lender which is not directly or indirectly controlling, controlled by, or under common control with the broker or dealer or the issuer of the securities . . . ." <sup>195</sup> Such a restriction is unquestionably meaningful in the context of the conventional securities market where a "hard sell" of securities on credit might result through the affiliation of a lender with a broker, dealer or issuer. Such a restriction, however, appears unnecessary in the context of a real estate transaction because mortgage lenders are already heavily regulated by state and federal agencies, and thus are almost certain to make conservative loan commitments based upon credit-worthiness of the borrower and foreclosure value of the real estate, whether or not they are affiliated with the broker, dealer, or issuer. <sup>196</sup>

Subparagraph (b) (1) <sup>197</sup> deals with the disclosure requirements of the rule. It requires that the customer be given a written statement covering his obligations and costs under the loan, his risk, and a commission schedule, possibly in the form of a prospectus or offering circular. At first glance, this requirement seems sensible enough, but the difficulty with it is that such a requirement is largely a duplication of the disclosure requirements of Regulation Z of the Federal Reserve Board <sup>198</sup> which requires that a lender inform a borrower of all costs, interest rates and charges. The redundancy should be eliminated. <sup>199</sup>

## VII. CONCLUSION

Despite its apparent shortcomings and inherent burdens of compliance, proposed rule 3a12-5 meets a genuine need of the condominium developer when the units of his project are deemed to be a security. There can be no doubt that the determination of the Federal Reserve Board that Regulation T applies to the credit financing of condominiums would devastate that industry without the exemption that rule 3a12-5 provides. The legislative history of sections 7 and 11(d) (1) of the Securities Exchange Act of 1934 and related statutory and regulatory provisions clearly demonstrates they were never intended to apply to a condominium security, which has its own peculiar attributes unknown to the conventional security. In fact, it is precisely these attributes that insure that the interests of the investing public will be protected despite the exemption from the standard statutory scheme.

Unfortunately, the conceptual advantages of the proposed rule fail to find practical application in several sectors of the condominium

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195. SEC Securities Exchange Act Release No. 10845, BNA SEC. REG. & L. REP. No. 256, E-1, E-2 (1974).

196. See, e.g., letter from Raymond R. Dickey, former chairman of the SEC Real Estate Advisory Committee, and partner in the Washington firm of Danzauskay, Dickey, Tydings, Quint & Gordon to SEC, August 15, 1974.

197. See note 151 *supra*.

198. 12 C.F.R. § 226 [hereinafter referred to as Regulation Z].

199. See letter from William B. Ingersoll, General Counsel to American Land Development Ass'n to SEC, August 15, 1974.

security area. Specifically, the scope of the exemption offered by proposed rule 3a12-5 seems unnecessarily limited in at least three areas. First, the exemption apparently fails to cover condominiums sold with other than fee simple ownership, as, for example, long term leasehold interests. Second, the proposed rule covers only residential condominiums, leaving commercial and industrial condominiums still subject to compliance with the extension of credit provisions for no apparent reason. Third, the proposal does not appear to cover all the situations defined in Release No. 33-5347 which could occur, for example, if no management services were offered in connection with the condominium. Again, there would seem to be no good reason why the Commission would desire such a result. Most likely, this effect of the rule's wording was inadvertent.

In addition to the limited scope of the proposal, several of the conditions imposed for its use appear unnecessarily burdensome. The first of these is the requirement that the security interest be related only to the real property. A secured party should be permitted a broader security interest if needed.

The second seemingly extraneous condition is the prohibition of common control between the lender and a broker, dealer, or the issuer of the securities. The extensive pre-existing state and federal regulation of mortgage lenders precludes any need for this requirement.

A further needless condition is the disclosure requirement. The truth in lending provisions of Regulation Z make further disclosure confusing and redundant.

Perhaps the most burdensome provision of the rule is the suitability portion. This aspect adds enormously to the cost of compliance with the rule, yet appears to add neither to the effectiveness of the rule, nor to the protection of the investing public. This is because the suitability requirement appears to be a totally unnecessary duplication of rule 15c2-5.

It is submitted that the rule should not only be modified to delete the suitability requirement, but that it should include an exemption from rule 15c2-5 as well, leaving applicable only the NASD or SECO ethical standards. This approach would promote ethical dealing with the public's investment dollar, but would not invite an inference that a condominium seller is a warrantor of a profitable investment by creating an implied private cause of action in a disappointed purchaser.

In summary, proposed rule 3212-5 represents a welcome and worthy concept that is attired in flawed and tattered apparel. The rule must be rewritten to adequately serve the purpose that inspired its genesis.