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Increasing Application of Federal Securities Laws to Real Estate Transactions

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North Carolina adopts the doctrine of comparative negligence, the justices will probably only apply it to the case before the court and leave many issues unanswered. The California and Florida courts left many issues to be resolved at the trial level in a practical manner instead of in a theoretical manner at the appellate level.

Whether by legislation or by judicial decision, it is time for North Carolina to abolish the antiquated doctrine of contributory negligence and replace it with a system under which liability damages will be borne by those whose negligence caused it in direct proportion to their respective fault. Logic, practical experience, and fundamental justice beckon that we nullify a doctrine that automatically destroys all claims of injured persons who have contributed to their injuries in any degree, however slight.

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Increasing Application of Federal Securities Laws to Real Estate Transactions

I

INTRODUCTION

The Wall Street crash of 1929 and the ensuing economic chaos of the 1930's prompted Congress to pass corrective legislation to regulate the securities market. To accomplish this purpose, Congress passed the Securities Act of 1933 ("the 1933 Act")[1] and the Securities and Exchange Act of 1934 ("the 1934 Act").[2] The main thrust of the legislation was "to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent fraud in the sale thereof . . . ."[3]

The purpose of this comment is to discuss the application of the securities law to real estate transactions. Three main areas of real estate transactions will be examined; cooperative apartment corporations, condominiums, and real estate syndications. This is not meant to be a comprehensive examination of all areas of real estate transactions that are subject to the federal securities laws, but rather an overview of certain select areas.

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1. 15 U.S.C. § 77(a) *et seq.* (1971).
2. 15 U.S.C. § 78(a) *et seq.* (1971).
3. Preamble to the Securities Act of 1934, Ch. 38, 48 Stat. 74.

II

HISTORY OF REAL ESTATE AS A SECURITY

The average person would not think of a real estate transaction as involving some form of a security, nor for that matter, would the average lawyer at first mention. However, the definition of a "security", as contained in the securities laws, is extremely broad.[4] Included within this broad definition of securities are investment contracts or participations in profit sharing agreements.[5] In 1946, the United States Supreme Court construed the term "investment contract" in the landmark case, *Securities and Exchange Commission v. Howey and Co.*[6] The *Howey* case involved the sale of citrus groves to be cultivated and marketed by a third party with no effort or supervision by the buyers. The Court found this real estate transaction to be an investment contract, defined 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 the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interest in the physical assets employed in the enterprises.[7]

The Supreme Court also stated in *Howey* that this broad definition ". . . embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."[8]

The Supreme Court previously had found the sale of oil and gas leases, coupled with the promise that a proposed exploration well would be drilled on the tract of land that was the subject of the lease, constituted an investment contract under the 1933 Act.[9] The Court found in this arrangement that the purchasers were looking to the efforts of a third person to make profits on their investments. This central idea of relying on the efforts of third parties to make a profit has pervaded court decisions, from that time to the present.

As early as 1937, the lower federal courts had found certain types of enterprises involving real estate transactions to constitute investment contracts. In that year, the Seventh Circuit held that investments in an enterprise to grow crops by intensive scientific methods in which the

4. Securities Act of 1933 § (1), 15 U.S.C. § 77(b)(1) (1933); Securities Exchange Act of 1934 § (a)(10), 15 U.S.C. § 78C(a)(10) (1934).
5. Securities Act of 1933 § 2(1), 15 U.S.C. § 77B(1) (1933); Securities Exchange Act of 1934 § (a)(10), 15 U.S.C. § 78C(a)(10) (1934).
6. 328 U.S. 293 (1946).
7. *Id.* at 298-99.
8. *Id.* at 299.
9. Securities & Exch. Comm'n v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943).

investor would not actively participate were investment contracts.[10] A district court also held that the sale of land suitable for growing tung trees, coupled with contracts to cultivate and market tung oil therefrom, was an investment contract.[11] A variety of schemes and enterprises have been declared to constitute investment contracts.[12] Therefore, the lawyer involved in real estate transactions, where purchasers hope to make a profit by the efforts of third parties, should be alert to the possibility that these transactions are subject to federal securities laws.

III

Cooperative Housing Corporations

One of the major areas of real estate transactions that has been held to constitute a "security" in certain circumstances is the cooperative housing corporation. Previously, this form of real estate transaction was thought to be exempt from the securities laws even though it involved the transfer of share certificates. Rule X-15A-2 has been construed to state:

> [s]hares of a corporation which represent ownership, or entitle the holders thereof to possession and occupancy, of specific apartment units in property owned by such corporations and organized and operated on a cooperative basis are hereby exempted from the operation of section 15(a) of the Securities Exchange Act of 1934, when such shares are sold by or through a real estate broker licensed under the laws of the political subdivision in which the property is located.[13]

This exemption has been further delineated in Securities & Exchange Commission ("SEC") Rule 235 ("Rule 235").[14] Rule 235 defines a cooperative housing corporation as a corporation whose members are entitled, solely by reason of membership,

> (1) To occupy for dwelling purposes a house, or an apartment in a building, owned or leased or to be owned or leased by such corporation; or
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> (2) To purchase a dwelling constructed or to be constructed by such corporation.

10. Securities & Exch. Comm'n v. Universal Serv. Ass'n, 106 F.2d 232 (7th Cir. 1939), *cert. denied*, 308 U.S. 622 (1940).

11. Securities & Exch. Comm'n v. Barley, 41 F. Supp. 647 (D.C. Fla. 1941); Securities & Exch. Comm'n v. Tung Corp. of Am., 32 F. Supp. 371 (D.C. Ill. 1940).

12. *See*, Grimes and Kings, *A Look At Condominium Offerings Under the Federal Securities Laws—For the Idaho Lawyer*, 9 Idaho L. Rev. 149, 155 (1937) (for a discussion of the various schemes and enterprises that have been declared investment contracts by the courts).

13. Securities Exch. Act Release No. 3963 (June 10, 1947).

14. 17 C.F.R. § 230.235 (1973), promulgated pursuant to 1933 Act § 3(b), 15 U.S.C. § 77c(b) (1971).

Rule 235 further provides:

> (b) Such corporation shall not be or intend to be engaged in any business or activity other than the ownership, leasing, management or construction of residential properties for its members, except to the extent that such business or activity is incidental to the ownership, leasing, management or construction of such residential properties.
>
> (c) The securities shall be issued only in connection with the sale or lease of dwelling units to persons who are or thereupon become members of the corporation and shall be transferable by the purchasers only in connection with the transfer of such dwelling units or leases to other persons who are or thereupon become such members.
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> (d) The aggregate offering price of all securities of the corporation offered pursuant to this rule during any twelve-month period shall not exceed $300,000, including any unsold securities initially offered prior to the beginning of such period.
>
> (e) The aggregate offering price of securities offered pursuant to this rule shall be computed upon the basis of the price at which the securities are to be sold to members or, if such price is not separately specified, upon the basis of the par or stated value of the securities to be offered.

The aggregate offering price limitation of $300,000 has been interpreted to mean the par value of the total number of shares that may be issued and not the actual selling price of the shares authorized to be sold.[15] Thus it is recommended that in order to stay within Rule 235

> sponsors of cooperatives keep low par values on their stock, issue a minimum amount of shares and break down unit prices to show two figures: (1) product of par value times shares allocated to each apartment, plus (2) a figure for "additional paid-in capital" which reflects the balance.[16]

Anyone dealing in the sale of shares in cooperatives is cautioned that even though the stock of a cooperative is exempt under Rule 235, this does not exclude liability for fraudulent practices under sections 12[17] and 17[18] of the 1933 Act.

Recently, with increased emphasis on forms of housing other than the single family residence, the cooperative housing corporation has become an attractive alternative. Along with this increased interest in and sales of cooperatives have come suits by purchasers against sellers, for fraud connected with the sale of stock in these cooperatives. Initially most of

15. Lynbrook Gardens Tenant Corp. (1970-1971 Transfer Binder) CCH FED. SEC. L. REP. ¶ 78,146 (1971). *See also* Summit House Tenants Corp. (1971-1972 Transfer Binder) CCH FED. SEC. L. REP. ¶ 78,611 (1972).

16. Parness, *Stock In Cooperative Apartment Corporation As A Security Under Federal Securities Laws*, 9 REAL PROP., PROF. AND TRUST J. 259, 260 (1974).

17. 15 U.S.C. § 77l (1971).

18. 15 U.S.C. § 77q (1971).

these actions were in state courts,[19] however, recently the scene has shifted to the federal courts. A federal district court in New York held in *1050 Tenants Corp. v. Jakobson*[20] *("Jakobson")*, a fraud action brought under Section 10(b) of the 1934 Act, Rule 10b-5 and Sections 17(a) and 12(2) of the 1933 Act held, that shares in a cooperative housing corporation are "securities" within the meaning of the 1933 act section 2(1) and the 1934 Act Section 3(a)(10).[21] The defendants asserted that the purchasers did not intend to purchase investments, but only homes, and that stock certificates were used simply as a vehicle to accomplish this purpose.[22] This argument was rejected by the district court and it held that shares in a cooperative are securities within the definition of the 1934 Act. In reaching this conclusion, the court gave weight to "negative implications" drawn from Rule 235—*i.e.*, that if cooperative housing corporation stock were not a "security to begin with, there would be no need to exempt it from the 1933 Act registration provisions."[23] The court also enumerated six factors that it found common to the stock in the case at bar which made it an

> "investment contract" under the *Howey* test, by means of the following factors:
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> (1) Shares could be resold at a profit;
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> (2) The tax benefits of cooperative ownership constitute direct monetary benefit, or profit;
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> (3) Income from professional offices in the building, in reducing maintenance charges, constitutes profit;
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> (4) The defendant sponsors controlled initial financial arrangements and guidelines under which the cooperative operated;
>
> (5) The defendants would have representation on and veto power over the Board of Directors of the cooperative if all the shares were not sold, as well as involvement in the sale of unsold shares after closing; and
>
> (6) The cooperative was obligated to nine contracts at closing, including one for management by an agent of the sponsors.[24]

A second case in the same district, *Forman v. Community Services, Inc.*,[25] *("Forman")*, which was reversed on an appeal, involved alleged violations of section 10(b) of the 1934 Act. *Forman* deals with the sale of stock in Riverbay Corporation, a nonprofit cooperative housing cor-

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19. *See*, 9 REAL PROP., PROB. AND TRUST J., *supra* note 16, at 260, (for a catalog of cases in state courts).

20. 365 F. Supp. 1171 (S.D.N.Y. 1973).

21. *See*, 9 REAL PROP., PROB. AND TRUST J., *supra* note 16, at 260-262, for a full discussion of the case.

22. 365 F. Supp. at 1173.

23. *Id.* at 1174-1175, 9 REAL PROP., PROB. AND TRUST J., *supra* note 16, at 261-262.

24. 365 F. Supp. at 1176-77.

25. 366 F. Supp. 1117 (S.D.N.Y. 1973), *rev.* 500 F.2d 1246 (1974).

poration which owns "Co-op City" a 15,400 unit low-middle income cooperative in New York City mortgaged and supervised by agencies of New York State.[26] Here the district court found that there was no sale of "securities", relying on essentially the same argument made by defendants in *Jakobson*, that ". . . form should be disregarded for substance and the emphasis should be economic realty"[27] in determining what is a "security."

In *Forman* the district court took the position that shares in a cooperative are not a "security" because they "do not represent any right to any apportionment of tangible profits."[28] The court listed five reasons why there was no expectation of profits or economic benefits in purchasing shares in the cooperative as:

(1) Shares were required to be resold to the corporation for no more and no less than the purchase price;

(2) There were to be no dividends, or apportionment of profits, assets or earnings;

(3) State law forbade any possibility of profits from ownership of shares or from occupancy of units;

(4) Both the cooperative corporation and the sponsor were nonprofit corporations; thus, there was no possibility of gain from their operation; and

(5) The tax benefits were an economic inducement incident of real estate, not securities, ownership.[29]

The Second Circuit, relying on *Jakobson*, reversed on appeal.[30] The court of appeals based its ruling on the fact that the Riverbay stock was not very different from that of private cooperative housing corporations such as that in *Jakobson*, stating[31]

(1) that the repurchase provisions in Riverbay were comparable to the rights of first refusal granted private cooperatives;[32]

(2) that the stock was literally an instrument defined as a "security" within the ambit of the statutes;[33]

(3) that Rule 235 does create negative implications that cooperative housing stock is a "security" within the securities laws;[34]

(4) finally, the stock does meet the *Howey* test of "investment contract"[35] there being "profit" in the form of reduced carrying charges

26. 9 REAL PROP., PROB. AND TRUST J., *supra* note 16, at 262.
27. 366 F. Supp. at 1126.
28. *Id.* at 1127.
29. *Id.* at 1128-29.
30. 500 F.2d 1246 (2d Cir. 1974).
31. *See*, (1973-1974 Transfer Binder) CCH FED. SEC. L. REP. ¶ 94,594 (2d Cir. June 19, 1974).
32. *Id.* ¶ 96,095-5.
33. *Id.* ¶ 96.095-5-96,095-6.
34. *Id.* ¶ 96,095-6-96,095-7.
35. 328 U.S. 293, 298-99 (1946).

from the leasing of retail establishments, office space, parking and other commercial enterprises (*e.g.* washing machines) on the premises, in the form of tax benefits, and in the form of paying carrying charges less than the going rate for similar apartments.[36]

The Second Circuit also affirmed *Jakobson*,[37] relying on the same rationale used in *Forman*. Recently the SEC has revised its position regarding whether shares in a cooperative housing corporation constitute a "security". In *Society Hill Towers, Inc.*,[38] the SEC issued the statement that:

> [i]n light of the appellate court (CA-2) [sic] decisions in *Forman v. Community Services, Inc.* (par. 94,594) and *1050 Tenants Corp. v. Jakobson* (par. 94,702) holding that shares in cooperative housing corporations constitutes "securities" in the form of both stock and investment contracts, the SEC staff is currently re-examining the availability of Rule 235 as an exemption from Securities Act registration where the aggregate purchase price of such a corporation's stock and appurtenant property exceeds $300,000. 'Accordingly a request for a no-action position with respect to Rule 235 will not be considered at this time.'[39]

In summation it is recommended that persons who are connected with the sale of cooperative stock minimize or eliminate any advertising which promotes the cooperative as a "good investment", *i.e.* emphasizes tax reductions, or rental value. Also, it is suggested that par value stock certificates be used and that the total aggregate par value be kept below $300,000.[40]

IV

CONDOMINIUMS

Condominiums did not become a popular housing form until after World War II when a trend began toward more leisure time because of the expansion of the economy.[41] Subsequently, the condominium has become popular as a "second home", usually at some resort area. The buying and selling of a condominium as a permanent residence is thought of only as a real estate transaction. However, when a condominium is bought as a "second home", and rented when not in use, the

36. (1973-1974 Transfer Binder) CCH FED. SEC. L. REP. ¶ 94.594 at 96.095-7-96.095-8, 9 REAL PROP. AND TRUST J., *supra* note 16, at 263-264.

37. 500 F.2d at 1252.

38. (Current Volume) CCH SEC. L. REP. ¶ 80,103 (Dec. 27, 1974).

39. *Id.*

40. See, 9 REAL PROP., PROB. AND TRUST J., *supra* note 16, at 260 (for further sug gestions for attorneys that are involved in the sale of cooperative stock).

41. Grimes and King, *A Look At Condominium Offerings Under the Federal Securities Laws—For the Idaho Lawyer*, 9 IDAHO L. REV. 149 (1973).

problem arises as to whether the condominium constitutes a form of a "security" or simply real estate.

The application of federal securities laws to the sales of condominiums was given little consideration by developers until the middle of the 1960's.

> In 1965 and 1966 the Hale Koancepoli Apartment Hotel Development Company, Inc. ("Hale") offered and sold condominium apartments to the public. Each purchaser, at the time of his purchase, was offered an opportunity to enter into an arrangement with the seller whereby his apartment would be rented to others when unoccupied. Hale was subsequently advised by the Securities and Exchange Commission that it was selling securities and that registration was required. Hale therefore ceased its sales operation and registered the remaining apartments under the '33 Act before resuming sales.[42]

Even after the SEC issued this initial warning that condominium sales coupled with a rental agreement with the seller constituted a "security" under the 1933 Act, developers ignored registration requirements. Developers continued to devise schemes to make resort condominiums an attractive buy. These arrangements were promoted as a way that the condominium would pay for themselves. The agreement took many forms; the seller staying on after all units in the development were sold to perform management functions, such as rental services, or arranging for a third party to perform the rental service. Also, to enhance the purchase of a unit, the seller would arrange a rental agreement whereby the rent received from the rental of all units and expenses incurred were pooled and the net proceeds distributed pro rata to all the owners. Often the rental arrangement was a mandatory prerequisite for purchase of the condominium unit.[43]

The SEC seemed to be undecided as to which of these various types of services, tied to the sale of a condominium, constituted a "security." In *Edward S. Jaffry*,[44] involving the sale of condominium units and a leaseback to offeror's subsidiary, which would provide rental services, the SEC ruled that this agreement constituted the offering of a "security"; requiring registration under the 1933 Act. Even though rental services are provided, no "security" is found to exist by the seller in some situations where the benefits to the purchaser are not emphasized in the initial sale of the unit.

The SEC ruled in *Sunriver Properties, Inc.*,[45] that a rent management

42. K.B. Romney and W.C. Petty, *Resort Condominiums: History, Securities, Aspects, Registration Requirements*, N.Y.L.J. Feb. 22, 1973, at 6, col. 2.

43. *See*, Rosenbaum, *The Resort Condominium and the Securities Laws—A Case Study on Governmental Inflexibility*, 60 VA. L. REV. 785, 786 (1974).

44. (1971-1972 Transfer Binder) CCH FED. SEC. L. REP. ¶ 78.395 (1971).

45. (1973-1974 Transfer Binder) CCH FED. SEC. L. REP. ¶ 79,691 (1973).

program, permitting owners to lease their property when not in residence, was not offering the sale of an investment contract under Section 2(1) of the 1933 Act. A qualification was added that the developer would not offer the rental service to owners until after the purchase of a home was completed; its salesman would not initiate conversations with potential buyers on the rental aspects of homeownership; also, that there would be no written representations on the rental service.

It appeared that the SEC would hold that no security offer existed if there was no emphasis on the rental service and if the rental service was optional. In order that the sale of a condominium not be declared a "security", more was required than simply making the rental services optional. As shown in *Desert Heritage Co.,*[46] the SEC decided that a rental pooling agreement offered to purchasers, although entirely optional, constituted an investment contract and was subject to the registration requirements of the 1933 Act. Developers also devised several arrangements to make the purchase of condominiums attractive; other than agreements to provide a rental service to the individual purchaser. One way in which developers reduced the overall cost to the purchasers of upkeep on the condominium complex was to develop a portion of the complex for lease to commercial enterprises. The profit from the rent was used to pay the upkeep of the common area. This type of condominium development was viewed as not constituting a security by the SEC in Clemson Properties Inc.[47] In this particular case the SEC based its ruling on the fact that the rental income realized by the unit owner would be extremely minor in relation to the cost of the residential units.

Another innovative idea in condominium developments is offering units on a time sharing plan. This arrangement consisted of selling undivided interests (usually a one-twelfth interest) in a condominium to purchasers, who held as tenants in common. Under the terms of the agreement each purchaser had the exclusive right to occupy the unit for a designated portion of the year. Originally the SEC ruled in *The Innisfree Corp.*[48] that this type of arrangement did not constitute a "security", because there was no provision in the purchase agreement for either a rental pool or other income-producing facility. But, the SEC has recently decided to re-examine its original position and has refused to issue a no-action letter to the Innisfree Corporation, which was seeking to offer to the public the sale of additional condominiums on a time

46. SEC No-Action Letter, *In re* Desert Heritage Corp. (Dec. 9, 1971), *cited in* 51 TEX. L. REV. 239 at 246 (1973).

47. (1971-1972 Transfer Binder) CCH FED. SEC. L. REP. ¶ 78,387 (1972). *See also* Surftide Condominiums, (1971-1972 Transfer Binder) CCH FED. SEC. L. REP. ¶ 78,686 (1972).

48. (1973 Transfer Binder) CCH FED. SEC. L. REP. ¶ 79,398 (1973).

sharing basis.[49] However, the SEC stated that this did not revoke the previous letter issued to The Innisfree Corporation dated April 5, 1973.

Confronted with the problem of when the sale of a condominium tied to various services or arrangements offered by the seller constitutes a "security", the SEC in 1972, established the Real Estate Advisory Committee to study the problem.[50] "Its proclaimed purpose was to assist the Commission in the review of its disclosure procedures and policy objectives in the area of real estate security interest."[51] While covering a wide range of real estate security interests, the report of the Committee[52] made a number of recommendations concerning the resort condominium.

Several of these recommendations were adopted by the SEC with some modifications, when it issued its Securities Act of 1933 Release No. 5347, entitled "Guidelines as to the Applicability of the Federal Securities Laws to Offers and Sales of Condominiums or Units in a Real Estate Development."[53] In the release the SEC states, "[r]esort condominiums are one of the more common interests in real estate the offer of which may involve an offering of securities."[54] Even though the release speaks in terms of condominiums, it covers all types of real estate developments having the same characteristics. This would undoubtedly include cooperatives.

The release stresses the investment contract concept, as enunciated in *Howey*, for its authority to declare the offering of condominiums tied to other services offered by the seller to constitute a "security". The SEC spelled out certain circumstances under which it would find the offering of condominiums a security.

> (1) Where 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) Where the condeominium offering consists of an offering of a participation in a rental pool arrangement, whether it be mandatory or optional to participate in the rental pool.
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> (3) Where the condominium-offering involves the offering of a rental or similar arrangement whereby the purchaser must hold his

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49. (Current Volume) CCH FED. SEC. L. REP. ¶ 79,398 (1973).

50. The Committee was chaired by Raymond Dickey, Esq. The report of the Committee is known as the "Dickey Report."

51. Ellsworth, *Condominiums Are Securities?*, 2 REAL ESTATE L.J. 694, 695-96 (1974).

52. The report was issued on October 12, 1972. A summary of the recommendations is printed in (1972-1973 Transfer Binder) CCH SEC. L. REP. ¶ 79,265 (1972).

53. 1 CCH SEC. L. REP. ¶ 1049, SEC Release 5347 (January, 1973).

54. *Id.*

unit available for rental for any part of the year, or must use an exclusive rental agent or is otherwise materially restricted in his occupancy.[55]

While the release comments on rental arrangements, or other similar services which are offered and sold with emphasis on the economic benefits to the purchaser, it does not directly spell out any policy concerning condominium developments where commercial facilities are a part of the common elements. In the report by the Real Estate Advisory Committee it was recommended that:

> Where commercial facilities are a part of the common elements of a residential project, no registration should be required where (a) the income from such facilities is used to offset common area expenses and (b) the operations of such facilities are incidental to the project as a whole and are not established as a primary income source for the individual owners of a condominium or cooperative unit.[56]

However, Release 5347 did affirmatively point out certain circumstances where the offering of a condominium would not be considered the offering of investment contract securities:

> If the condominiums are not offered and sold with emphasis on the economic benefits to the purchaser to be derived from the managerial efforts of others, and assuming that no plan to avoid the registration requirements of the Securities Act is involved, an owner of a condominium unit may, after purchasing his unit, enter into a nonpool rental arrangement with an agent not designated or required to be used as a condition to the purchase, whether or not such agent is affiliated with the offeror, without causing a sale of a security to be involved in the sale of the unit. Further, a continuing affiliation between the developers or promoters of a project and the project by reason of maintenance arrangements does not make the unit a security.[57]

When it declared that each case would be decided on its own facts, the SEC retained an area of latitude within which to decide if a particular arrangement involved ". . . 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 . . . ."[58] Several months after the SEC issued Release No. 5347, it made public a no-action letter[59] in response to a request for an exemption by Big Sky of Montana, Inc., ("Big Sky") dated February 6, 1973. To each of its

55. *Id.* (Quoted in 2 REAL ESTATE L. at 696, *supra* note 51).

56. (1972-1973 Transfer Binder) CCH SEC. L. REP. ¶ 79,265 (1972).

57. 1 CCH SEC. L. REP. ¶ 1049, SEC Release 5347 (January 4, 1973). (quoted in 2 REAL ESTATE L. J., *supra* note 51, at 697).

58. *Id.*

59. SEC Release No. 33-5347 (April 13, 1973) *cited in* 2 REAL ESTATE L.J., *supra* note 51, at 697.

purchasers Big Sky offered a rental service that was entirely optional and did not involve any pooling of rents. Big Sky had created a separate division of the corporation to handle the rental service. The no-action letter indicated to the SEC that the rents collected, less fees and expenses, would be remitted directly to the owner of the particular unit rented. Big Sky also indicated that it had instructed its salesmen to tell each purchaser who inquired about rental services that the rental division of Big Sky was only one of several rental agents available. The purchaser was allowed to select whichever rental agent he preferred. If the purchaser decided to use the rental services offered by the separate rental division of Big Sky, he was not required to make his unit available for rent during any specified period of time. Furthermore, salesmen had been instructed not to discuss the actual or estimated rental charges with prospective buyers. This was a matter the purchaser would take up directly with the rental division of Big Sky. Based on these facts, the SEC granted the exemption. In its opinion the offer made by Big Sky did not constitute an offer of securities within the meaning of Section 2(1) of the Securities Act of 1933.

This no-action letter points out a valid way for a developer to offer a rental service to purchasers without having to register his offering of condominiums with the SEC. The only difference in this arrangement and other similar arrangements,[60] previously ruled to be an offering of a security, was that the developer avoided outright emphasis on economic benefits to the purchaser. The creating of a separate division consisted of no more than designating or arranging for a third person to perform the rental services.[61] The SEC had also previously ruled that making the rental service optional would not remove the offering from the category of a security.[62] Therefore, it is recommended that the developer avoid emphasis of any kind on economic benefit to be gained by the purchaser from a rental service offered by the developer.

A. Problems Other Than Registration

Once it was determined that an offering of condominiums was required to be registered under Section 2(1) of the Securities Act of 1933, the developer was then faced with a number of other problems encountered in complying with the securities laws. In order to clarify some of these problems for developers, the SEC issued Release 5382,[63] entitled,

60. *See In re* Desert Heritage Co., *supra* note 46.

61. *See*, SEC Release 5347, *supra* note 53 (where the circumstances under which the offering of a condominium would constitute the offering of a security are spelled out.)

62. *See, In re* Desert Heritage Co., *supra* note 46. (There a rental pool was offered the purchaser).

63. 1 CCH SEC. L. REP. ¶ 1050, SEC Release 5382 (April 9, 1973).

"Advertising and Sales Practices in Connection with Offers and Sales of Securities Involving Condominium Units and Other Units in Real Estate Developments." Essentially the release emphasized what could and could not be done by the developer before the registration process was completed. The release called attention to the fact that "Section 5(a) of the Securities Act of 1933 ("Act") provides that it is unlawful absent an exemption for any person, directly or indirectly, to sell a security using the means or instruments of interstate commerce or the mails unless a registration statement is in effect as to such security."[64] This meant that prior to the filing of the registration statement that it was illegal under Section 5(a) to disseminate sales literature, brochures or publicity concerning the condominium units or the proposed offering. An exception to this requirement was notices by an issuer, given in accordance with the provisions of Rule 135.[65] These notices were deemed not to constitute an offer of securities under Section 5(a) of the Act and could accordingly be published before the registration process was completed. The release goes on to point out that ". . . no purchase price payments, deposits, or purchase commitments may be accepted, nor may indications of interest be solicited prior to filing the registration statement."[66] This is a very crucial point as far as the developers are concerned because of the time involved completing the registration process.[67] The release also covers the types of communications the developer may make to the public between the period after the registration statement is filed and the period when it becomes effective. Finally, the release reminds the developer that, after the registration statement is effective, the statutory prospectus must comply with the requirements of Section 10(b) of the Act before sales can begin. The release also stated that [c]ommunications meeting the requirements of Rule 134[68] may be published or transmitted."[69]

This release made it clear that once an offering of condominiums, with related rental or other types of managerial services, was found to constitute an offering of securities, the developer had to comply with the full gambit of regulations set out in the Securities Laws. Perhaps this is why only 59 offerings of resort condominiums were registered with the SEC by August, 1973; when experts in this field had estimated that between 500 and 700 condominiums offerings would have been subject to registration under the guidelines issued by the SEC on January 4,

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64. *Id.*
65. *Id., see* App. A.
66. 1 CCH SEC. L. REP. ¶ 1050, SEC Release 5382 (April 9, 1973).
67. *See,* 2 REAL ESTATE L.J., *supra* note 51, at 699 (this time period may range up to in excess of one year).
68. 1 CCH SEC. L. REP. ¶ 1050, SEC Release 5382 (April 9, 1973).
69. *Id., see* App. B.

1973, in its Release No. 5347.[70] The time involved in registration and the ban on advertising before registration were not the only problems facing the developers in registering their offerings. Registration also involved large expenditures on the part of the developers. This expense ranged from $4,000 to $125,000[71] for the 59 offerings that had been registered by August 1, 1973.

The developers were not only faced with the regulations and procedures required under the 1933 Act; they were also subject to the entire regulatory structure of the 1934 Act. One such requirement was that the corporation register as a broker-dealer under Section 15(a).[72] In 1971, the SEC required Haystack Hotel Association, Inc., a corporation acting as sales agent for the distribution of condominium units consisting of hotel rooms and an undivided interest in the common facilities, to register as a broker-dealer.[73] Registration as a broker-dealer requires that all persons associated with the offering pass a general securities exam. Furthermore, once registered the coporation must comply with the Commission's net capital rules; the reporting and record keeping rules, and many other regulatory rules that serve no useful purpose to a real estate sales corporation.[74] In addition, sales on credit of condominiums, arranged through broker-dealers, have been held to be sales of securities within the meaning of Rule 10(b)-16 of the 1933 Act and disclosure of credit terms, in compliance of regulation Z under the Truth in Lending Act, is required by the SEC.[75] Developers must also comply with the Federal Reserve Board's regulation T,[76] which was adopted pursuant to Section 7(c) of the 1933 Act. This regulation controls the extent to which a broker-dealer may extend or arrange for the extension of credit to purchasers of securities from the broker-dealer.[77] The effect of this regulation on a condominium offering is to make "it unlawful for the real estate developer to arrange a loan for the purchaser of the condominium unit if a securities broker-dealer participates in the offering."[78] This requirement imposes a great burden on the

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70. 2 REAL ESTATE L.J. *supra* note 51, at 698.

71. Id., at 699.

72. 15 U.S.C. § 780 (1970).

73. Haystack Hotel Ass'n, Inc., (1970-1971 Transfer Binder) CCH SEC. L. REP. ¶ 78,049 (1971).

74. *See, e.g.*, 17 C.F.R. §§ 240.1561-2, 240.15b10-6 (1973).

75. Freedman, Silverberg & Lewis, Inc., (1972-1973 Transfer Binder) CCH SEC. L. REP. ¶ 78,930 (1972).

76. 12 C.F.R. §§ 220.1 *et. seq.* (1973).

77. See, Rosenbaum, *The Resort Condominium and the Securities Laws—A Case Study in Governmental Inflexibility*, 60 VA. L. REV. 785, 787; 804-08 (1974); Hart, *Securities Regulation of Real Estate Developments—Financing Arrangements Considered as an Extention of Credit*, 35 OHIO L.J. 300 (1974).

78. 60 VA. L. REV., *supra* note 77, at 787.

developer who has to register an offering of condominiums, in that it restricts the market of potential buyers during periods of tight credit.

Rosenbaum has leveled severe criticism at the application of Regulation T to the sale of resort condominiums in his article, *The Resort Condominium And The Securities Laws—A Case Study in Governmental Inflexibility*.[79] He states that "[t]he primary purpose was to provide the Board with an effective method of reducing the aggregate amount of the nation's credit resources which can be directed by speculation into the stock market and out of other more desirable uses of commerce and industry."[80] He also found that the application of Regulation T to the sale of resort condominiums in no way fulfills this purpose. Instead it actually prevents the fulfillment of the objective of the Regulation. Rosenbaum bears this out in his statement "[c]redit for the purchase of common stocks generally merely supports trading from one investor to another, while credit extended for purchase of a resort condominium supports the construction of dwelling units, surely one of the 'more desirable' uses referred to in the legislative history."[81] Besides being subject to Regulation T, condominium developers also find themselves subject to the requirements of Section 11(d)(1) of the 1934 Act. This sections contains a prohibition against a person who is both a broker and a dealer, transacting business in securities, from effecting

> any transaction in connection with which, directly or indirectly, he extends or maintains or arranges for the extention or maintenance of credit to or for a customer on any 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. . . . .[82]

The purpose of this section is to prevent the salesman from zealously inducing his brokerage customers to purchase the securities he is distributing, by using his ability to obtain credit for them. The SEC has held that Section 11(d)(1) applies to individuals who register as broker-dealers solely for the purpose of selling condominiums.[83] Once again the purpose of this section is not fulfilled by applying it to real estate transactions. It is unlikely that a broker would abuse his fiduciary obligation to his brokerage customer by offering him a purchase money mortgage. Rosenbaum speculates, ". . . it seems unlikely that a custom-

79. *Id.* at 785.

80. 78 Cong. Rec. 7704 (1934). *See also* Remar v. Clayton Securities Corp., 81 F. Supp. 1014, 1017 (D. Mass. 1949); 60 VA. L. REV., *supra* note 77, at 807.

81. 60 VA. L. REV., *supra* note 77, at 807.

82. 15 U.S.C. § 78K(d)(1) 1970. *See* 60 *VA.* L. REV., *supra* note 77 at 808, N 89.

83. Lake Point Elsinare, Ltd. (1972-1973 Transfer Binder) CCH FED. SEC. L. REP. ¶ 78,842 (1972). *See* 60 VA. L. REV., *supra* note 77, at 809, nn 91, 92.

er would purchase an expensive resort condominium which he would otherwise not have bought merely because he would be offered a purchase money mortgage on the condominium."[84]

The effects of the application of Regulation T and Section 11(d)(1) to the condominium developer caused the SEC to propose Rule 3(a) 12-5. Provided that certain conditions are met, this rule would exempt any transaction involving the "direct ownership of specified residential real property and related management services" from the provisions of Sections 7(c) and 11(d)(1).[85]

The above mentioned exemption is a move in the right direction toward freeing resort condominium developers from the full requirements of the 1934 Act. These regulations impose unjustified burdens on the developer while not fulfilling the purpose for which they were promulgated. While registration and a prospectus may be legitimate requirements of the condominium developer, who offers rental or other managerial services, the imposition of the full superstructure of the 1934 Act certainly is not necessary.

Along the lines of limiting the full impact of the securities laws to the resort condominium industry, the SEC has ruled that the ownership of an individual condominium by a limited partnership does not fall within the definition of an investment company,[86] under Section 3(c)(5)(C) of the Investment Company Act of 1940.[87] In addition, the SEC ruled that a corporation proposing to sell an individual condominium to a limited partnership is not an investment company,[88] within the meaning of Section 3(a) of the Investment Company Act of 1940.[89]

The impact of the Securities Laws to resort condominiums is also limited by certain exemptions applicable to all offerings of securities. These exemptions will be discussed at a later point in this comment.[90]

V

REAL ESTATE SYNDICATES

By its very nature, the real estate syndicate, especially in the form of a limited partnership, fits the definition of an investment contract given in

84. 60 VA. L. REV., *supra* note 77, at 809-10.

85. *See* Securities Exchange Act Release No. 10845, *see also* 60 VA. L. REV., *supra* note 77, at 810-11.

86. Properties in Paradise Inc., (1972-1973 Transfer Binder) CCH SEC. L. REP. ¶ 79,062 (1972).

87. 15 U.S.C. § 80b-3(c)(5)(c) (1940).

88. Properties in Paradise Inc., (1972-1973 Transfer Binder) CCH SEC. L. REP. ¶ 79,062 (1972).

89. 15 U.S.C. 80b-3(a) (1940).

90. *See*, § VI *infra*.

Howey[91] more readily than does an offering of cooperatives or condominiums. The real estate syndicate, in the form of a limited partnership, consists of a number of investors, who contribute the capital for the venture, and a general partner, usually called the syndicator, primarily contributes his services as a manager. Therefore, it can readily be seen that the limited partners are investing money in a scheme; whereby, they hope to make a profit through the efforts of a third person, the syndicator. The nature of the limited partnership form precludes the limited partners from actively participating in the management of the syndication. This then prevents the limited partners from escaping the consequences of falling within the definition of an investment contract. The SEC in Release No. 4877 confirmed the preceding observation by stating:

> Under the Federal Securities Laws, an offering of limited partnership interest and interests in joint or profit sharing real estate ventures generally constitute an offering of a "profit sharing agreement" or an "investment contract" which is a "security" within the meaning of Section 2(1) of the Securities Act of 1933.

The release goes on to state:

> In other words, the investor provides the capital and shares the risk and the profits; the promoter or third party manages, operates and controls the enterprise, usually without active participation on the part of the investor.[92]

The limited partnership form in real estate syndications has been used primarily as a tax shelter for wealthy investors. However, Van Camp[93] observes that the less affluent and less sophisticated public investor has become involved in real estate investments in recent years. He also states, "[n]ot infrequently such syndicates have been inadequately financed, poorly managed and deceptively advertised from the outset."[94] Therefore, in his analysis, it is very desirable to classify an offering to form a real estate syndicate as an offering of a "security" and thereby require registration under Section 6 of the 1933 Act.

A federal district court has also held that where a general partnership is formed in a real estate syndicate, for the purpose of purchase and leaseback to the seller of a motel, then certificates of interest or participation in a profit sharing or investment contract exist.[95] Therefore, the

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91. *See*, text, *supra*, at note 7.

92. SEC Securities Act Release No. 4877 (August 8, 1967) (Transfer Binder) CCH SEC. L. REP. ¶ 77,462 (Aug. 8, 1967).

93. Mr. Van Camp is the California Commissioner of Corporations and was President, Mid-West Securities Commissioners' Association 1973-1974.

94. Van Camp, *Securities Regulation of Real Estate Investments: The California Model*, 35 OHIO L.J. 309 (1974).

95. Pawgan v. Silverstein, 265 F. Supp. 898 (D.C. N.Y. 1967); (1966-1967 Transfer Binder) CCH SEC. L. REP. ¶ 91,196 (1967).

registration requirement does not just apply to limited partnerships. The SEC in Release No. 4877 took a very broad view as to the types of real estate syndications that would fit the investment contract definition when it stated, "[i]nterest in novel and uncommon ventures fit the broad definition of an 'investment contract'."[96] Therefore, attempts to evade the registration requirement, by changing the form that the real estate syndicate will take, are usually of no avail.

Once a syndicate is required to make out a registration statement under Section 5, it then becomes subject to the anti-fraud provisions of the securities laws. In *Parish v. Boltel & Co.*,[97] the court found a violation of Section 10(b)5 of the 1934 Act where the general partner had been disseminating false financial information.

Furthermore, the SEC has found that a company consisting of an unincorporated organized group of persons whose only investment is the security of a single issuer (i.e. the limited partner offering limited partnership interests in a real estate partnership) would be an investment company within the meaning of the Investment Company Act.[98] This seems to indicate that the SEC is more willing to apply the entire superstructure of the securities laws to an offering of a real estate syndicate than it is to an offering of a cooperative or a condominium. This is probably why a discussion of the various exemptions from the registration requirements, available under the securities laws, is included in articles dealing with the real estate syndicate.[99] These various exemptions will be discussed briefly in the following section.

VI

EXEMPTIONS FROM THE REGISTRATION

Up to this point the discussion has centered on whether or not a real estate offering constituted a "security" and if so what the impact of the securities laws would be on the offering. The real estate developer can shield his offering from the full impact of the securities laws by bringing

96. (1966-1967 Transfer Binder) CCH SEC. L. REP. ¶ 77,462 (Aug. 8, 1967).

97. (1974-1975 Transfer Binder) CCH SEC. L. REP. ¶ 94,802 (U.S. Dist. Ct. of Neb., No. 72-0-480, Sept. 11, 1974). *See also* SEC v. Capital Syndications, Inc., (Current Volume) CCH SEC. L. REP. ¶ 94,726 (U.S. Dist. Ct. N.D. Tex., July 22, 1974). (In this case funds were diverted from a limited partnership and the defendants were unable to repay them).

98. *See* Urban Land Investments, Inc. (1971-1972 Transfer Binder) CCH SEC. L. REP. ¶ 78,533 (1971).

99. *See*, Erwin, *Marketing Investment Condominiums and Real Estate Syndications Without Securities Registration: SEC Rule 146*, 3 REAL ESTATE L.J. 119 (1974); Greenwood, *Syndication of Underdeveloped Real Estate and Securities Law Implications*, 9 HOUSTON L. REV. 53 (1971); Comment, *SEC Regulation of California Real Estate Syndication*, 61 CAL. L. REV. 205 (1973); Note, *Application of the Securities Doctrine of Integration to Real Estate Syndications*, 46 SO. CAL. L. REV. 428 (1973).

it within one of the standard exemptions available to all offerings of securities. However, it should be pointed out that the burden of proof that a particular exemption applies is on the party who asserts the existence of the exemption.[100] This burden is only met when clear and convincing evidence is produced.[101] Furthermore, the courts have strictly construed the exemptions against the party claiming them.[102] It should also be remembered that, even though a real estate offering falls within an exemption from the registration, it is still "subject to the full and fair disclosure requirements of the Securities Acts if the mails or facilities of interstate commerce are used in connection with their offer or sale."[103]

With this in mind, real estate developers should closely examine three exemptions to the 1933 Act: the private placement,[104] intrastate sale,[105] and Regulation A[106] (small offering) exemptions. Having weighed the benefits of registration to the investing public against the burden and expense that registration would require, Congress recognized that compliance with the registration provision would not be necessary in some situations and enacted these exemptions.[107]

A. Private Placement Exemption

This exemption involves "transactions by an issuer not involving any public offering."[108] In *SEC v. Ralston Purina Co.*[109] the United States Supreme Court set out a test for determining what constitutes a "private offering." "The Court held that in order for an offering to qualify as a

100. SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953); Chapman v. Dunn, 414 F.2d 153, 159 (6th Cir. 1969); SEC v. Los Angeles, Trust Deed & Mortgage Co., *cert. denied*, 366 U.S. 919 (1961); Lively v. Hirschfeld, 440 F.2d 631 (10th Cir. 1971).

101. SEC v. Ralston Purina Co., 346 U.S. 119 (1953), Lively v. Hirschfeld, 440 F.2d 631 (10th Cir. 1971).

102. Chapman v. Dunn, 414 F.2d 153, 159 (6th Cir. 1969); SEC v. Sunbeam Gold Mines Co., 95 F.2d 699, 702 (9th Cir. 1938); Corporation Trust Co. v. Logan, 52 F. Supp. 999, 1002 (D.C. Del. 1943). *See also* SEC Securities Act Release No. 4552 at 215 (November 6, 1962); Advanced Research Associates, Inc., 415 S.E.C. 579, 587 (1963).

103. Greenwood, *Syndication of Undeveloped Real Estate and Securities Law Implications*, 9 HOUSTON L. REV. 53, 64 (1971). The civil liabilities created in Section 12 of the Securities Act of 1933, 15 U.S.C. § 77 *l* (1964), are expressly made applicable to transactions exempt under the provisions contained in Section 5 of the Act, 15 U.S.C. § 77e (1964). *See* Pawgan v. Silverstein, 265 F. Supp. 898 (S.D.N.Y. 1967).

104. 15 U.S.C. § 77d(2) (1970).

105. 15 U.S.C. § 77c(a)(11) (1970).

106. 15 U.S.C. § 77c(b) (1970) and SEC Rules 251-63 (17 C.F.R. 230.251-63 (1972)).

107. *See* H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933); SEC v. Ralston Purina, 346 U.S. 119, 122 (1953) (for a discussion of these considerations as they apply particularly to the private exemption).

108. Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1933).

109. 346 U.S. 119 (1953).

'private placement' the potential private investor must (1) be sufficiently sophisticated, and (2) have access to that information which would otherwise be available in a registration statement."[110] In setting forth these criteria, the Court made it plain that the number of individuals that the offering was extended to did not determine whether a particular offering fell within the exemption.

The SEC had offered little information as to what constituted a "private offering" until Rule 146 was proposed.[111] Rule 146 set forth a number of criteria, all of which must be met, before an offering falls within the private offering exemption. Two of these criteria are particularly important in determining whether or not a transaction is a "private offering": "(1) access to information that registration would disclose and (2) the ability of offerees to be able to fend for themselves so as not to need the protection afforded by registration."[112]

These two criteria can be broken down into four conditions which must be met in determining the availability of the exemption. The first condition requires that all offers and sales be made in "negotiated transactions". This means direct negotiation in which there is an opportunity to ask questions and receive answers from the issuer. Thus, the issuer is precluded from the use of any form of general advertising. A second condition requires that the offeree be sophisticated enough to evaluate the proposed investment intelligently, and also, has to be able to bear the financial risk involved in the investment. The third condition requires the offeror to provide the offeree with the same kind of information that is provided in a registration statement. In addition, the offerer must provide the offeree access to any information necessary to verify the information which is supplied to him in place of a registration statement.[113] The fourth condition limits the number of purchasers to 35 in any consecutive twelve-month period. Steps must also be taken against deferred distribution of the securities by an underwriter.

The SEC adopted Rule 146 on April 23, 1974, and it became effective on June 10, 1974.[114] Gregory Rufus Erwin states that Rule

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110. Note, *Application of the Securities Doctrine of Integration to Real Estate Syndications*, 46 So. CAL. L. REV. 428, 442 (1973).

111. *"Notice of Proposed Rule 146 'Transactions By An Issuer Not Deemed to Involve Any Public Offering And Related Form 146',"* SEC Securities Act Release No. 5336 (Nov. 28, 1972).

112. *See* Grimes and King, *A Look at Condominium Offerings Under the Federal Securities Law—For the Idaho Lawyer*, 9 IDAHO L. REV. 149, 159 (1973) [Hereinafter cited as Grimes].

113. *See* Andrews v. Blue, 489 F.2d 367 (10th Cir. 1973) (1973-1974 Transfer Binder) CCH SEC. L. REP. ¶ 94,316 (1973) (for a previous judicial interpretation on this point.)

114. Securities Act Release No. 5784 (Apr. 23, 1974).

146, "promises to usher in a new era in real estate syndications."[115]

B. Intra-State Offering Exemption

Section 3(a)(11) of the 1933 Act provides an exemption from registration for ". . . any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within such State or Territory."[116] If an offering qualifies for the intra-state exemption, the developer may make the offering to any number of persons and may use the mails and other means of interstate commerce to do so. In addition, he is not limited in the dollar amount of securities he can sell without having to register under the 1933 Act.[117] However, the developer, issuer must be incorporated and have his principal place of business in the State where the intrastate offering takes place.[118]

To qualify for the intrastate exemption, it is essential that nonresidents do not obtain even a beneficial interest in the securities offered before the entire issue has come to rest in the hands of permanent investors, who are residents of the state in which the offering is made. If a nonresident does acquire a beneficial interest in any of the securities offered, then the exemption is lost as to the entire offering. The issuer may then be held liable to all purchasers for the return of their original investment, plus interest.[119] Therefore, it is suggested that the developer, issuer, put a restriction on ". . . the transfer of participating interests to residents by appropriate provisions in the limited partnership agreement, that he place a restrictive legend on his brochure, and that he get each investor to give an 'investment letter'[120] which clearly states that ownership and transfer rights are restricted to residents only."[121]

In the past, a number of problems have arisen in interpreting the intra-state exemption.[122] Finally, in 1973, the SEC took steps to clarify the availability of the intra-state exemption when it proposed Rule 147.[123] After more than a year of study, the Commission adopted Rule

115. Erwin, *Marketing Investment Condominiums and Real Estate Syndications "Without" Securities Registration: SEC Rule 146*, 3 REAL ESTATE L.J. 119 (1974).

116. 15 U.S.C. § 77c(a)(11) (1933).

117. 1 CCH FED. SEC. L. REP. ¶ 2270-2277 (1961).

118. *Id.* at ¶ 2273.

119. 54 U.S.C. § 77*l* (1964). *See* 1 CCH FED. SEC. L. REP. at ¶ 2276.

120. An "investment letter" should contain the investors representation that he is a resident, that he is acquiring the security for his own account, that he does not intend to resell security to a non-resident and that the transfer of his security shall be expressly conditioned upon any future prospective transferee giving similar representations. 9 HOUSTON L. REV., *supra* note 103, at 66, n.79).

121. 9 HOUSTON L. REV., *supra* note 103, at 66.

122. *See* 9 IDAHO L. REV., *supra* note 112, at 161.

123. "Notice of Proposed Rule 147 *'Part of an Issue', 'Person Resident' and Doing*

147 and it became effective for transactions commenced on or after March 1, 1974.[124]

Rule 147 clarifies the question of what constitutes "part of an issue,"[125] stating:

> all securities of the issuer, its affiliates and predecessors, other than those exempt under Section 3(a) of the Act, that are offered or sold by the issuer, its affiliates and predecessors within any consecutive six-month period . . . provided, however, that securities offered, offered for sale or sold by a person which is a business enterprise separate and distinct from the issuer and which is affiliated with the issuer solely by reason of the existence of a common general partner, shall be deemed not to be part of such issue.[126]

Rule 147 goes on to give guidelines on the questions of when a person is resident of a state, and what is meant by doing business within a state.[127]

It should be pointed out that the rule does not provide the exclusive means for compliance with Section 3(a)(11).[128] Gardiner, in his article commenting on Rule 147, believes that because of ". . . the comprehensive scope of the rule and the refinement and narrowing it represents of certain pre-rule administrative and judicial interpretations, the rule's substantive provisions undoubtedly will have a significant effect on subsequent judicial decisions involving non-rule transactions relying on Section 3(a)(11)."[129]

C. *Regulation A: Small Offerings Exemption*

The "small offerings exemption" is provided in Section 3(b) of the 1933 Act.[130] The purpose of the exemption is to exclude from registration, for the protection of investors which involve a small dollar amount or which, in the public interest, are so limited in character as not to require the full application of the registration provisions of the 1933 Act. For the exemption from full registration to apply, the aggregate amount of securities offered must not exceed $500,000.[131]

Besides the aggregate amount limitation, additional requirements are

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Business Within For Purposes of Section 3(a)(11) of the Securities Act of 1933", SEC Securities Act Release No. 5349 (January 8, 1973).

124. Securities Act Release No. 5450 (Jan. 7, 1974)

125. *See* Comment, *SEC Regulation of California Real Estate Syndicates*, 61 CAL. L. REV. 205 (1973). (for discussion of the problem of integration of offerings).

126. SEC Securities Act Release No. 5480 (Jan. 7, 1974).

127. *See* Gardiner, *Intrastate Offering Exemption: Rule 147—Progress or Stalemate?* 35 OHIO L.J. 340 (1974), for a complete discussion of all the aspects of Rule 147. [Hereinafter cited as Gardiner].

128. Rule 147, Preliminary Note 1.

129. Gardiner, *supra* note 127, at 341.

130. 15 U.S.C. § 77b(3) (1933).

131. 15 U.S.C. § 77b(3) (1933).

set out in Regulation A.[132] Regulation A makes provisions for a short form registration. The use of Regulation A registration is of interest to the developer, issuer because there is no restriction as to the number, sophistication, or residence of the offerees or purchasers. Other advantages are (1) that the financial statements required to be filed do not have to be certified, (2) the information requested in the registration is not as extensive, and (3) the filing and processing of the materials takes less time and is done in a regional office.[133]

An issuer, who may otherwise qualify under the exemption, may be disqualified under Rule 252,[134] if any of certain parties connected with the offer have previously been temporarily or permanently enjoined on the basis of a securities law violation.[135] However, even if any of the parties subject to the rule have been enjoined, the SEC, on a showing of good cause, may nevertheless grant the exemption.

Attention should also be given to Rule 254,[136] under Regulation A, which limited the aggregate amount of securities that may be sold to $500,000. This rule points out which securities, of a particular issuers, must be aggregated and how to value all those securities in determining whether or not the issuer comes within the maximum $500,000 limit of Regulation A.

There has been discussion as to the possibility of avoiding the $500,-000 maximum limit on an offering by breaking the development down into several Regulation A offerings.[137] However, this should not be done without first consulting the SEC and obtaining an interpretation as to Rule 254(d)(5) and how it applies to the facts of a particular offering.

VII

CONCLUSION

The increasing use of the federal security laws to regulate real estate transactions for the purpose of protecting the investing public, has placed a heavy burden on the real estate developer. The question of whether or not the benefits gained by the investing public, by requiring full compliance with the Securities Laws, outweighs the burdens placed

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132. SEC Reg. A, 17 CFR § 230.251-230.263 (1956).
133. *See* Grimes, *supra* note 112, at 164-166.
134. SEC Reg. A, 17 CFR § 230.252 (1956).
135. *See, e.g.*, S.E.C. v. Arco Industries, Inc. (1970-1971 Transfer Binder) CCH FED. SEC. L. REP. ¶ 92,921 (D.C.N.Y. 1971).
136. SEC Reg. A, 17 CFR § 230.254(a) (1971).
137. *See* Grimes, *supra* note 112, at 165 (This suggestion was discussed at the Capital Conference/Workshop on Regulation and Registration of Second Home Rental Condominiums held in Lincoln City, Oregon, during February, 1972).

on the developer, remains to be answered. Better yet, are alternative ways available to protect the public while lessening the burden on the developer?

In the report of the Real Estate Advisory Committee[138] (The "Dickey Report") several suggestions were offered as to lessening the burden on the real estate developer. The report recommended a short form of registration tailored to meet individual factual situations.[139] The report also recommended that a financial statement (which need not be audited, but only sworn to be true) be included in the prospectus portion of the registration statement.[140] Furthermore, the report suggested that licensed real estate brokers be exempt from the broker-dealer reporting and regulatory requirements under the 1934 Act, where their sales of real estate securities are limited to interest in condominiums and cooperatives.[141] The report finally points out that a short form examination, focusing on the fraud provisions of the 1933 and the 1934 Acts, should be used in registration of real estate brokers, except where state examinations cover the appropriate fraud questions.[142]

At this time, the SEC has not affirmitively acted on these recommendations. Their adoption, with some modification, has been urged by Rosenbaum.[143] He proposes that all persons associated with the real estate offering be required to pass an examination limited to the applicable anti-fraud provisions of the Securities Laws.[144] He also recommends that the Commission retain the enforcement tools of suspension bar, or revocation of the right of broker-dealers to participate in real estate offerings.[145]

Another valid objection to the full application of the Securities Laws to real estate developments is the enforcement of Regulation T and Section 11(d)(1). Since the public gains little benefit from the enforcement of these regulations, an exemption from them should be granted to those persons dealing in offerings of cooperative or condominiums. In closing, I would like to emphasize that even though a real estate security is exempt from registration under the federal law, it is not necessarily exempt under state laws. It is important that anyone dealing in real estate securities consult all applicable state laws.

ROBERT J. ROBBINS, JR.

138. Report of the Real Estate Advisory Committee to the Securities and Exchange Commission, Raymond R. Dickey, Chairman, presented on October 12, 1972, (1972-1973 Transfer Binder) CCH SEC. L. REP. ¶ 79,625 (1972).
139. *Id.* recommendation 29.
140. *Id.* recommendation 30.
141. *Id.* recommendation 31(a).
142. *Id.* recommendation 31(b).
143. 60 VA. L. REV., *supra,* note 77, at 812-13.
144. *Id.* at 813.
145. *Id.*