# SECURITIES REGULATION OF REAL ESTATE DEVELOPMENTS—FINANCING ARRANGEMENTS CONSIDERED AS AN EXTENSION OF CREDIT

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Section 7 of the Securities Exchange Act of 1934[1] [the 1934 Act] directs the Board of Governors of the Federal Reserve System to prescribe rules and regulations regarding the use of credit through margin accounts in the purchase of securities. This directive has been implemented through regulation T[2] which sets forth the specific rules upon which a

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1 15 U.S.C. § 78 (g) (1970) provides in pertinent part:

§ 78g. Margin requirements.

(a) For the purpose of preventing the excessive use of credit for the purchase or carrying of securities, the Board of Governors of the Federal Reserve System shall, prior to October 1, 1934, and from time to time thereafter, prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security other than an exempted security. . . .

. . .

(c) It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer—

(1) on any security (other than an exempted security), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under subsections (a) and (b) of this section;

(2) without collateral or on any collateral other than securities, except in accordance with such rules and regulations as the Board of Governors of the Federal Reserve System may prescribe (A) to permit under specified conditions and for a limited period any such member, broker or dealer to maintain a credit initially extended in conformity with the rules and regulations of the Board of Governors of the Federal Reserve System, and (B) to permit the extension or maintenance of credit in cases where the extension or maintenance of credit is not for the purpose of purchasing or carrying securities or of evading or circumventing the provisions of paragraph (1) of this subsection.

2 12 C.F.R. § 220 (1973) provides in pertinent part:

§ 220.2 Definitions

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(b) The term "creditor" means any broker or dealer including every member of a national securities exchange.

(c) The term "customer" (1) includes any person, or any group of persons acting jointly, (i) to or for whom a creditor is extending, arranging, or maintaining any credit, or (ii) who, in accordance with the ordinary usage of the trade would be considered a customer of the creditor, and (2) includes, but is not limited to (i) in case the creditor is a firm, any partner in the firm who would be considered a customer of the firm if he were not a partner, and (ii) any joint venture in which a creditor participates and which would be considered a customer of the creditor if the creditor were not a participant.

broker dealer may sell securities on credit. But the legislative history of § 7 of the 1934 Act does not provide any very easy basis for exempting "real estate securities" from the impact of regulation T. Section 7 is drawn in strict prophylactic terms. A broker or dealer subject to regulation may not "extend, maintain, or arrange for the extension or maintenance of credit to purchase or carry any security" without obtaining collateral of the kinds and in the amounts which the Board of Governors prescribes subject to limits fixed by the law. This means that if there is "credit", a "security", and a "broker/dealer" the regulation does apply.

If there is no "security" subject to registration with the SEC, the seller has no problem under regulation T. Again, if no credit is extended or arranged as part of the security package—if the purchaser obtains his own credit—the seller has no problem under the regulation, and if no broker *or* dealer is involved in selling the security (the Board usually holds such involvement to mean arranging for credit connected with the security), the seller again has no problem under the regulation. Also, while § 11(d)(1) of the 1934 Act[3] also has a prohibition against the extending or arranging for credit in connection with a new issue, this

(d) The term "registered security" means any security which (1) is registered on a national securities exchange; or (2) in consequence of its having unlisted trading privileges on a national securities exchange is deemed, under the provisions of section 12(f) of the Act (15 U.S.C. 78*l*), to be registered on a national securities exchange; or (3) is exempted by the Securities and Exchange Commission from the operation of section 7(c)(2) of the Act (15 U.S.C. 78g(c)(2)) only to the extent necessary to render lawful any direct or indirect extension or maintenance of credit on such security or any direct or indirect arrangement therefor which would not have been unlawful if such security had been a security (other than an exempted security) registered on a national securities exchange.

(e)(1) The term "OTC margin stock" means stock not traded on a national securities exchange which the Board of Governors of the Federal Reserve System has determined to have the degree of national investor interest, the depth and breadth of market, the availability of information respecting the stock and its issuer, and the character and permanence of the issuer to warrant subjecting such stock to the requirements of this part.

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§ 220.3 General Account

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(b) *General rule.* (1) (i) A creditor shall not effect for or with any customer in a general account, special bond account subject to § 220.4(i), or special convertible debt security account any transaction which, in combination with the other transactions effected in such account on the same day, creates an excess of the adjusted debit balance of such account over the maximum loan value of the securities in such account, or increases any such excess, unless in connection therewith the creditor obtains, as promptly as possible and in any event before the expiration of 5 full business days following the date of such transaction, the deposit into such account of cash or securities in such amount that the cash deposited plus the loan value of the securities deposited equals or exceeds the excess so created or the increase so caused.

[3] 15 U.S.C. § 78k (d)(1) (1970).

prohibition must be distinguished from that arising under § 7. Not only is it restricted to new issues but it also applies only to a seller functioning as both broker *and* dealer.

Regulation T does not "prohibit" sale of any security on credit terms, of course. The regulation merely requires that a purchaser put up eligible collateral—exchange-registered, OTC Margin, or exempted securities (chiefly "governments")—with a maximum loan value equal to the amount of credit extension. The seller of real estate securities has a problem under the regulation arising from the fact that such securities are neither exchange-registered nor traded in a sufficiently active secondary market to be eligible collateral for securities credit extended by brokers and dealers.

Before the 1968 amendments (the Over-the-Counter Margin Act)[4] the law was stricter in some ways, less strict in others. Until those amendments were enacted, the Board had no authority under the statute to permit brokers and dealers to extend credit against collateral other than exchange-registered or exempted securities. The Board now has this authority, but the legislative history of the 1968 amendments indicates rather clearly that Congress did not intend securities other than those traded *like* exchange-registered securities to be given loan value. Real estate securities are not so traded—at least not up until the present time.

Until enactment of the 1968 amendments, on the other hand, a broker or dealer was not subject to the Board's margin regulations unless he was an exchange member or transacted a business in securities through the medium of such a member. Thus the Board might conceivably exempt sellers of real estate securities from regulation T if they did not fit the pre-1968 definition of "creditor" under the regulation. It is difficult to find a rational justification, however, for an exemption which would forbid ordinary broker/dealers, including reputable firms with a nation-wide organization, to sell real estate securities.

It is also difficult to find a statutory basis for special margin treatment of real estate securities. The exemptive provisions of § 7(c)[5] do not cover the case of credit on real estate securities. They merely authorize the Board to allow credit to be maintained for a limited time if originally extended in conformity with regulation T or to be extended or maintained if the credit is not for the purpose of purchasing or carrying securities or not designed for evading or circumventing the prohibition against extend-

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[4] Act of July 29, 1968, Pub. L. No. 90-437, 82 Stat. 452.

[5] 15 U.S.C. § 78g (c) (1970).

ing "purpose" credit without appropriate collateral. Section 7(b)[6] does permit the Board to prescribe lower margins in certain cases. Such credit must meet two tests, however. It must be deemed necessary or appropriate for the accommodation of commerce and industry and the Board must, in granting it, have due regard to the implication for the general credit situation of the country. This means the Board must take into consideration economic factors, such as whether it is appropriate to direct scarce resources into the particular areas involved.

A legal argument can also be made, moreover, that since § 7(b) was not amended in 1968, the Board's authority to set lower margin requirements under that section refers only to lower requirements on collateral consisting of exchange-registered securities. Arguably, Congress did not intend the Board to exercise its discretion in such a way as to facilitate the trading on a highly leveraged basis of thinly-traded over-the-counter equities. This argument may also cast some doubt on whether the Board has authority to grant a lower margin to real estate securities.

There does not seem to be any clear affirmative answer to the question as to how Congress intended § 7 to apply to securities like real estate securities. The Board's primary responsibility under § 7 is to prevent credit on securities from destabilizing the securities markets. It is certainly true that there are presently no organized secondary markets trading securities of this kind. On the other hand, experiments are already being made in establishing such markets.

The Board's margin regulations are also supposed to protect investors from over-extending themselves on thin margins. Real estate securities lack two of the three characteristics that Congress said stocks must have before the Board may make them eligible for margin: reliable and publicly available price quotations and depth and breadth of market.[7] At the same time, limited partnership interests and certain investment contracts shade imperceptibly into ordinary thinly-traded equities. There is a serious policy question as to how the Board could justify permitting broker/dealers to extend credit on limited partnership interests in a big real estate issue but not on stock in the incorporated XYZ local department store in a medium-sized town.

The next question is how regulation T impacts on the sale of real estate securities offerings. Section 220.7(a) of regulation T[8] forbids a broker or dealer to arrange for any credit which he could not himself extend. Brokers and dealers clearly could not extend "purpose" credit

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[6] 16 U.S.C. § 78g (b) (1970).
[7] S. REP. NO. 1264, 90th Cong., 2d Sess. 1-4 (1968).
[8] 12 C.F.R. § 220.7(a) (1973).

on real estate securities. The Board has concluded that if they sell real estate securities embodying a credit feature, they are "arranging" for the credit, and the Board has concluded that an installment sale is a sale on credit. Thus, a broker/dealer may not sell real estate securities containing a built-in instalment feature unless he obtains collateral of the kinds, and in the amounts, specified under the regulation for any other sale of securities.

The Board has taken no position on the applicability of § 220.7(a) to any securities that are not required to be registered with the SEC. The result is that it is up to counsel to determine whether regulation T applies to sales of private offerings or intrastate placements. The principles of the Board's interpretation would seem to apply, however, to regulation A[9] offerings.

The requirements of rule 15c(2)(5)[10] that the seller determine appropriateness of the investment for the purchaser and furnish him with specified disclosures, giving him written statements on both, apply to real estate securities, even though not required to be registered with the SEC. The sale of such securities should not be regarded as "in compliance with" regulation T.[11]

The principal areas where the Board's position has had an impact on real estate securities involve limited partnerships in real estate ventures and resort condominiums. In the case of a limited partnership it seems clear that the interest obtained by a purchaser is essentially an "equity security". The partnership itself can "leverage", of course, by borrowing against its net worth and anticipated earnings, but a corporation can borrow in the same way.[12] On the other hand, if the individual partners pledge their credit for partnership borrowings (for example by giving notes which the partnership repledges), Board staff has regarded the entire transaction as involving an extension of credit arranged by the partnership to the individual partner to finance the purchase of his interest. Depending upon the purpose of the analysis the transaction may also involve an extension of credit by the partner to the partnership (both may exist at once).

Limited partnerships in real estate ventures are sometimes structured in several stages. Conventionally, the purchaser commits to pay in sev-

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[9] SEC REGULATION A, 17 C.F.R. §§ 230.251-230.263 (1973).

[10] 17 C.F.R. § 240.15c 2-5 (1973).

[11] 17 C.F.R. § 240.15c(2)(5). *See also*, Letter of the Board, September 20, 1973; Letter from the SEC to Mr. Robert DeLambo, Supervisor of Registration of Securities for the State of Ohio, September 27, 1973).

[12] If the partnership itself invests in real estate securities, however, this would be a "purpose" loan and the prohibition of § 220.7(a) might apply.

eral instalments. The Board has concluded that a purchase on instalments involves an extension of credit, but to avoid the impact of § 220.7(a) of regulation T, a number of issuers have structured their issues as purchases of a series of securities for cash. The operative question in deciding whether the regulation applies is whether purchases in stages involve genuinely separate securities or merely disguised instalments. Some tests that may be applied to distinguish purchases of discrete securities from instalment sales of a single security include whether there is a penalty for failure to purchase a subsequent stage, and whether the interests are equal in amount and of equal value.[13] If there are assessments, it may be asked whether they are substantial in amount, and how likely to occur are the events giving rise to the assessment.

In the case of resort condominiums with related management and/or rental agreements, the operative question is whether the package is essentially a real estate transaction, or essentially a security. The Board does not attempt to define what is a security.[14] The courts have taken a very expansive view, however, as to what is an investment contract and thereby a security,[15] and the SEC has laid down guidelines as to when a resort condominium with a related rental agreement becomes a security.[16]

The Board's "divisible credit" interpretations, under which regulation T did not apply if property was sold with a separate management contract and any credit that was extended related solely to the property, seem to have arisen out of a sense that the transactions presented to it involved primarily purchases of property, rather than of a security.[17] They were strictly limited to the particular facts. There could be no more than one kind of credit and there could be no credit on the non-property portion of the transaction. A beneficial interest in a trust holding a thirty year lease on land, with the beneficiary blocked under local law from ever acquiring title, was apparently not an interest in property.[18] The management could not advance cash to the purchasers, for instance, by way of advances on rentals to pay current management expenses. The purchaser must deposit cash in advance.

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13 Letter of the Board, October 30, 1973.

14 15 U.S.C. § 78c(a)(11), (12); 15 U.S.C. § 78c(b) (1970).

15 SEC v. Howey, 328 U.S. 293 (1945); SEC v. Joiner Leasing Corp., 320 U.S. 344 (1943); SEC v. Marasol Properties, Current CCH FED. SEC. L. REP. 94,159 (D.D.C. September 28, 1973).

16 SEC, SECURITIES ACT RELEASE NO. 5347 (Jan. 4, 1973).

17 Letter of the Board, June 8, 1971 (cattle) and letter of the Board, May 25, 1971 (citrus groves).

18 Staff letter, September 18, 1973.

In fact, it is frequently difficult to say that the credit obtained by the purchaser does not inure to the management aspect—for example, to help finance the common elements.[19] In any event, the Board has effectively overruled these interpretations by adopting § 220.6(1) of regulation T.[20] The amendment applies, regardless of whether credit is "arranged" by the issuer, a related person, or the selling broker or dealer. The amendment does not apply, of course, unless the package is a "security", as defined by the courts and the Commission.[21]

There are other types of real estate securities to which the considerations discussed above may apply, for example, raw land syndications. Counsel should at the least be aware of the possible applicability of regulation T, and should contact the Federal Reserve Bank of their district for advice if in doubt.

There is one practical point which it is important for all sellers of real estate securities to note: if a security is sold for "cash", § 220.4(c) of regulation T[22] requires that payment be made "promptly", but in no more than seven full business days after the security becomes available for delivery to the purchaser. The second or third stage of a real estate security may not be considered to be "issued", of course, until "made available by the issuer for delivery to purchasers", under § 220.4(c)(3), but counsel should carefully consult the provisions of this section before determining the actual dates before which payment must be obtained.

What of the future? The problem of the applicability of regulation T to real estate securities has arisen, essentially, because of changes in marketing practises. Resort condominiums are being packaged and sold to people who buy primarily for investment and have little if any intent to use them as second homes. Limited partnerships are being sold to large numbers of people for some of whom the tax benefits are marginal at best, and securities broker/dealers are beginning to offer these items and others as alternative "products" to conventional securities investments. These changes in the market give rise to seri-

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[19] *See, e.g.*, registration statement No. 2-46701 for Elkhorn at Sun Valley and preliminary prospectus dated March 2, 1973, for Crested Butte Overlook filed with the SEC.

[20] 38 Fed. Reg. 34988 (December 21, 1973), released to the press December 14, 1973:
220.6—CERTAIN TECHNICAL DETAILS

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(1) *Investment contract securities.* Credit for the purpose of purchasing or carrying any part of an investment contract security shall be deemed to be credit on the entire security.

[21] The amendment does not become effective until six months after its adoption, i.e. June 21, 1974. 28 Fed. Reg. 34988 (December 21, 1973).

[22] 12 C.F.R. § 220.4(c) (1973).

ous questions as to the Board's responsibility under the 1934 Act. The Board's primary responsibility is to prevent destabilizing use of credit in the securities markets. As noted above, however, it is not impossible that functioning secondary markets will spring up in real estate securities.

Investor protection is primarily the responsibility of the SEC. Nonetheless, as noted above, the Board's margin regulations were intended to have the secondary effect of helping protect investors from overextending themselves by purchasing securities on thin margins. It would be difficult to conclude that this reasoning does not apply to securities that are functionally indistinguishable from thinly-traded conventional equities.

Possibly the policy questions should be laid before Congress. Thus far, the industry has shown little interest in seeking legislation to resolve the various problems it has under the Securities Acts. But it is difficult to argue that because real estate securities were not known at the time the 1934 Act was conceived, they are not intended to be covered by the plain language of § 7. Statutes are supposed to be construed in such a way as to apply sensibly to new circumstances arising after their enactment.[23] Moreover, the *Howey*[24] and *Joiner*[25] decisions are approximately thirty years old, and Congress has been on notice at least since *Howey* that an investment contract covering the purchase of property with a related management contract is a "security". Thus there does seem to be a genuine question whether the sale by broker/dealers on credit of real estate securities—at least all but those clearly involving credit on second homes—should not be subject to margin requirements unless Congress makes a fresh review of the question and provides otherwise.

A final note might be added as to the proposals of the Real Estate Advisory Committee.[26] The Board's reaction to the REAC proposals might be similar to its reaction to H.R. 6821[27] (a bill providing for the registration and regulation of oil and gas programs). It would probably object to any change which removed from its jurisdiction or fixed in advance the rules to be applicable to margin on securities that are actually or potentially traded in a secondary market, and to any provisions pur-

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[23] J. SUTHERLAND, STATUTORY CONSTRUCTION § 7104, and *generally* § 600-7 (1943).

[24] SEC v. Howey, 328 U.S. 293 (1945).

[25] SEC v. Joiner Leasing Corp., 320 U.S. 334 (1943).

[26] REPORT OF REAL ESTATE ADVISORY COMMITTEE TO THE SECURITIES AND EXCHANGE COMMISSION (October 12, 1972).

[27] H.R. 6821, 93rd Cong., 1st Sess. (1973).

porting to define what is credit so narrowly as to constrict by implication the Board's necessary authority under § 7 of the 1934 Act.[28]

[28] Letter from the Board to the Honorable Harley O. Staggers, June 19, 1973, concerning H.R. 6821, 93rd Cong., 1st Sess. (1973).