

NEWS

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

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FOR RELEASE 1 P.M. E.D.T. THURSDAY, SEPTEMBER 28, 1972

REQUIREMENTS OF A NATIONAL MARKET IN REAL ESTATE SECURITIES

by

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Securities and Exchange Commission

September 28, 1972

4th National Real Estate
Conference & Exposition
Statler Hilton Hotel
New York City

Some people tell me that there is nothing new in real estate financing--that the syndication trend we are witnessing today is nothing more than the visible upside of a cyclical popularity of the limited partnership form of public ownership of real estate.

Whether real estate syndication in fact is an established business form that is enjoying renewed interest or an emerging financial institution that will provide new sources of risk capital for real estate ventures is an important question. It's important because the allocation of capital by competition among investment instruments in our nation's capital markets has been the basis of this nation's unparalleled economic growth, and if real estate securities are to effectively compete in this capital pool there is much to be done by the securities industry as well as the real estate industry. It will be necessary to assure that all who enter our capital markets play by the same rules. These rules must be so structured that no one industry has a competitive advantage over another which is not based on economic need and efficiency, particularly one imposed by unequal regulatory treatment.

With this question in mind let me trace for a moment the recent history of public ownership of real estate.

In the 1920's mortgage bonds were a particularly popular investment in the United States and approximately 10 billion dollars were placed in real estate securities. The Great Depression and the excessive carrying charges on these bonds forced many into default. The carrying charges were excessive because the face amounts of the bonds were frequently unreasonable in light of the underlying values of the property. Excessive loans based on fraudulent appraisals procured for the purpose of permitting the promoters to collect exorbitant front-end fees often assured in advance that the carrying charges would be excessive. The lack of adequate cash flow to meet scheduled distributions to the bond-holders caused the market value of these bonds to collapse. "Protective bondholders committees" were formed to represent the interest of the bondholders. But these committees were often controlled by the promoters who originally owned the properties and used their influence to buy back the bonds for a few cents on the dollar. A major scandal ensued and these abuses were well-publicized by investigations and hearings in the Congress.

In the late 1950's and early 1960's public real estate syndication enjoyed great popularity in New York. But the business collapsed because of an excess of offerings whose promised return exceeded economic reality. During this time companies emerged which specialized in the packaging and marketing of public real estate syndicates. In the competition for investors' money, the promoters promised annual cash yields in excess of 10 percent, even when it was evident in advance that the properties could not generate such cash flows. The pressures of high operating overhead for the syndicator's offices as well as a sales force hungry for a product lead the promoters to reach for properties that in other circumstances they would have ignored. They were willing to make up deficits in cash flow themselves by allowing buildings to go into disrepair or incurring second mortgages to meet promised distributions. The name of the game was to collect the syndication mark-up, as often as possible, meeting the promised yield on a previous offering in order to get the next one out. By the early 60's the over-priced and under-valued offerings had avalanched. This, coupled with several major bankruptcies resulting from sour deals, lead the New York regulatory authorities into a tough regulatory posture which finally ended the movement.

Shortly after the fall off of syndication activity in New York in the early 60's there emerged a group of firms in Southern California that concentrated on the sale of large amounts of under-developed acreage. These firms typically acquired large desert tracts or ranches and subdivided the land into a number of small parcels. They were sold primarily on the basis of investment potential without consideration of their appropriateness for investor use. This type of real estate syndication spread out from California and drove up the price of rural land throughout the decade of the 60's. Because of rising construction costs and higher land prices, apartments and other multi-family dwellings increased in importance and a greater portion of the annual housing starts were in the form of multi-family units. In 1967 and 1968 real estate mortgage investment trusts started providing substantial debt financing. With the emergence of the mortgage REIT as well as a resurgence of traditional sources of real estate debt financing following the decline of money market rates in 1970, substantial mortgage money was available for real estate development. This coupled with the tax aspects of the real estate syndicate investments; Congress' declaration of the national housing goal "of a decent

home and suitable living environment for every American family";^{2/} changing social-economic patterns in terms of higher incomes, greater mobility, more interest in non-resident related leisure; water and sewer moratoriums; stimulated growth in multi-family housing and recreational facilities, was the environment in which the popularity of the syndication of real estate interest manifest itself.

Recent figures show that tax shelter offerings filed with the NASD for the calendar year 1971 numbered 405, representing a gross dollar amount of 4.2 billion dollars. Of these 405 offerings 210 were real estate offerings, accounting for 3.1 billion dollars of which 90 were offered at the intra-state level representing 155 million dollars. In the calendar year of 1972 as of August 15, 305 tax shelter offerings were filed representing 20 percent of the volume of all issues filed and a gross dollar amount of 2.5 billion dollars. Of these 305 offerings, 165 were real estate offerings accounting for 1.6 billion dollars, of which 80 were offerings at the intra-state level representing 195 million dollars. These figures are based only on those offerings which are distributed by NASD members. They are,

^{2/}Housing and Urban Development Act of 1968

however, representative of the volume of real estate offerings as compared to other types of tax sheltered investments on an overall basis. They do not include any real estate offerings made under a corporate structure and do not include any agri-business (farming) type offerings which are somewhat real estate oriented. As real estate securities and other tax shelters are typically sold during the last months of the year to afford greater tax benefits to potential investors, the figures for 1972 can be expected to increase substantially over last year's figures.

Will this growth trend continue--will the dollar volume of real estate syndications offered to the public increase--or will the syndication phenomenon of real estate interests fade away to appear later in a heretofore cyclical pattern?

Syndications of real estate interest today are quite different than those of earlier periods. First, perhaps for the first time the regulators of securities are much more involved in the distribution of tax sheltered real estate syndications than ever before. The NASD, the Midwest Association of Securities Administrators and the North American Association of Securities Administrators, as well

as California and other states, have proposed rules to deal with real estate tax shelters. Second, the firms involved in the business are larger, more strongly capitalized and have to a greater extent more long term orientation in the sale of real estate interest than ever before. Broker dealers are sponsors of over 45 percent of all real estate tax shelters being filed with the NASD today. Names like Merrill Lynch, Blyth, and Eastman Dillon are among them. Thirdly, the economic forces behind the syndication of real estate are more significant, diverse and prevalent than ever before. All of these factors will be important but, in my view no more important than untangling a morass of confusion, misunderstanding and conflicting requirements which prevails in the regulation of real estate offerings today, in determining the durability of the current popularity of real estate syndications.

Real estate syndication is confronted by a whole host of regulatory problems. A great many real estate offerings are not registered. Analysis of filings with the Securities and Exchange Commission and some of the major states indicate that in some cases more than half the filings made with a

state agency have not been registered with the Securities and Exchange Commission, presumably in reliance on the private offering exemption or the intra-state exemption. I wonder how many syndicators realize that, no matter what the Securities and Exchange Commission does, they may well be giving away a put to any buyer in a position to decide later on that he doesn't like the investment and would prefer to have his money back.

In recent enforcement actions a syndicator sold over \$15 million dollars in unregistered real estate securities to 1296 investors, another sold 17 million dollars worth to 2000 investors over four years. Clearly real estate syndicators will have to face up to their registration obligations. We are working on clarification of the private offering and intra-state exemptions. These rules will come out soon, and the reputable real estate syndicator will have considerably less doubt as to when he is required to register.

There are problems and concerns in the type of disclosure, selling practices, conflicts of interest, sales and promotional compensation and on many other fronts. From this multiplicity of problems and the concern they have

generated comes what I consider the greatest danger to the current wave of public financing of real estate equities-- conflicting regulations which unless they round out will make it impossible to market real estate development on a national basis. We have a great national capital market. We don't want to set up barriers which will deprive housing and other types of real estate development of access to the full market and prevent capital from moving to the soundest and most attractive developments--no matter where they originate. Yet that is where we are headed if meeting the requirements in one jurisdiction makes it impossible to meet those in another. I am not calling for conformity. We can live with different standards but not with contradictory requirements which can only fragment our national capital market.

To assess these emerging problems last May I appointed a Real Estate Advisory Committee ("REAC") to the Commission to assist us in our review of the public offering of real estate interest. This committee, chaired by Raymond Dickey, a Washington, D.C. attorney, is due to report to the Commission within the next several weeks. I met briefly with them last week, and gather from our conversation

that you'll be very interested in what is in their report and that they will have a lot to say. Let me tell you what I think REAC's most significant contribution is going to be. It should be noted that in today's fast paced business and regulatory climate we often fail to stand far enough away from our specialty to look broadly at the entire problem before us. This does not appear to have been the case with REAC. They tentatively have concluded that the most overriding need in the offering of real estate securities is the need for uniformity of regulation. Accordingly, I understand that REAC is going to recommend some kind of a staffed permanent body, composed of representative state regulators, securities associations, the real estate industry, attorneys and accountants, to work continuously on harmonizing the regulation of real estate offerings by the state, the self-regulatory bodies and the Commission.

Anyone who has tried to register a real estate syndication on a national basis is aware of the conflicting regulations. The conflicting regulatory and disclosure requirements are so juxtaposed that compliance with a Securities and Exchange Commission requirement can result in a stop order in New York, Texas, California or elsewhere and vice versa. Let me illustrate the acuteness of the contradictory requirements with just one illustration. The Midwest proposal encourages the use of projections, provided they meet certain requirements, while the NASD prohibits forecast and projections of capital appreciation and assurances of safety or protection against loss. California would allow certain projections based on past operating statements but forbid those assuring future sale of properties. At least one state proposes to require projections. New York prohibits the use of projections outside of low cost government subsidized housing syndications. I am sure REAC's report will provide us with a list of conflicts. We will move rapidly to evaluate this report

thoroughly at the Commission and will want to take whatever action is appropriate to promote consistency of standards. It seems important to me that all securities regulators and associations which have proposed new real estate tax shelter rules withhold the implementation of them until we can have some kind of an organized exchange of ideas and principles with a view toward achieving uniformity.

At the outset I told you there was a great deal of work to be done by the securities industry as well as the real estate industry if real estate securities are going to effectively compete among themselves and among all other securities in our capital markets. The need for uniformity of regulation is just one part of the demanding work load ahead of us. There are liquidity, tax, and aftermarket problems with the real estate security which not only have to be disclosed but must be dealt with substantively to improve the investment characteristics of the real estate security in the hands of the holder.

We must also square the real estate syndicator's desire for tax shelter with sound investment objectives. This shelter comes from prepaid interest, points, finder's fees, commissions, accelerated depreciation and capital gains upon resale. The greater the portion of the investor's dollar that goes for these items the greater the tax shelter. Dollars invested that will be tax deductible are called "soft dollars," the remaining being "hard dollars." The syndicator's goal is to create as many "soft dollars" as possible, and the most marketable product is the investment that includes the greatest percentage of "soft dollars" in the first year's payment, since the syndicator's primary target is the person looking for a maximum tax shelter in the current year. Thus, the tax sheltered package must convert as much as possible of the initial payment into items like prepaid interest. The problem is such a package is usually highly reckless from a sound investment point of view and also presents an opportunity for exorbitant and undisclosed profits and fees to the principals

involved. We saw one deal come to us where 67 percent of the money to be raised was going to the principals.

A widespread method of packaging the "deep" tax shelter is through "all inclusive" or "wrap-around" financing to generate more "soft dollars" upon initial investment than traditional financing provides. Through a "wrap-around" or "all inclusive" trust deed (mortgage) the purchaser pays a small down payment and executes a trust deed for the remaining purchase price, which includes or "wraps around" the underlying debt. The purchaser makes payments on the "all inclusive" and the holder of the trust deed pays off or makes payments on the underlying liens. This permits the purchaser to execute a new note for the major portion of the entire purchase price and provides the opportunity to convert a major portion of the cash invested into prepaid interest.

This technique presents tax disadvantages to the seller in that it creates substantial ordinary income. The seller raises his price to compensate for this, and the syndicator passes on this highly inflated price to the investor. The syndicator thus has a conflict between bargaining for an

attractive deep "tax shelter" or for a fair purchase price. Since the tax shelter is hard to find and the fairness of the price easy to cover up, the syndicator is induced to accept the inflated price.

The tax incentive also provides peculiar disclosure problems. If the issuer really isn't a partnership for federal tax purposes, it will be deemed an association taxable as though it were a corporation, and the rationale for the whole thing collapses.

Right now we don't require a ruling from the Internal Revenue Service; we'll take the opinion of qualified tax counsel. However, the prospectus must drive home the consequences to the investor if counsel is wrong; tax lawyers, after all, have been know to err. If the deal is really only suitable to high tax bracket investors, we also try to get that across.

Another tax disclosure problem relates to the consequences of recapture. Should the property acquired by the partnership on which accelerated depreciation is

elected be disposed of voluntarily or involuntarily -- through foreclosure or otherwise, the investor may suffer severe and adverse tax consequences. In essence, upon sale, because of recapture, the investor will have to pay a tax (at ordinary income rates) on the difference between accelerated depreciation and that which would have been taken had straight line depreciation been used. This liability could well exceed the investor's investment in the partnership.

In addition the prospectus should point out that there is no assurance that the tax treatment will stay the same throughout the life of the investment. The Internal Revenue Service has been known to change its interpretations and regulations and Congress has some history of changing the tax law.

Another substantial area which must be addressed involves the use of sales literature. Preliminary investigation shows that sales literature and not the

prospectus is the material primarily used to market real estate securities. More often than not the sales literature contains optimistic projections of the economic return anticipated from the investment, without disclosing the assumptions on which the projections are made. The sales literature also contains elaborate assurances of the safety and soundness of investment in the program. Much of the material found in the sales literature has been stricken from use in the prospectus by the SEC or state securities regulators. In addition, the sales literature usually omits the more significant information needed to assess the investment risk and sponsor's profits. Real estate syndicators should be aware of the considerable liability they risk by the use of such literature.

Regardless of the difficulty of the task which faces us, I feel that the time has come to remove the impediments to investment caused by the fact that the real estate security is generally too complicated to be sold to the general public and is often too elusive for standard and uniform disclosure of the economic realities. Uniform standards for disclosure and analysis must be developed and the complications must be

simplified to allow an informed investment decision in a product which is commonly being offered to the public. Without such an approach, disillusionment will again set in and the real estate limited partnership security will fade away for another thirty years. We're all too old to wait for the cycle to bring it back again.