NEWS
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 755-4846

AN ADDRESS BEFORE THE

SAN DIEGO MORTGAGE BANKERS ASSOCIATION

By Ray Garrett, Jr., Chairman

Securities and Exchange Commission

July 2, 1974

SAN DIEGO MORTGAGE
BANKERS ASSOCIATION

San Diego, California

Ladies and gentlemen --

It is obvious that the people who organize conferences on securities laws have discovered San Diego, and I think it's great. Not only am I very fond of this lovely city, but I also like to visit my daughter Nancy, her husband John Worcester, and our granddaughter Hadley. Ever since the U.S. Navy introduced them to San Diego, we have rarely seen them back East. So I am a doubly easy mark to accept an invitation to come here.

My visit at this particular time is occasioned by a two-week series of seminars on federal securities laws just getting under way at the Del Coronado. This is an ambitious undertaking of a very worthy organization with a name that cries out for some handy acronym -- the Joint Committee on Continuing Legal Education of the American Law Institute and the American Bar Association. Only lawyers could put up with something like that.

Last year was the first year for this two-week seminar, and it was held at about this time at Haverford College, near Philadelphia. I had agreed to appear for two days as one of the faculty and the weekend I arrived at Haverford the news had leaked out that I would be the next Chairman of the SEC. That is to say, the newspapers all seemed to know it, but the President had not yet announced his decision. Until he did, I didn't want to talk to reporters, and it all got both exciting and amusing. I was sneaked out of Haverford through a back door and flown here, where a car picked me up in the dark of night and drove me to San Clemente. The next morning I visited with the President and General Haig and the announcement was made. Then, of course, there was no escaping the media.

Most of the reporters seemed baffled that I would take the job and kept searching for reasons. I recall one telephone interview in particular where the reporter asked in menacing tones if I had contributed to the President's campaign. I said yes. He said, "May I ask how much?" I replied, "I think it was $100." He muttered an expletive which I shall delete and cut the interview short.

Actually, it was not a bad time to go to Washington, and especially not a bad time to go with the SEC. As citizens, we are, of course, not indifferent to the Constitutional crisis facing our nation. But we don't discuss the subject at the office. We go about our business to the best of our ability and wisdom. We have an unusually able and compatible group of Commissioners and a splendid staff. While the Commission, by law, is bipartisan -

currently three Republicans and two Democrats -- party politics play no part in our deliberations. Naturally our votes are not all unanimous, but we have never split on party lines.

Nor have we found it difficult to attract good people to the staff or it unusually difficult to retain them. For several reasons, mainly salary, it is always something of a problem to retain the most able people on the staff. At the top level, our staff people are bumping a government-wide ceiling of $36,000. Someone has calculated that these senior government executives have, in fact, experienced a 30 percent reduction in purchasing power over the last 5 years. But this is not a problem peculiar to the SEC.

I have read reports in newspapers describing a sort of massive paralysis in the federal government, as though everyone in Washington has stopped work and was waiting in bewilderment for the impeachment crisis to be resolved. This does not at all describe that part of the government that I can see and that we work with. I think, rather, that in many parts of the government, if not all, there is a special sense of dedication and responsibility -- an awareness of the deep concern that so many citizens feel about their government and a determination to keep things going in our respective areas of concern.

This is also something of an anniversary for the SEC. Exactly 40 years ago today the Commission held its first official meeting. When the Securities Act was adopted in 1933, the administration of the Act was assigned to the Federal Trade Commission, which was already in existence, having been established in 1916. But the Securities Exchange Act of 1934, extending federal regulatory jurisdiction over the stock exchanges and the trading markets generally, also created the Securities and Exchange Commission and assigned the regulatory duties under the '33 Act, as well as the '34 Act, to the new agency.

For the first Chairman of the SEC, President Roosevelt selected Joseph P. Kennedy, who was candid enough to observe that if these laws had been enacted 10 years earlier, he would never have been a millionaire. Mr. Kennedy was to serve 13 months and then move over to become Chairman of the Maritime Commission and, later, our ambassador to the Court of St. James.

The other members of the initial body were George C. Matthews, a public utility engineer who stayed for 6 years and then went with a major public utility company; James M. Landis, who was one of the principal draftsmen of the two Acts, succeeded

Joseph Kennedy as Chairman and two years later resigned to become Dean of the Harvard Law School; Robert E. Healy, a state judge from Vermont, who served longer than anyone else as an SEC Commissioner -- 12 years -- and died in office in 1946; and Ferdinand Pecora, who had been chief counsel to the Congressional committee investigating the stock markets and left after 6 months to become a judge in New York.

The record does not reveal that anything terribly exciting occurred that first day, but the initial Commission set certain patterns that are still apparent. One is relatively short tenure for Commissioners, even shorter for Chairman. Our official term of office is 5 years, one expiring each June 5, but the average period in office is 3 years and 8 months. The average term for Chairmen is 2 years and 4 months. They also contributed to the early establishment of imaginative, not to say, aggressive, construction of our laws to bring within the fold all interests that might plausibly come within the broad definition of "security" where the policy of full disclosure and investor protection seemed applicable.

Some other federal agencies have been quick to accept statutory constructions leading to their lack of authority and, hence, of responsibility. The SEC has never had this sort of shyness. In the firm belief that registration and accompanying investor protections are good for people as a whole, and realizing that Congressional clarification of jurisdictional vagueness might be long in coming, the Commission has always shown a readiness to extend the reach of its statutes as far as a reasonable reading of the statutes would allow.

From time to time this has led us into alien and hostile territory, not always with happy results. For example, the Commission persuaded the Supreme Court that variable annuity contracts offered by insurance companies are securities and that the variable annuity portfolio or fund thus created is an investment company subject to registration under the Investment Company Act of 1940, and that the salesmen of variable annuities are securities broker-dealers subject to registration as such under the '34 Act. Since then, the Commission has not had great trouble with the Securities Act application but the '40 Act registration has been something of a nightmare.

We are now caught up in the throes of deciding when variable life insurance policies should fit under our Acts. Because of the competitive problems involved on the industry side and, in a sense, on the government side, it is the sort of game we can't win. Any decision we make is certain to be unpopular with a great many people.

The emphasis in the Commission's activities has naturally changed from time to time as our financial markets have changed. Sometimes we have trouble keeping up. Not very long ago a major problem for the Commission was simply processing the great flood of registrations of new offerings being filed. The original 10-day deficiency letter of which the staff had so long been proud disappeared, never to return, and registrants were waiting months for comments on their filings. Staff ingenuity was devoted to devising means of expediting selected categories of filings.

The Commission got alarmed at the wild price gyrations of many first offerings and undertook a special study of so-called "hot" issues. By the time the study was completed and the staff was ready with its recommendations, the problem had all but disappeared. But we will be ready if hot issues ever come back.

Some problems seem always to be with us. One of them is the matter of enforcement of our laws and the suppression of fraud. Businessmen sometimes complain that SEC Commissioners are always talking about fraud, creating the public impression that American business generally is run by a bunch of crooks. Obviously, that is not a correct impression.

If it were -- if crooks really dominated our business community -- the task of the Commission would be utterly hopeless. The only reason our system works at all is because voluntary compliance is the norm and non-compliance the aberration.

Furthermore, all violations of the securities laws cannot fairly be characterized as fraud. Perhaps we use the word too loosely.

Nevertheless, there are some crooks in business and some fraud continues to be committed, and in this area, as in others, the policeman's lot is not a happy one. Quite naturally the instances of fraud, when exposed, attract the most attention. In a sense I wish some of them would attract more attention. Some types of fraud depend upon credulous investors who really should know better.

The two most recent cases to attract nation-wide attention -- Home-Stake Oil and the industrial wine fraud -- were both variations on the classical Ponzi scheme. The first investors were paid off out of the proceeds of sales to later investors and nothing, or very little, was ever invested in the supposed business.

The facts in Home-Stake go back several years, and the case is receiving current attention only because the Chapter X trustee recently submitted a list of the names and amounts of the investors. It is a most illustrious list of leaders of industry and finance. At least those who have lost money in Home-Stake have the dubious satisfaction of being in elegant company.

The wine fraud centered in the Washington, D. C., area and it included among its victims some local bank presidents. The scheme was to corner the market in Portugal for cheap "industrial" wine -- a non-existent item in the wine industry -- and import it for sale to U.S. canners of salad dressings, etc. Investors were offered something like double their money in a year.

You would like to think that a promoter offering a chance to double your money in a year in the Portuguese industrial wine market simply would be laughed at. But, of course, many people did double their money -- as long as the promoter was able to keep selling enough notes to produce funds to pay off the earlier ones.

Some of the stories the local papers are picking up are heart-rending. One widow with children approaching college age cashed in her entire savings of $10,000 to invest in the wine scheme and it is unlikely that she will recover much, if any, of this. Except for the basic implausibility of the whole thing, she had tried to be careful. Before plunging, she took the proposal to a lawyer for his advice. He not only advised her to go ahead; it looked so good to him that he put $10,000 of his own money into the scheme!

It was our staff that broke the case. We were on the job and moved with commendable speed as soon as we had reason to believe something was wrong. But a lot of people have been badly hurt.

There is nothing new about fraud, of course, but the state of our capital markets is new. Stock prices have been down before. In fact, the SEC was born when they were very much down and there were grave doubts that they would ever revive. But the combination of events is new. Never before have we had such low stock prices with such a high cost of money and high rate of business activity.

The SEC has traditionally, and for good reason, tried to remain aloof from stock prices as long as the market is operating fairly, and certainly we have no authority to cause prices to go up or down. But we share the concern of those who wonder where the capital, especially the equity capital, is coming from to meet the enormous projected demands of U.S. industry over the next decade, unless equity investments become more attractive.

In part, because of the poor market for stock and the accelerated rate of inflation, investors are turning to other forms of investment, some of which are giving us new problems. I refer to such things as Scotch Whiskey, coins, stamps, and, of course, resort real estate. Let me spend my remaining minutes on this last topic.

In this area we are faced with one fundamental question. When, if ever, is the sale of a condominium unit a security within the meaning of the Securities Act of 1933 and the Securities Exchange Act of 1934?

If the units are securities within the meaning of those Acts, then they may not be offered for sale or sold without effective registration under the Securities Act -- unless some exemption is available, such as the intrastate or private offering exemptions, or, the Regulation A exemptions for offerings of less than $500,000. Failure to comply with the registration requirements, where no exemption is available, gives the purchaser a one-year right of rescission -- a free one-year "put," as some describe it. It also enables the Commission to go to court to enjoin the unlawful sales and any future unlawful sales.

These are the consequences of failing to register when legally required to do so. If one registers but fails to comply with the requirements for full and fair disclosure, other remedies are available with a longer statute of limitations.

But none of this applies unless a security is involved. Interests in property are not ordinarily securities. We have nothing to do with the normal buying and selling of interests in property, and we don't want to have anything to do with it. From the earliest days of our Acts, however, we have been concerned when the sale of interests in property are accompanied by other features so that the purchaser of the property, while indeed acquiring title to property -- not in itself a security -- is also investing in an enterprise to be managed by others from which he hopes to reap profit. In such a case, we have said that a security is involved -- an "investment contract" in statutory terms -- and the U.S. Supreme Court agreed as early as 1946.

Based on this analysis, eighty-two condominium registration statements have been filed with the Commission from 1967 to the present. The Commission instituted several enforcement actions against condominium sales in the late '60s. But it was not until January, 1973, that the Commission formally expressed a general position with respect to the offer and sale of condominiums as securities. At that time, Securities Act Release No. 5347 was published to provide guidance to condominium developers as to the applicability of the federal securities laws to offers and sales of condominiums or units in real estate developments. In the release, the Commission reached the conclusion that an investment contract, a security, is offered and sold if condominiums are offered and sold in conjunction with any of the following:

1. Any rental arrangement or other similar service 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 the rental of the condominium;

2. The offering of a participation in a rental pool arrangement; or

3. The offering of a rental or similar arrangement whereby the purchaser must hold his unit available for rental for any part of the year, must use an exclusive rental agent or is otherwise materially restricted in his occupancy or rental of the unit.

Accompanied by varying degrees of understanding, this pronouncement caused quite a stir among developers of resort real estate who had not previously viewed themselves as being in the securities business -- some still don't. Thirty of the eighty-two condominium registrations have been filed since publication of that release.

Processing those eighty-two registration statements, responding to innumerable interpretative and "no action" requests, and filing several injunctive actions against violations of the federal securities laws have provided the Commission and its staff with a significant amount of experience in the condominium field. And, from our point of view, the result of this experience has established a sound foundation for responding to the needs of condominium developers and, at the same time, assuring public investors the information and protection guaranteed by the Securities Act.

The Division of Corporation Finance has designated a special branch to process all condominium registration statements and related questions. Developers now spend far less time "in registration." The staff issues its first letter of comment on the registration statement about thirty days from the filing date. The length of the average prospectus has been reduced to between twenty and thirty pages. The prospectus now provides more information, in a clear manner, directly stating the facts necessary for an offeree to make an informed investment decision. The prospectus format and type of information required is widely understood by lawyers engaged in this type of work.

The threshold question which continues to plague developers and the Commission alike is: "when is a condominium offered and sold in such a manner that it becomes part of an investment contract?" Release No. 5347 does try to provide real answers to this question. But unfortunately, classification of this thing offered as a security usually depends at least in part on the oral representations made at the time of each offer and sale. This approach to defining securities was utilized by the Supreme Court in SEC v. C. M. Joiner Leasing Corp. where the Court noted that "In the enforcement of [the Securities Act], it is not inappropriate that promoters' offerings be judged as being what they were represented to be." 1/ This factor naturally causes confusion in any consideration of proposed "facts" for the purpose of giving sound legal interpretations, no less so for the private bar than for the Commission's staff. Now that the real estate industry and the Commission have lived and worked with Release 5347 for a year and a half, the staff is considering whether it can improve the usefulness of the present guidelines.

The staff has adopted progressively more stringent warnings in responding to requests for "no action" that any deviation from the proposed "facts" presented for consideration will destroy the efficacy of the staff's "no action" letter.

An area of considerable concern to developers and to real estate salesmen is the metamorphosis, under particular circumstances, of real estate salesmen into securities salesmen who may be required to register with the Commission as securities broker-dealers. Quite naturally, a profession which is traditionally the subject of state regulation has an aversion to additional regulation at the federal level --

---

1/ 320 U.S. 344, 353 (1943).

even more so where the industry views the offer and sale of residential real estate or the arrangement of rental services as the traditional function and province of the real estate broker and his agents.

When an investment contract security is offered and sold, the federal regulatory scheme does impinge on the participants. If an exemption from registration as a broker-dealer is not available to the real estate salesman, registration as a broker-dealer is required by the statute. The Exchange Act defines a broker as any person engaged in the business of effecting transactions in securities for the account of others (but it excludes banks).

Many real estate developers retain their own employees to sell the condominium projects under development. This may be on a salaried or salaried plus commission basis. Generally speaking, so long as the salesman is a bona fide employee of the developer, is not employed solely for the purpose of making sales, and has the intention to remain an employee after sales are completed, the definition of broker is thought not to apply to the salesman. This is the so-called "issuer's exemption." But, this is an umbrella exemption for which the issuer, the developer, and not just the salesman, must qualify. A problem arises with respect to the developer's qualification for an exemption if the developer engages in the successive development and sale of several condominium projects as investment contract securities. Then, the developer may be viewed as a broker, as that term is defined in the Securities Exchange Act, that is, a person "engaged in the business of effecting transactions in securities for the account of others". This pattern of securities sales may cause the exemption to be unavailable, even though the application of the broker-dealer registration requirements may not be apparent at the time of the developer's first experience selling real estate securities. The interstate nature of resort real estate sales limits the utility of the registration exemption to broker-dealers with a strictly intrastate business.

The last topic I will mention today is the one that for a considerable period of time has cast a pall over the development and marketing of condominium and similar securities. If a broker-dealer were to participate in selling the condominium securities, Regulation T, and to a lesser extent, Section 11(d)(1) of the Exchange Act, could function to prohibit arrangements of credit for purchasers by either the developer or the broker-dealer. The Federal Reserve Board administers Regulation T and the Commission administers Section 11(d)(1), although the Securities Exchange Act provides for both. Both provisions control arrangements for credit in the sale of securities. As you are well aware, the Commission recently published for public comment a proposal to ameliorate the harsh consequences deriving from the application of these provisions to the offer and sale of direct interests in residential real estate.

The Federal Reserve Board has had considerable unpleasant experience trying to interpret the application of Regulation T to the sale of condominium securities. This parallels the Commission's own difficulty with application of broker-dealer principles to employees of developers and real estate salesmen, and of the credit provisions of Section 11(d)(1).

From the time the implications of Regulation T in financing of condominium securities became apparent, the Federal Reserve Board took an interpretative position which had the effect of excluding from the operation of the Regulation arrangements for mortgage credit on certain real estate. Essentially, the Board viewed the real estate and the rental arrangement as separable. As long as the mortgage was extended exclusively on the fair market value of the real estate, the Board said the extension of credit was not for the purpose of purchasing a "security." Of course, in Release No. 5347, the Commission expressed the view that the real estate and rental arrangement were inseparable for purposes of defining the security to be offered and sold. In the face of this anomaly and of growing dissatisfaction with the interpretation with respect to condominium securities for the purposes of Regulation T, the Board felt constrained to propose an amendment to Regulation T, which would have had the effect of reversing their prior interpretations and placing Regulation T squarely on top of the financing of condominium securities. This would have prevented participation of securities broker-dealers in the offer of condominium securities for which financing was arranged. The possible securities broker-dealer status of many real estate salesmen, which I have just mentioned, and the need for credit in sales of real estate, seemed to the industry to sound its death knell. The Board's amendment to Regulation T was to have taken effect on June 21, 1974.

The Commission has long recognized the unique characteristics of this type of investment contract, similar as it is to conventional purchases of real estate with the functional limitations on creation of an active secondary market. A careful review of the history of Section 7 of the Securities Exchange Act, authorizing the promulgation of Regulation T, and of Section 11(d)(1) of that Act, confirms that the problems and abuses they are designed to correct may not be present in the direct ownership of residential real estate even if it is offered and sold as an investment contract. In the view of the Commission, it may be appropriate to provide an exemption from the operation of these provisions for the offer and sale of this type of security. As a result of consultation with the Federal Reserve Board, the Commission has proposed to utilize its rulemaking power to provide an exemption from these provisions. The Board has announced a deferral for six months of the effectiveness of its amendment to Regulation T.

The Commission's proposal to adopt Securities Exchange Act Rule 3a12-5 was published for public comment on June 7. 2/ The public has until August 15 to submit comments. The Commission does not expect to take further action on the proposal until the comment period has expired and the public comments received are given the careful consideration of the staff and the Commission.

It should be noted that the proposed exemption would be limited to securities which involve direct ownership in residential real estate, and which are offered and sold in transactions complying with the provisions of the proposed rule:

2/ Securities Exchange Act Release No. 10845 (June 7, 1974).

1. The debt is secured by a mortgage or other security interest which is related only to the real property;

2. The amount of the credit is reasonably related to the market value of the real property on the date the credit is extended;

3. The lender is not an affiliate of the broker-dealer or the issuer of the securities;

4. The broker or dealer delivers specified written information to the purchaser; and

5. The broker-dealer reasonably determines that the entire transaction, including the loan arrangement, is suitable for the purchase.

The third condition, that is, the independence of the lender from the developer and the broker-dealer, is perhaps the most important investor safeguard in the proposed rule, and it certainly has the most significance to the mortgage banking industry -- although all of its other conditions are important as well. This feature of the proposed rule goes to the basic concern of the Congress in legislating the credit controls in the Exchange Act: the abuse of credit made possible by the self-interest of a broker or dealer intent upon making sales of securities and at the same time arranging credit for those sales. Abuses such as overvaluing the securities for credit purposes, offering excessive credit as an inducement to purchase securities, and encouraging, against the customer's best interests, the financing of purchases of securities, were all sought to be avoided. The Commission believes that the requirement of an independent lender in proposed Rule 3a12-5 will remove this conflict and help to assure the proper availability of credit to purchasers of condominium securities. We are depending to a large extent on the judgment of the independent lender.

Although not presently covered by the proposed rule, the Commission is seeking advice concerning inclusion of direct interests in foreign residential real estate not conveyable in fee simple under foreign law and of direct interests in domestic real property which is not residential in character.

As I suggested earlier, many real estate developers have had little experience with the federal securities laws. Disbelief has encouraged some to ignore the requirement of registration, and some appear to have adopted an attitude of "catch me and prove it in court." (I must say in all fairness that this attitude is not unique to real estate developers.) The Commission has undertaken vigorous investigatory and enforcement action to discourage this attitude.

The fruits of these actions are only partially visible in the Marasol and the Hare, Brewer & Kelley actions, the former now concluded with an injunction. Reports received by the Commission indicate that more enforcement action is called for in the future.

Another facet of enforcement is perhaps of more importance to you, that is, the right of private action under the federal securities laws. As the public becomes increasingly aware of this remedy, the frequency of its use and attempted use will undoubtedly increase. Unless developers register their condominiums and rental arrangements, and their sales personnel, when appropriate, they provide their purchasers with an important and effective method of voiding the transaction, either before or after closing. This frustrates the developer's purpose, which is to sell, and also must erode the confidence of mortgage lenders in resort condominiums, and perhaps in condominiums in general.

In conclusion, there are essentially three areas of concern to the Commission today with respect to investment contracts involving condominiums and other interests in real property.

First, raising the level of compliance with the registration provisions of the Securities Act. The Commission hopes to achieve this goal by reducing the confusion as to when a security arises, simplifying the registration and disclosure practices, and vigorous enforcement action for failure to comply.

Second, eliminating confusion created by the broker-dealer registration requirements for those who are essentially real estate brokers. Possible solutions for these problems are under study by the Commission's staff.

And, third, credit restrictions that may hamper development and sales of condominium securities. The Commission's proposal to adopt a new category of exempt securities should eliminate most of the problems under Regulation T and Section 11(d)(1).