

Date of Hearing: July 2, 2012

ASSEMBLY COMMITTEE ON BANKING AND FINANCE

Mike Eng, Chair

SB 978 (Vargas & Price) – As Amended: June 18, 2012

SENATE VOTE: 38-0

SUBJECT: Securities transactions: exemption from qualification requirements.

SUMMARY: Enacts several changes to the Real Estate Law and Corporations Code, by increasing real estate investor protections, and requiring the Department of Corporations (DOC) to focus greater regulatory scrutiny on, and provide greater transparency regarding, the activities of those who solicit investors in connection with real estate investments. Specifically, this bill:

- 1) Adds the following requirements to the portion of the Real Estate Law, which regulates real estate brokers who make or broker loans funded by a single investor:
 - a) The loans for which investors are sought could not exceed specified loan-to-value (LTV) ratios specified in the statute. These LTVs would vary from 35% to 80%, depending on the type of property and its intended use (i.e., developed single-family residence, developed commercial, construction, undeveloped, etc.). This bill also imposes additional, specified requirements governing property valuations and loan disbursements, when all or a portion of the loan is used for construction or rehabilitation; and,
 - b) Interests in loans could not be sold, unless the real estate broker soliciting the investor ensures that the investor meets at least one of the following two requirements: the investment does not exceed 10% of the investor's net worth, exclusive of home, furnishings, and automobiles; or the investment does not exceed 10% of the investor's adjusted gross income for federal income tax purposes for the last tax year or, in the alternative, as estimated for the current year.
- 2) Requires every real estate broker that solicits investors for privately-funded loans to make reasonable effort to ensure all of the following, on the basis of information he or she obtains from the purchaser:
 - a) All persons to whom securities are sold can be reasonably assumed to have the capacity to understand the fundamental aspects of the investment, by reason of their educational, business or financial experience;
 - b) All persons to whom securities are sold can bear the economic risk of the investment; and,
 - c) The investment in the security is suitable and appropriate for each purchaser, given the purchaser's investment objective, portfolio structure, and financial situation.
- 3) Requires any issuer that claims a securities qualification exemption for the offer or sale of securities involving real property for an offering which involves the offer or sale of securities to any person who is not an accredited investor and which involves the offer or sale of

securities that are not registered with the United States Securities and Exchange Commission to provide additional information regarding the nature of their proposed offering to DOC on a form prescribed by the DOC Commissioner.

- 4) Requires any issuer that claims a securities qualification exemption, and that is engaged in the business of purchasing, selling, financing, or brokering real estate for an offering which involves the offer or sale of securities to any person who is not an accredited investor and which involves the offer or sale of securities that are not registered with the United States Securities and Exchange Commission to make reasonable efforts to ensure all of the following:
 - a) All persons to whom securities are sold can be reasonably assumed to have the capacity to understand the fundamental aspects of the investment, by reason of their educational, business, or financial experience;
 - b) All persons to whom securities are sold can bear the economic risk of the investment; and,
 - c) The investment in the security is suitable and appropriate for each purchaser, given the purchaser's investment objective, portfolio structure, and financial situation.
- 5) Requires the DOC Commissioner to annually prepare a report, as specified, for publication on the DOC's Internet Web site, summarizing data collected from persons to which it issues securities permits.
- 6) Authorizes the DOC Commissioner to examine those persons to which it issues permits pursuant to Corporations Code Section 25113, review compliance with the conditions of the permits and other applicable state law, and disqualify an offering permitted pursuant to Corporations Code, Section 25113, if he or she finds that the issuer materially violated the provisions of their permit.

EXISTING FEDERAL LAW:

- 1) Establishes the Securities Act of 1933 and the Securities and Exchange Act of 1934 administered by the Securities and Exchange Commission.
- 2) Establishes the National Association of Security Dealers that helps define the national behavior standards for member and minimum standards for listed securities which is regulated by the Securities and Exchange Commission.
- 3) Defines an "accredited investor" as any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:
 - a) Any bank or any savings and loan association or other institution whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company, any investment company registered under the Investment Company Act of 1940 or a business development company, any Small Business Investment Company licensed by the U.S. Small Business

Administration, any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of \$5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of \$5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

- b) Any private business development company;
- c) Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$5,000,000;
- d) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;
- e) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000;
- f) Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;
- g) Any trust, with total assets in excess of \$5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person; and,
- h) Any entity in which all of the equity owners are accredited investors. [17 C.F.R. 230.501] [Rule 501, Regulation D]

EXISTING STATE LAW

- 1) Establishes the Corporate Securities Law of 1968 provides for exemptions from qualification for certain securities transactions. [Corporations Code, commencing with Section 25000]
- 2) Provides that the Commissioner of the DOC to approve all securities offered or sold in California. [Corporation Code, Section 25100]
- 3) Prohibits any person to offer or sell in this state any security in an issuer transaction whether or not by or through underwriters, unless such sale has been qualified under Section 25111, 25112 or 25113 or unless such security or transaction is exempted or not subject to qualification. The offer or sale of such a security in a manner that varies or differs from, exceeds the scope of, or fails to conform with either a material term or material condition of

qualification of the offering as set forth in the permit or qualification order, or a material representation as to the manner of offering which is set forth in the application for qualification, shall be an unqualified offer or sale. [Corporations Code, Section 25110]

- 4) Requires all purchasers to have either have a preexisting personal or business relationship with the offeror or any of its partners, officers, directors or controlling persons, or managers (as appointed or elected by the members) if the offeror is a limited liability company, or by reason of their business or financial experience or the business or financial experience of their professional advisers who are unaffiliated with and who are not compensated by the issuer or any affiliate or selling agent of the issuer, directly or indirectly, could be reasonably assumed to have the capacity to protect their own interests in connection with the transaction. [Corporations Code, Section 25102 (f)]
- 5) Defines "issuer" as any person who issues or proposes to issue any security, except when specified. [Corporations Code, Section 25010]
- 6) Requires every issuer qualifying securities for sale in this state to keep and maintain a complete set of books, records, and accounts of such sales and the disposition of the proceeds thereof, and shall thereafter, at such times as are required by the commissioner, make and file in the office of the commissioner a report, setting forth the securities sold by it under such qualification, the proceeds derived there from and the disposition thereof. [Corporations Code, Section 25145]
- 7) Requires California Real Estate Law, Finance Lenders Law, and Residential Mortgage Lending Act licensees to comply with the federal Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (the SAFE Act) by requiring those engaging in mortgage loan origination activities to obtain a license from DOC after meeting specified requirements, or if a real estate licensee, obtain a license endorsement from the Department of Real Estate after meeting specified requirements.

FISCAL EFFECT: Unknown.

COMMENTS:

According to the author, SB 978 would amend several actions of law governing the ability of entities to solicit funds from investors. The contents of the bill implement a series of recommendations stemming from a joint informational hearing held by Senate Banking and Financial Institutions Committee and Senate Business, Professions and Economic Development Committee on hard money lending on January 18, 2012. The changes contained in SB 978 would increase the reporting requirements on those who seek to raise money from investors pursuant to Corporations Codes securities law exemptions. SB 978 would also increase the protections available to people who invest their savings with entities soliciting funds for real estate investments.

What is hard money lending?

While hard money lending is not defined in statute, most hard money comes from private individuals with a great deal of money on hand. The money used for investment purposes comes from people, not a typical lending institution.

Most hard money lenders lend solely based upon the deal or property at hand. They only lend up to a certain percentage of the fair market value of the property, that way in the event of default, the hard money lender would profit if they had to foreclose or sell. Hard money lending is common in real estate and construction characterized by short-term, high-interest loans and relaxed underwriting standards. Hard money lending is typically used by investors intending to buy a blighted property and rehabilitate it to increase its market value. Most hard money lending happens in lower-middle class neighborhoods where property values are relatively stable and blighted properties are available to purchase at significant discounts.

Typically hard money lenders will only loan you up to 70% ARV (after repaired value). This means that a hard money lender can loan you up to 70% of what the home is worth in repaired condition. So if a home is worth \$45,000 in the condition it's in and needs \$20,000 in repair work and after it is repaired the current fair market value is worth \$100,000, then typically a hard money lender can lend you up to \$70,000, which would cover the cost of the house and the repairs. Hard money lenders will often loan the investor the funds necessary to both purchase the property and to complete its rehabilitation.

A downside to hard money lending is high interest rates. Interest rates vary from 12% - 20% annually and terms can last for 6 months to a few years. Many times these rates vary depending on a credit score. Typically hard money lenders will charge anywhere from 2-10 points just to use their money. One point equals one percent of the mortgage amount. So charging 1 point on a \$100,000 loan would be \$1000.

Investors also use hard money when they need to purchase quickly. Typical soft money or conventional loans take 30 days or more.

State securities laws generally authorize two types of activity: (1) permitted or qualified activity, which requires the submission of application documents to DOC, and the review and approval of those documents, before money may be raised from investors; and (2) exempt activity, which allows persons to raise money from investors without a lengthy and costly securities filing requirement, provided they adhere to the rules which apply to the exemption under which they are operating.

The Real Estate Law also authorizes the solicitation of investors in connection with hard money lending, and defines a class of brokers called threshold brokers, who can generally be thought of as those who make, broker, and/or service mortgage loans that are funded by private individuals and small pension plans, and who are authorized to solicit investors to fund these loans. In deference to the nature of their activities, threshold brokers are subject to several layers of regulatory supervision and reporting to which other real estate brokers are not. The special rules that apply to threshold brokers are found in Articles 5 and 6 of the Real Estate Law. Real estate brokers who make or broker single-investor loans (i.e., loans where a single investor funds the entire loan) must follow Article 5. Real estate brokers who make or broker multi-investor loans (i.e., loans with between two and ten investors funding the loan) must follow Articles 5 and 6. Both types of brokers (single-investor and multi-investor) are also subject to all of the other provisions of the Real Estate Law that apply to non-threshold brokers.

Money raised from investors is typically lent out either pursuant to the rules contained in the Real Estate Law or (less commonly) pursuant to the California Finance Lenders Law.

PREVIOUS LEGISLATION

SB 53 (Calderon and Vargas), Chapter 717, Statutes of 2011: Enacted several changes to California's Real Estate Law, to give DRE more enforcement tools with which to crack down against mortgage fraud and other real estate violations, add safeguards to protect consumers who seek out services from real estate licensees, and make technical changes. Among its provisions, the bill included a requirement that hard money lenders operating under Article 6 inform their investors about which provision or provisions of the Real Estate Law or the Corporate Securities Law govern their transactions. Prior to enactment of SB 53, that information was required to be documented in a licensee's files, but was not required to be shared with investors.

AB 2288 ((Blakeslee) 2010 Legislative Year) Failed passage in Assembly Banking and Finance Committee. Would have implemented specific criteria for issuers involved in hard money lending.

REGISTERED SUPPORT / OPPOSITION:

Support

None on file.

Opposition

1 individual

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