

5. The purchase of credit life or credit disability insurance cannot be a condition of making the loan.
6. If the property securing the loan, either directly or collaterally, is an owner-occupied dwelling of less than three units and is not a note given back to the seller by the purchaser, then no payment that is more than twice the amount of the smallest payment can be due in less than 73 months; therefore, the installment payments must be substantially equal for an owner-occupied dwelling loan with a term of six years or less.
7. If the property securing the loan, either directly or collaterally, is not a note given back to the seller by the purchaser and is not an owner-occupied dwelling of less than three units, then no payment that is more than twice the amount of the smallest payment can be due in less than three years; therefore, the installment payments must be substantially equal for loan on an owner-occupied dwelling of less than three units.
8. A late charge cannot be more than 10% of the principal and interest installment due except that a minimum of \$5 can be charged if the late charge would be less than \$5. No charge can be imposed more than once for the same late payment. A late charge cannot be imposed if the payment is made within 10 days of its scheduled date. For a balloon payment, the late charge cannot be more than that assessed for the largest single monthly payment other than the balloon payment. A late charge for a balloon payment can be imposed for each month the balloon payment is past due.
9. A prepayment penalty on a loan secured by a single-family, owner-occupied dwelling can be charged only if the prepayment is made within seven years of the date the loan was executed. A prepayment not exceeding 20% of the unpaid balance of the loan can be made without penalty in any 12-month period, and any prepayment made in excess of that amount can be subject to a charge of not more than six months' advance interest.

Reference: Sections 10240, 10240.1, 10240.2, 10240.3, 10241, 10241.1, 10242, 10242.5, 10242.6, 10244, 10244.1, 10245; Regulations 2840, 2840.1, 2843

SECTION 8 – Article 5 - Private Money Transactions

Article 5 does not apply to the negotiation or sale of notes that were created for the purpose of financing the sale or exchange of real property where the broker acted as an agent, was not a party to the transaction, and where the required disclosures were given to each party to the transaction. The provisions of Article 5 dealing with “threshold” reporting, loan servicing agreements, and the delivery of appraisals do not pertain to transactions where the lenders/purchasers are institutional lenders or investors or where the note or sale is negotiated or the loan is being serviced pursuant to a permit issued by the Department of Business Oversight pursuant to the Corporate Securities Law of 1968.

Does the broker arrange loans for, sell existing notes to, or service loans for private individual, non-institutional lenders or note-purchasers?

Correct Procedure:

1. Pooling of loan funds – Except as authorized by a permit from the Department of Business Oversight pursuant to the Corporate Securities Law of 1968, funds accepted by the broker from a lender/purchaser or caused to be deposited into an escrow from a lender/purchaser must be for a specific loan transaction. Payments of loan funds payable according to the terms of a note secured by real property or by a real property sales contract, including payoffs, cannot be retained by a broker for more than 25 days without a written agreement with the lender/purchaser.
2. Self-dealing - When a broker, or a salesperson acting on behalf of a broker, solicits funds from a prospective lender or note purchaser for a purchase or loan transaction that will directly or indirectly benefit the broker (so-called self-dealing), certain rules must be followed. Prior to making the solicitation or presenting the investor with the Lender/Purchaser Disclosure Statement (LPDS), the broker must first submit a complete copy of the disclosure statement, without the investor's signature, to the Department. The completed disclosure is sent along with a statement that it is being submitted pursuant to Section 10231.2. (Self-dealing does not include transactions where the broker is benefiting only from the commissions, costs, or expenses of making or arranging a loan.) The broker must then provide the investor with the completed LPDS not less than 24 hours before receiving any funds from the investor or the execution of any agreement obligating the investor to make the loan or purchase the note. The disclosure statement must be signed by the prospective lender/purchaser, and an exact copy must be retained by the broker for four years.

3. Threshold reporting – Brokers who meet the “threshold” reporting criteria are required to submit specified quarterly and annual reports to the Department. There are several ways for a broker to meet the reporting criteria as follows:

- Negotiation of 10 or more of the following transactions in an aggregate amount of more than \$1 million in a successive 12-month period:
 - loans secured directly or collaterally by liens on real property or business opportunities as an agent of another
 - sales or exchanges of real property sales contracts or notes secured directly or collaterally by liens on real property or business opportunities as an agent of another or others
 - sales or exchanges of real property sales contracts or notes secured directly or collaterally by liens on real property or business opportunities as the owner of those notes or contracts
- Making collections of payments in an aggregate amount of \$250,000 or more on behalf of owners (beneficiaries) of notes secured directly or collaterally by liens on real property, owners of real property sales contracts, or both in a successive 12-month period
- Making collections of payments in an aggregate amount of \$250,000 or more on behalf of obligors (borrowers) of notes secured directly or collaterally by liens on real property, lenders of real property sales contracts, or both in a successive 12-month period
- Negotiation of a combination of two or more new loans, sales, or note or real property sales contract exchanges in an aggregate amount of more than \$250,000 in any successive three months or a combination of five or more new loans, sales, or exchanges in an aggregate amount of more than \$500,000 in any successive six months

Within 30 days of meeting any of the above criteria, the broker must submit a Threshold Notification (RE 853) to the Department. The “threshold” reporting criteria apply only to transactions where the prospective lender/purchaser is a private individual investor or trustees of a pension, profit-sharing, or welfare fund with a net worth of less than \$15 million and where the loan or sale is not negotiated or the note is not serviced under the authority of a permit issued by the Department of Business Oversight pursuant to the Corporate Securities Law of 1968.

If a broker who meets the threshold reporting criteria fails to notify the Department in writing of that fact within 30 days of meeting the criteria, the broker shall be assessed a penalty of \$50 per day for each additional day the notification is not received for the first 30 days and then a penalty of \$100 per day not to exceed \$10,000 until the Department receives written notification. The notification must also be submitted when a broker will no longer meet the above reporting criteria.

4. Threshold reports – Brokers who meet the above criteria must submit quarterly and annual reports to the Department based on their fiscal year as follows:

- Within 90 days after the end of the broker’s fiscal year, an independent California-licensed accountant’s report of a review of trust funds (Trust Account Review). If a broker did not collect trust funds during the entire fiscal year, the broker may submit a Trust Fund Non-Accountability Report (RE 854) signed before a notary. If the broker’s fiscal year ends between November 30 and the last day of February, then the Trust Account Review shall be due no later than May 31 of each calendar year.
- Within 90 days after the end of the broker’s fiscal year, a Business Activity Report (online RE 881) that reports the broker’s business activities during the fiscal year.
- Within 30 days after the end of each of the first three of the broker’s fiscal quarters, a Trust Fund Status Report (RE 855), a Trust Fund Bank Account Reconciliation (RE 856), and the bank statement for the last month of the fiscal quarter. If the broker did not collect trust funds during a fiscal quarter, the broker shall submit a Trust Fund Non-Accountability Report (RE 854) for that fiscal quarter.

If the broker fails to submit any of the above reports by the established due date or within any additional time as the Department may allow for good cause, the Department may conduct an audit of the brokers books and records and prepare the reports at a cost to the broker of one and a half times the cost of conducting the audit and preparing the reports.

5. Investor suitability - The broker must make reasonable efforts to ensure investor suitability by making certain:

- the investor has the capacity to understand the fundamental aspects of the investment;
- the investor can bear the economic risk of the investment; and
- the investment is suitable and appropriate for the investor.

The broker must obtain from the investor at least the age, investment objective, investment experience, income net worth, financial situation, and other investments of the investor.

A broker can be deemed to have complied with the investor suitability determination requirement by:

- having the investor complete the Investor Questionnaire, RE 870, and
- using the information from the questionnaire as an aid in the broker's determination of investor suitability.

The completed questionnaire should be obtained from each investor at least two business days – and not more than one year – prior to completing each sale. After obtaining an initial questionnaire, any subsequent questionnaire from the same investor need only reflect any updates from the immediately preceding questionnaire.

6. Disclosure statements – When soliciting or negotiating the arrangement of a loan or sale of a note, a broker must provide the prospective investor with a LPDS (RE 851) as early as practicable and before the receipt of funds by or on behalf of the investor. The LPDS must be signed by the lender/purchaser and by the broker, or a salesperson licensed to the broker, and must be retained for a period of three years. There are separate versions of the LPDS for the arrangement of a loan, the sale of a note, or the collateral assignment of a note. Each must be fully completed with the required information in order for the lender/purchaser to be able to make an informed decision whether or not to make the loan or purchase the note. Each disclosure must contain the real estate broker's license identification number if an individual broker or the corporation's license identification number if a licensed corporation. The prospective lender/purchaser is entitled to a copy of a written, independent appraisal. On a case-by-case basis, the investor may waive his right to the appraisal in writing. In that case, the broker must provide the investor with a written estimate of the fair market value of the property securing the loan supported by objective data.

The LPDS is not required with respect to the following persons:

- The prospective purchaser of a security offered under the authority of a permit issued by the Department of Business Oversight pursuant to the Corporate Securities Law of 1968 which requires that each prospective purchaser be given a prospectus or other approved disclosure statement.
- The seller of real property carrying back all or part of the purchase price.
- The prospective purchaser of a security offered pursuant to a Department of Business Oversight regulation granting an exemption from qualification of the offering if one of the conditions is that each prospective purchaser be given a prescribed disclosure statement before becoming obligated to purchase the security.
- The prospective lender or purchaser is a bank, savings institution, finance lender, or other institutional lender or investor or is a licensed residential mortgage lender.
- A licensed real estate broker selling all or part of the note to a person that is not required to receive a LPDS.

7. Maximum number of investors and investor qualification statements - The notes or interests cannot be sold to more than 10 persons who meet one or both of the qualifications based on income or net worth. The person must sign a specified statement which must be retained by the broker for a period of four years.

8. Maximum loan to value ratios, construction loans - The aggregate principal amounts of the notes or interests sold, including the balance of any senior encumbrances, are subject to maximum loan to value percentages. The percentages are based on the current market value of the property as determined by the broker or appraiser as required by Section 10232.6. This amount can be exceeded if mortgage insurance is obtained through a licensed insurer for the benefit of the holders of the notes or interests. The maximum loan to value percentages are:

- Single-family, owner-occupied - 80%
- Single-family, not owner-occupied - 75%
- Commercial and income-producing properties - 65%

- Single-family residentially zoned lot or parcel which as installed offsite improvements including drainage, curbs, gutters, sidewalks, paved roads, and utilities as required - 65%
- Land that produces income from crops, timber, or minerals - 60%
- Land that is not income producing but has been zoned for commercial or residential development - 50%
- Other real property - 35%

The percentages above can be exceeded when and to the extent that the broker determines that exceeding the percentages is reasonable and prudent considering all relevant factors pertaining to the property; however, in no event can the aggregate principal amounts of the notes or interests sold, including any senior encumbrances, exceed 80% of the current market value of improved real property or 50% of the current market value of unimproved real property, except in the case of a single-family zoned lot or parcel as described above which cannot exceed 65% of the current market value plus any insured amount as described above. The broker must keep a written statement of the material considerations and facts he relied upon in the transaction file. Either a copy of the statement or the information in the statement must be in the LPDS. A copy of the appraisal or broker's evaluation for each parcel or property securing the note must be delivered to each purchaser, and the broker must advise each purchaser of his right to receive a copy.

For construction and rehabilitation loans, the term "current market value" may be deemed the value of the completed project where the amount withheld for construction or rehabilitation at the start of the project exceeds \$100,000 if all of the following safeguards are met:

- An independent neutral third-party escrow holder is used for all deposits and disbursements.
- The loan is fully funded, with the entire amount to be deposited in escrow prior to recording the deed of trust.
- A comprehensive, detailed draw schedule is used to ensure proper and timely disbursement to allow for completion of the project.
- The disbursement draws from the escrow account are based on verification from an independent qualified person who certifies that the work completed to date meets the related codes and standards and that the draws were made in accordance with the construction contract and draw schedule. ("Independent qualified person" means a person who is not an employee, agent, or affiliate of the broker and who is a licensed architect, general contractor, structural engineer, or active local government building inspector acting in his official capacity.)
- An appraisal is completed by a qualified and licensed appraiser in accordance with USPAP.
- The documentation includes a detailed description of actions that may be taken in the event of a failure to complete the project, whether the failure is due to default, insufficiency of funds or other causes.
- The entire amount of the loan does not exceed \$2,500,000.

For construction and rehabilitation loans, the term "current market value" may be deemed the value of the completed project where the amount withheld for construction or rehabilitation at the start of the project is \$100,000 or less if all of the following safeguards are met:

- The loan is fully funded, with the entire amount to be deposited in escrow prior to recording the deed of trust.
- A comprehensive, detailed draw schedule is used to ensure proper and timely disbursement to allow for completion of the project.
- An appraisal is completed by a qualified and licensed appraiser in accordance with USPAP.
- The documentation must include a detailed description of actions that may be taken in the event of a failure to complete the project, whether the failure is due to default, insufficiency of funds or other causes.
- The entire amount of the loan does not exceed \$2,500,000.

9. Servicing agreements – A real estate broker who undertakes to service a promissory note secured directly or collaterally by a lien on real property or a real property sales contract must have the written authorization of the

borrower, lender, or note owner that complies with the following:

- The terms of the servicing agreement must satisfy all the requirements of Section 10238(k)(1), (2), (4), and (5).
- The licensee must provide the lender with the following accountings that identifies the person who holds the original note or contract and deed of trust:
 - An accounting of the unpaid principal balance at the end of the year
 - An accounting of collections and disbursements received and made during each year
- The licensee must provide the lender or note owner written notification within 15 days of any of the following:
 - The recording of a notice of default
 - The recording of a notice of trustee sale
 - The receipt of any payment constituting an amount greater than or equal to five monthly payments, together with a request for partial or total reconveyance of the real property, in which case the notice shall also indicate any further transfer or delivery instructions
 - The delinquency of any installment or other obligation under the note or contract for over 30 days

10. Advancing funds – If a broker is servicing a note secured by real property on behalf of a mortgagee, beneficiary, or note owner and causes funds other than funds received from the obligor (borrower) to be applied toward a payment to protect the security of the note being serviced, including a payment on a senior lien, the broker shall give written notice to the mortgagee, beneficiary, or note owner of the date and amount of the payment, the name of the person to whom the payment was made, the source of the funds, and the reason for making the payment. The notice must be made no later than 10 days after making the payment.

11. Loan servicing – For the purposes of the California Commercial Code, if a broker arranges or sells a note secured by real property, or any interest therein, and then undertakes to service the note on behalf of the lender or purchaser, delivery, transfer, and perfection shall be deemed complete even if the broker retains possession of the note or collateral instruments as long as the deed of trust or assignment of deed of trust in favor of the lender or purchaser is recorded in the office of the county recorder in the county in which the securing property is located and the note is made payable to the lender or is endorsed or assigned to the purchaser.

12. Recordation of trust deeds and assignments - When a licensee negotiates a loan secured by a deed of trust, the licensee must cause the deed of trust to be recorded in the name of the beneficiary or the beneficiary's nominee. The deed of trust cannot be recorded in the name of the licensee or licensee's nominee (so-called table funding). The deed of trust must be recorded with the county recorder in the county in which the securing property is located before funds are disbursed unless the lender has given written authorization for prior release.

If funds are released on the lender's written authorization prior to recording, the deed of trust must be recorded or delivered to the lender or beneficiary with a written recommendation that it be recorded within 10 days following release of the funds.

When a licensee sells, exchanges, or negotiates the sale or exchange of a real property sales contract or note secured by a deed of trust, the licensee must cause a proper assignment of the real property sales contract or deed of trust to be executed and cause the assignment to be recorded in the name of the purchaser or purchaser's nominee (who shall not be the licensee or licensee's nominee). The assignment must be recorded in the office of the county recorder in the county in which the secured property is located within 10 working days after the licensee or seller receives funds from the buyer or after close of escrow, or the real property sales contract or deed of trust must be delivered to the purchaser with a written recommendation that the assignment thereof be recorded forthwith.

The above requirements do not apply if the lender/purchaser is any person or entity listed in Section 10232(c)(1), the deed of trust is recorded with the county recorder in the county in which the property is located, and the property is not a single dwelling unit in a condominium or cooperative or any parcel containing only one to four residential units.

13. Delivery of copies of deed of trust – In addition to the above requirements, a broker must deliver or cause to be delivered conformed copies of any deed of trust to both the investor or lender and the borrower in a reasonable