

employer for a referral to an affiliated entity.

5. Neutral Display of Information on Settlement Service Providers and Their Products

Section 8(a) of RESPA prohibits compensated referrals. HUD may scrutinize non-neutral displays of information on settlement service providers and their products because favoring one settlement service provider over others may be affirmatively influencing the selection of a settlement service provider which could constitute a referral under RESPA. 24 CFR 3500.14(f). An agreement or understanding for the referral of business incident to or part of a settlement service may be established by a practice, pattern, or course of conduct. 24 CFR 3500.14(e). For example, if one lender always appears at the top of any listing of mortgage products and there is no real difference in interest rates and charges between the products of that lender and other lenders on a particular listing, then this may be a non-neutral presentation of information which affirmatively influences the selection of a settlement service provider. Furthermore, if there is an affiliate relationship between the CLO and a favored settlement service provider, the non-neutral presentation of information under certain circumstances could constitute a required use in violation of 3500.15(b)(2). This guidance on neutral displays should not be read to discourage CLOs from assisting consumers in determining which products are most advantageous to them. For example, if a CLO consistently ranks lenders and their mortgage products on the basis of some factor relevant to the borrower's choice of product, such as APR calculated to include all charges and to account for the expected tenure of the buyer, HUD would consider this practice as a neutral display of information.

Authority: 12 U.S.C. 2617; 42 U.S.C. 3535(d).

Dated: May 31, 1996.

Nicolas P. Retsinas,
Assistant Secretary for Housing-Federal
Housing Commissioner.
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24 CFR Part 3500

[Docket No. FR-3638-N-04]

Office of the Assistant Secretary for Housing-Federal Housing Commissioner; Real Estate Settlement Procedures Act (RESPA); Statement of Policy 1996-2 Regarding Sham Controlled Business Arrangements

AGENCY: Office of the Assistant Secretary for Housing-Federal Housing Commissioner, HUD.

ACTION: Statement of policy 1996-2, sham controlled business arrangements.

SUMMARY: This statement sets forth the factors that the Department uses to determine whether a controlled business arrangement is a sham under the Real Estate Settlement Procedures Act (RESPA) or whether it constitutes a *bona fide* provider of settlement services. It provides an interpretation of the legislative and regulatory framework for HUD's enforcement practices involving sham arrangements that do not come within the definition of and exception for controlled business arrangements under Sections 3(7) and 8(c)(4) of the Real Estate Settlement Procedures Act (RESPA). It is published to give guidance and to inform interested members of the public of the Department's interpretation of this section of the law.

FOR FURTHER INFORMATION CONTACT: David Williamson, Director, Office of Consumer and Regulatory Affairs, Room 5241, telephone (202) 708-4560. For legal enforcement questions, Rebecca J. Holtz, Attorney, Room 9253, telephone: (202) 708-4184. (The telephone numbers are not toll-free.) For hearing and speech-impaired persons, this number may be accessed via TTY (text telephone) by calling the Federal Information Relay Service at 1-800-877-8339. The address for the above-listed persons is: Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, DC 20410.

SUPPLEMENTARY INFORMATION:

General Background

Section 8 (a) of the Real Estate Settlement Procedures Act (RESPA) prohibits any person from giving or accepting any fee, kickback, or thing of value for the referral of settlement service business involving a federally related mortgage loan. 12 U.S.C. § 2607(a). Congress specifically stated it intended to eliminate kickbacks and referral fees that tend to increase unnecessarily the costs of settlement services. 12 U.S.C. § 2601(b)(2).

After RESPA's passage, the Department received many questions asking if referrals between affiliated settlement service providers violated RESPA. Congress held hearings in 1981. In 1983, Congress amended RESPA to permit controlled business arrangements (CBAs) under certain conditions, while retaining the general prohibitions against the giving and taking of referral fees. Congress defined the term "controlled business arrangement" to mean an arrangement:

[I]n which (A) a person who is in a position to refer business incident to or a part of a real estate settlement service involving a federally related mortgage loan, or an associate of such person, has either an affiliate relationship with or a direct or beneficial ownership interest of more than 1 percent in a *provider of settlement services*; and (B) either of such persons directly or indirectly refers such business to *that provider* or affirmatively influences the selection of *that provider*.

12 U.S.C. 2602(7) (emphasis added).

In November 1992, HUD issued its first regulation covering controlled business arrangements, 57 FR 49599 (Nov. 2, 1992), codified at 24 CFR 3500.15.¹ That rule provided that a controlled business arrangement was not a violation of Section 8 and allowed referrals of business to an affiliated settlement service provider so long as: (1) The consumer receives a written disclosure of the nature of the relationship and an estimate of the affiliate's charges; (2) the consumer is not required to use the controlled entity; and (3) the only thing of value received from the arrangement, other than payments for services rendered, is a return on ownership interest.

Section 3500.15(b) sets out the three conditions of the controlled business arrangement exception. The first condition concerns the disclosure of the relationship. The rule provides that the person making the referral must provide the consumer with a written statement, in the format set out in appendix D to part 3500. This statement must be provided on a separate piece of paper. The referring party must give the statement to the consumer no later than the time of the referral. 24 CFR 3500.15(b)(1).

The second condition involves the non-required use of the referred entity. Section 3500.15(b)(2) provides that the person making the referral may not require the consumer to use any particular settlement service provider, except in limited circumstances. A

¹ All citations in this Statement of Policy refer to recently streamlined regulations published on March 26, 1996 (61 FR 13232), in the Federal Register (to be codified at 24 CFR part 3500).

lender may require a consumer to pay for the services of an attorney, credit reporting agency or real estate appraiser to represent the lender's interest in the transaction. An attorney may use a title insurance agency that operates as an adjunct to the attorney's law practice as part of the attorney's representation of that client in a real estate transaction. 24 CFR 3500.15(b)(2).

The third condition relates to what is received from the relationship. The rule provides that the only thing of value that comes from the arrangement, other than permissible payments for services rendered, is a return on an ownership interest or franchise relationship. 24 CFR 3500.15(b)(3). The rule describes what are not proper returns on ownership interest at 24 CFR 3500.15(b)(3)(ii). These include ownership returns that vary by the amount of business referred to a settlement service provider, or situations where adjustments are made to an ownership share based on referrals made.

Both the statute and HUD's 1992 regulation make the controlled business arrangement exemption available in situations where referrals are made to a "provider of settlement services." These provisions do not authorize compensation to shell entities or sham arrangements that are not a *bona fide* "provider of settlement services." Since issuing the 1992 RESPA rule, HUD has received numerous complaints that some CBAs are being established to circumvent RESPA's prohibitions and are sham arrangements. The complaints often use the expression "joint venture" as a generic way to describe these new sham arrangements. While many joint ventures are *bona fide* providers of settlement services, permissible under the exemption, it does appear that some are not.

A joint venture is a special combination of two or more legal entities which agree to carry out a single business enterprise for profit, and for which purpose they combine their property, money, effects, skill and knowledge. Some of the alleged sham

arrangements may be joint ventures; others, however, may involve different legal structures, such as limited partnerships, limited liability companies, wholly owned corporations, or combinations thereof. Regardless of form, the common feature of these arrangements is that at least two parties are involved in their creation: a referrer of settlement service business (such as a real estate broker or real estate agent) and a recipient of referrals of business (such as a mortgage banker, mortgage broker, title agent or title company). At least one, if not both, of these parties will have an ownership, partnership or participant's interest in the arrangement.

Many of the complaints about these arrangements allege that the new entity performs little, if any, real settlement services or is merely a subterfuge for passing referral fees back to the referring party. For example, in a letter to HUD dated September 30, 1994, the Mortgage Bankers Association of America (MBA) expressed growing concern about "sham joint venture" controlled business arrangements. The MBA stated:

Under this scenario, a lender and a real estate broker jointly fund a new subsidiary that purports to be a mortgage broker but has no staff and minimal funding, does no work (out sources all process to the lender), receives all business by referral from the broker parent, sells all production to the lender parent, and pays profits to both parents in the form of dividends. We oppose such arrangements because they afford compensation to brokers but impose on them no work or business risk. In short, they are disguised referral fee arrangements.

The MBA encouraged HUD to define eligible joint venture entities. It suggested that such entities should have their own employees, perform substantive functions in the mortgage process and share in the risks and rewards of any viable enterprise in the marketplace.

Complaints also included arrangements that are wholly-owned by a referring entity. An example of such a complaint involved an arrangement promoted by a mortgage broker to real estate brokers to help them set up a

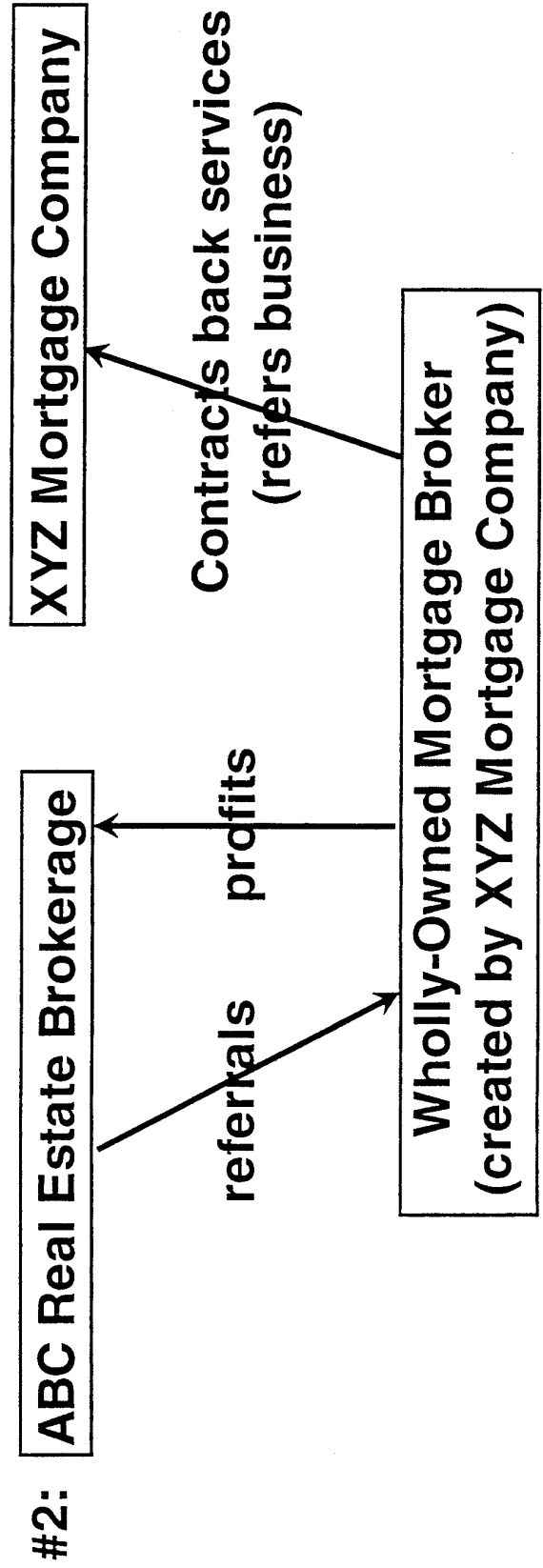
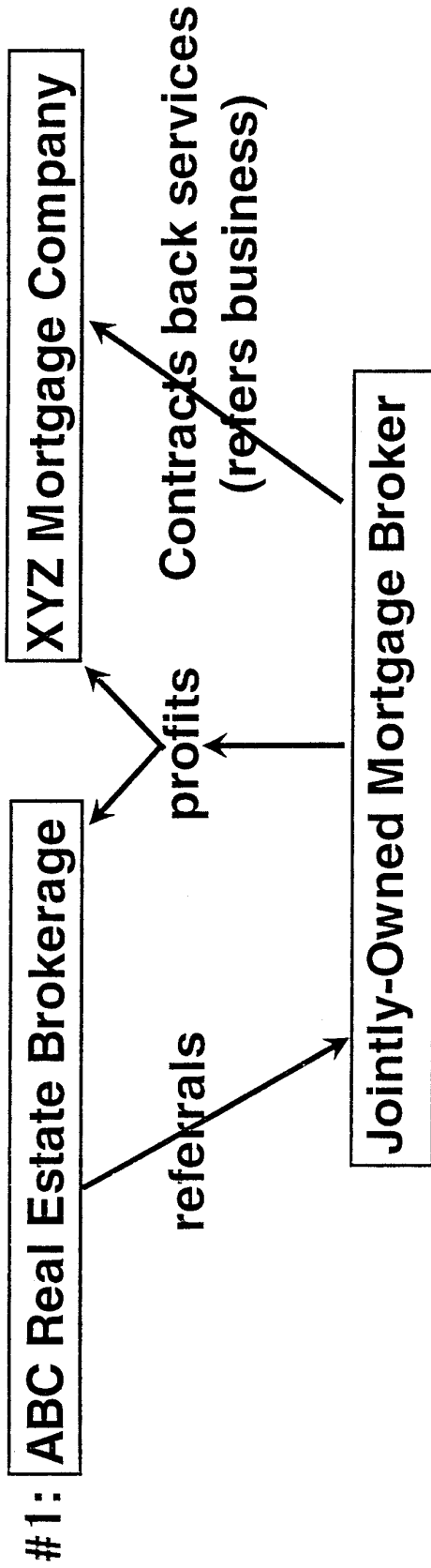
wholly owned mortgage brokerage subsidiary. The mortgage broker claimed that the real estate broker "can earn hundreds or even thousands of dollars each month without investing any money or changing [his or her] current business practices." The mortgage broker's pitch was that "my current staff can work for my company and also for yours." The real estate broker's new company "can use my investors, my office, my phones, my copy machines, my promotional material * * * Your company will have no overhead other than the taxes due on the income you generate and the bank fees for the money accounts your company must have. The entire annual expenses can be covered on the first loan your company closes * * * I can manage your company at the same time I manage mine so you won't have any time investment either." HUD's concern about this and similar complaints prompted the Department to issue this Statement of Policy.

In many of the arrangements that have come to HUD's attention, the substantial functions of the settlement service business that the new arrangement purports to provide are actually provided by a pre-existing entity that otherwise could have received referrals of business directly. In such arrangements the entity actually performing the settlement services reduces its profit margin and shares its profits with the referring participant in the arrangement. In some situations, such as in the last example, companies that could have received referrals of settlement service business directly (hereafter "creators") have assisted the referring parties in creating wholly owned subsidiaries at little or no cost to the referring party. These subsidiaries in turn refer or contract out most of the essential functions of its settlement service business back to a creator that helped set them up or use the creator to run the business.

The following illustrates the two general types of arrangements:

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Illustrations



There are numerous variations on these two general arrangements.

Regulatory and Legislative Framework

In amending RESPA to permit controlled businesses, Congress specifically stated that it did not intend to "change current law which prohibits the payment of unearned fees, kickbacks, or other things of value in return for referrals of settlement service business." H.R. Rep. No. 123, 98th Cong., 1st Sess. at 76 (1983). The statute's definition of "controlled business arrangement" uses the term "provider of settlement services" to describe the entity receiving the referral of business. 12 U.S.C. 2602(7). The term "provider of settlement services" means a person that renders settlement services. The statute further defines "settlement services" to include any service provided in connection with a real estate settlement and includes a list of such services. If the controlled entity performs little or none of its settlement service function, it may not be "providing" settlement services, and therefore may not meet the statutory definition of a controlled business arrangement.

HUD's existing regulations address a shell controlled entity that contracts out all of its functions to another entity. See Appendix B to Part 3500, Illustration 10.² Where the shell controlled entity provides *no substantive services* for its portion of the fee, HUD deems the arrangement as violating Section 8(a) and (b) of RESPA because the controlled entity is merely passing unearned fees back to its owner for referring business to another provider. Besides this Illustration, however, HUD has not addressed arrangements that perform some, but not all of the settlement service functions it purports to provide.

RESPA's earliest legislative history shows that Congress tried to address whether a payment is for services actually performed or is a disguised referral fee. See H.R. Rep. No. 1177, 93d

Cong., 2d Sess. 1974 (hereafter "the Report"). The Report stated that RESPA's anti-kickback provisions were not intended to prohibit the payments for goods furnished or services actually rendered, "so long as the payment bears a *reasonable relationship* to the value of the goods or services received by the person or company making the payment. To the extent the payment is in excess of the reasonable value of the goods provided or services performed, the excess may be considered a kickback or referral fee * * *. " *Id.* at 7-8. The Report stated:

Those persons and companies that provide settlement services should therefore take measures to ensure that any payments they make or commissions they give are not out of line with the reasonable value of the services received. The value of the referral itself (i.e., the additional business obtained thereby) is not to be taken into account in determining whether the payment is reasonable.

Id. at 8. The Report further explained that section 8(c) set forth the "types of legitimate payments that would not be proscribed." As an example, the Report noted that commissions paid by a title insurance company to a duly appointed agent for services actually performed in the issuance of a policy of title insurance would be permitted. The Report explained:

Such agents * * * typically *perform substantial services* for and on behalf of a title insurance company. These services may include a title search, an evaluation of the title search to determine the insurability of the title (title examination), the actual issuance of the policy on behalf of the title insurance company, and the maintenance of records relating to the policy and policyholder. In essence, *the agent does all of the work that a branch office of the title insurance company would otherwise have to perform.*

Id. at 8 (emphasis added). Thus, the Report shows that Congress anticipated that reasonable payments could be paid to entities that perform "all of the work" normally associated with the settlement service being provided.

The legislative history for the controlled business arrangement provides guidance for cases in which a new entity does not perform "all of the work" that would otherwise need to be performed by a fully functioning service provider. The testimony of officials of existing affiliated companies at Congressional hearings in 1981 provided an analysis of companies that do little substantive work. *Real Estate Settlement Procedures Act—Controlled Business: Hearings Before the Subcomm. on Housing and Community Development of the House Comm. on*

Banking, Finance and Urban Affairs, 97th Cong., 1st Sess. 24, (1981) (hereafter "Hearings"). Charles R. Hilton, then Senior Vice President, Coldwell, Banker & Co. stated: "In our line of operation, all of our ancillary services are operated as a full line service company. We do our title searches; we do the examinations; we share in the risk; we take all of the risk, in some cases." Hearings at 423. Stanley Gordon, then Vice President and General Counsel for the residential group of Coldwell, Banker & Co., acknowledged that some title agencies may have been formed to circumvent Section 8 of RESPA. He said:

The most common examples of circumvention are those agencies which provide little or no service to their customers. They do not perform a search of the title records, and have few of the other characteristics of an ongoing business, such as a staff of employees and related operating expenses. Such agencies, in our opinion, come within the prohibition of Section 8.

* * * * *

There must be, for a violation of Section 8, the involvement of a third party, such as a title insurance underwriter of a title agency, that has agreed to make a kickback to the broker. This arrangement is best established by the absence of reasonable compensation from the underwriter to the title agency for the services actually rendered by the title agency. The kickback is the payment by the title insurer to the title agency (which is then passed through to the broker owner) where there is no service being rendered which reasonably corresponds to the payment * * *.

Hearings at 429-431.

Consequently, in cases where work is contracted out to another entity (be it an independent third party, a creator, an owner, or a participant in a joint venture), HUD has looked at whether the contracting party receives payments from the new entity at less than the reasonable value of the services rendered. If so, then the difference between the payments made to the contracting party and the reasonable value of the services rendered may be seen as a disguised referral fee in violation of Section 8. 24 CFR 3500.14(g)(2).

Statement of Policy—1996-2

To give guidance to interested members of the public on the application of RESPA and its implementing regulations to these issues, the Secretary, pursuant to Section 19(a) of RESPA and 24 CFR 3500.4(a)(1)(ii), hereby issues the following Statement of Policy.

Congress did not intend for the controlled business arrangement ("CBA") amendment to be used to

²Illustration 10. *Facts:* A is a real estate broker who refers business to its affiliate title company B. A makes all required written disclosures to the homebuyer of the arrangement and estimated charges and the homebuyer is not required to use B. B refers or contracts out business to C who does all the title work and splits the fee with B. B passes its fee to A in the form of dividends, a return on ownership interest.

Comments: The relationship between A and B is a controlled business arrangement. However, the controlled business arrangement exemption does not provide exemption between a controlled entity, B, and a third party, C. Here, B is a mere "shell" and provides no substantive services for its portion of the fee. The arrangement between B and C would be in violation of Section 8(a) and (b). Even if B had an affiliate relationship with C, the required exemption criteria have not been met and the relationship would be subject to Section 8.

promote referral fee payments through sham arrangements or shell entities. H.R. Rep. 123, 98th Cong., 1st Sess. 76 (1983). The CBA definition addresses associations between *providers* of settlement services. 12 U.S.C. 2602(7). In order to come within the CBA exception, the entity receiving the referrals of settlement service business must be a "provider" of settlement service business. If the entity is not a *bona fide* provider of settlement services, then the arrangement does not meet the definition of a CBA. If an arrangement does not meet the definition of a CBA, it cannot qualify for the CBA exception, even if the three conditions of Section 8(c) are otherwise met. 12 U.S.C. 2607(c)(4)(A-C). Therefore, subsequent compliance with the CBA conditions concerning disclosure, non-required use and payments from the arrangement that are a return on ownership interest, will not exempt payments that flow through an entity that is not a provider of settlement services.

Thus, in RESPA enforcement cases involving a controlled business arrangement created by two existing settlement service providers, HUD considers whether the entity receiving referrals of business (regardless of legal structure) is a *bona fide* provider of settlement services. When assessing whether such an entity is a *bona fide* provider of settlement services or is merely a sham arrangement used as a conduit for referral fee payments, HUD balances a number of factors in determining whether a violation exists and whether an enforcement action under Section 8 is appropriate. Responses to the questions below will be considered together in determining whether the entity is a *bona fide* settlement service provider. A response to any one question by itself may not be determinative of a sham controlled business arrangement. The Department will consider the following factors and will weigh them in light of the specific facts in determining whether an entity is a *bona fide* provider:

(1) Does the new entity have sufficient initial capital and net worth, typical in the industry, to conduct the settlement service business for which it was created? Or is it undercapitalized to do the work it purports to provide?

(2) Is the new entity staffed with its own employees to perform the services it provides? Or does the new entity have "loaned" employees of one of the parent providers?

(3) Does the new entity manage its own business affairs? Or is an entity that helped create the new entity running

the new entity for the parent provider making the referrals?

(4) Does the new entity have an office for business which is separate from one of the parent providers? If the new entity is located at the same business address as one of the parent providers, does the new entity pay a general market value rent for the facilities actually furnished?

(5) Is the new entity providing substantial services, *i.e.*, the essential functions of the real estate settlement service, for which the entity receives a fee? Does it incur the risks and receive the rewards of any comparable enterprise operating in the market place?

(6) Does the new entity perform all of the substantial services itself? Or does it contract out part of the work? If so, how much of the work is contracted out?

(7) If the new entity contracts out some of its essential functions, does it contract services from an independent third party? Or are the services contracted from a parent, affiliated provider or an entity that helped create the controlled entity? If the new entity contracts out work to a parent, affiliated provider or an entity that helped create it, does the new entity provide any functions that are of value to the settlement process?

(8) If the new entity contracts out work to another party, is the party performing any contracted services receiving a payment for services or facilities provided that bears a reasonable relationship to the value of the services or goods received? Or is the contractor providing services or goods at a charge such that the new entity is receiving a "thing of value" for referring settlement service business to the party performing the service?

(9) Is the new entity actively competing in the market place for business? Does the new entity receive or attempt to obtain business from settlement service providers other than one of the settlement service providers that created the new entity?

(10) Is the new entity sending business exclusively to one of the settlement service providers that created it (such as the title application for a title policy to a title insurance underwriter or a loan package to a lender)? Or does the new entity send business to a number of entities, which may include one of the providers that created it?

Even if an entity is a *bona fide* provider of settlement services, that finding does not end the inquiry. Questions may still exist as to whether the entity complies with the three conditions of the controlled business arrangement exception. 12 U.S.C.

§ 2607(c)(4)(A-C). Issues may arise concerning whether the consumer received a written disclosure concerning the nature of the relationship and an estimate of the controlled entity's charges at the time of the referral. 12 U.S.C. § 2607(c)(4)(A); 24 CFR 3500.15(b)(1). Other issues may arise concerning whether the referring party is requiring the consumer to use the controlled entity. 12 U.S.C. § 2607(c)(4)(B); 24 CFR 3500.15(b)(2).

Still another area that may arise concerns the third condition of the CBA exception, whether the only thing of value that comes from the arrangement, other than permissible payments for services rendered, is a return on ownership interest or franchise relationship. 12 U.S.C. § 2607(c)(4)(C); 24 CFR 3500.15(b)(3). Section 3500.15(b)(3)(ii) of the regulations provides that a return on ownership interest does not include payments that vary by the amount of actual, estimated or anticipated referrals or payments based on ownership shares that have been adjusted on the basis of previous referrals. When assessing whether a payment is a return on ownership interest or a payment for referrals of settlement service business, HUD will consider the following questions:

(1) Has each owner or participant in the new entity made an investment of its own capital, as compared to a "loan" from an entity that receives the benefits of referrals?

(2) Have the owners or participants of the new entity received an ownership or participant's interest based on a fair value contribution? Or is it based on the expected referrals to be provided by the referring owner or participant to a particular cell or division within the entity?

(3) Are the dividends, partnership distributions, or other payments made in proportion to the ownership interest (proportional to the investment in the entity as a whole)? Or does the payment vary to reflect the amount of business referred to the new entity or a unit of the new entity?

(4) Are the ownership interests in the new entity free from tie-ins to referrals of business? Or have there been any adjustments to the ownership interests in the new entity based on the amount of business referred? Responses to these questions may be determinative of whether an entity meets the conditions of the CBA exception. If an entity does not meet the conditions of the CBA exception, then any payments given or accepted in the arrangement may be subject to further analysis under Section 8(a) and (b). 12 U.S.C. § 2607(a) and (b).

Some examples of how HUD will use these factors in an analysis of specific circumstances are provided below.

Examples:

1. An existing real estate broker and an existing title insurance company form a joint venture title agency. Each participant in the joint venture contributes \$1000 towards the creation of the joint venture title agency, which will be an exclusive agent for the title insurance company. The title insurance company enters a service agreement with the joint venture to provide title search, examination and title commitment preparation work at a charge lower than its cost. It also provides the management for the joint venture. The joint venture is located in the title insurance company's office space. One employee of the title insurance company is "leased" to the joint venture to handle closings and prepare policies. That employee continues to do the same work she did for the title insurance company. The real estate broker participant is the joint venture's sole source of business referrals. Profits of the joint venture are divided equally between the real estate broker and title insurance company.

HUD Analysis. After reviewing all of the factors, HUD would consider this an example of an entity which is not a *bona fide* provider of settlement service business. As such, the payments flowing through the arrangement are not exempt under Section 8(c)(4) and would be subject to further analysis under Section 8. In looking at the amount of capitalization used to create the settlement service business, it appears that the entity is undercapitalized to perform the work of a full service title agency. In this example, although there is an equal contribution of capital, the title insurance company is providing much of the title insurance work, office space and management oversight for the venture to operate. Although the venture has an employee, the employee is leased from and continues to be supervised by the title insurance company. This new entity receives all the referrals of business from the real estate broker participant and does not compete for business in the market place. The venture provides a few of the essential functions of a title agent, but it contracts many of the core title agent functions to the title insurance company. In addition, the title insurance company provides the search, examination and title commitment work at less than its cost, so it may be seen as providing a "thing of value" to the referring title agent, which is passed on to the real estate broker participant in a return on ownership.

2. A title insurance company solicits a real estate broker to create a company wholly owned by the broker to act as its title agent. The title insurance company sets up the new

company for the real estate broker. It also manages the new company, which is staffed by its former employees that continue to do their former work. As in the previous example, the new company also contracts back certain of the core title agent services from the title insurance company that created it, including the examination and determination of insurability of title, and preparation of the title insurance commitment. The title insurance company charges the new company less than its costs for these services. The new company's employees conduct the closings and issue only policies of title insurance on behalf of the title insurance company that created it.

HUD Analysis. As was the case in the first example, HUD would not consider the new entity to be a *bona fide* settlement service provider. The legal structure of the new entity is irrelevant. The new company does little real work and contracts back a substantial part of the core work to the title insurance company that set it up. Further, the employees of the new company continue to do the work they previously did for the title insurance company which also continues to manage the employees. The new entity is not competing for business in the market place. All of the referrals of business to the new entity come from the real estate broker owner. The creating title insurance company provides the bulk of the title work. On balance HUD would consider these factors and find that the new entity is not a *bona fide* title agent, and the payments flowing through the arrangement are not exempt under Section 8(c)(4) and would be subject to further analysis under Section 8.

3. A lender and a real estate broker form a joint venture mortgage broker. The real estate broker participant in the joint venture does not require its prospective home buyers to use the new entity and it provides the required CBA disclosures at the time of the referral. The real estate broker participant is the sole source of the joint venture's business. The lender and real estate broker each contributes an equal amount of capital towards the joint venture, which represents a sufficient initial capital investment and which is typical in the industry. The new entity, using its own employees, prepares loan applications and performs all other functions of a mortgage broker. On a few occasions, to accommodate surges in business, the new entity contracts out some of the loan processing work to third party providers, including the lender participant in the joint venture. In these cases, the new entity pays all third party providers a similar fee, which is reasonably related to the processing work performed. The new entity manages its own business affairs. It rents space in the real estate participant's office at the general market rate. The new entity submits loan applications to numerous lenders and only a small percent goes to the lender participant in the joint venture.

HUD Analysis. After reviewing all of the factors, HUD would consider this an example of an entity which is a *bona fide* provider of settlement service business rather than a sham arrangement. The new entity would appear to have sufficient capital to perform the services of a mortgage broker. The participant's interests appear to be based on a fair value contribution and free from tie-ins to referrals of business. The new entity has its own staff and manages its own business. While it shares a business address with the real estate broker participant, it pays a fair market rent for that space. It provides substantial mortgage brokerage services. Even though the joint venture may contract out some processing overflow to its lender participant, this work does not represent a substantial portion of the mortgage brokerage services provided by the joint venture. Moreover, the joint venture pays all third party providers a similar fee for similar processing services.

While the real estate broker participant is the sole source of referrals to the venture, the venture only sends a small percent of its loan business to the lender participant. The joint venture mortgage broker is thus actively referring loan business to lenders other than its lender participant. Since the real estate broker provides the CBA disclosure and does not require the use of the mortgage broker and the only return to the participants is based on the profits of the venture and not reflective of referrals made to the venture, it meets the CBA exemption requirements. HUD would consider this a *bona fide* controlled business arrangement.

4. A real estate brokerage company decides that it wishes to expand its operations into the title insurance business. Based on a fair value contribution, it purchases from a title insurance company a 50 percent ownership interest in an existing full service title agency that does business in its area. The title agency is liable for the core title services it provides, which includes conducting the title searches, evaluating the title search to determine the insurability of title, clearing underwriting objections, preparing title commitments, conducting the closing, and issuing the title policy. The agent is an exclusive title agent for its title insurance company owner. Under the new ownership, the real estate brokerage company does not require its prospective home buyers to use its title agency. The brokerage has its real estate agents provide the required CBA disclosures when the home buyer is referred to the affiliated title insurance agency. The real estate brokerage company is not the sole source of the title agency's business. The real estate brokerage company receives a return on ownership in proportion to its 50%

ownership interest and unrelated to referrals of business.

HUD Analysis. A review of the factors reflects an arrangement involving a *bona fide* provider of settlement services. In this example, the real estate brokerage company is not the sole source of referrals to the title agency. However, the title agency continues its exclusive agency arrangement with the title insurance company owner. While this last factor initially may raise a question as to why other title insurance companies are not used for title insurance policies, upon review there appears to be nothing impermissible about these referrals of title business from the title agency to the title insurance company.

This example involves the purchase of stock in an existing full service provider. In such a situation, HUD would carefully examine the investment made by the real estate brokerage company. In this example, the real estate brokerage company pays a fair value contribution for its ownership share and receives a return on its investment that is not based on referrals of business. Since the real estate brokerage provides the CBA disclosure, does not require the use of the title agency and the only return to the brokerage is based on the profits of the agency and not reflective of referrals made, the arrangement meets the CBA exemption requirements. HUD would consider this a *bona fide* controlled business arrangement.

5. A mortgage banker sets up a limited liability mortgage brokerage company. The mortgage banker sells shares in divisions of the limited liability company to real estate brokers and real estate agents. For \$500 each, the real estate brokers and agents may purchase separate "divisions" within the limited liability mortgage brokerage company to which they refer customers for loans. In later years ownership may vary by the amount of referrals made by a real estate broker or agent in the previous year. Under this structure, the ownership distributions are based on the business each real estate broker or real estate agent refers to his/her division and not on the basis of their capital contribution to the entity as a whole. The limited liability mortgage brokerage company provides all the substantial services of a mortgage broker. It does not contract out any processing to its mortgage banker owner. It sends loan packages to its mortgage banker owner as well as other lenders.

HUD analysis. Although HUD would consider the mortgage brokerage company to be a *bona fide* provider of mortgage brokerage services, this example illustrates an arrangement that fails to meet the third condition of the CBA exception. 12 U.S.C. 2607(c)(4)(C). Here, the capitalization, ownership and

payment structure with ownership in separate "divisions" is a method in which ownership returns or ownership shares vary based on referrals made and not on the amount contributed to the capitalization of the company. In cases where the percent of ownership interest or the amount of payment varies by the amount of business the real estate agent or broker refers, such payments are not *bona fide* returns on ownership interest, but instead, are an indirect method of paying a kickback based on the amount of business referred. 24 CFR 3500.15(b)(3).

Authority: 12 U.S.C. 2617; 42 U.S.C. 3535(d).

Dated: May 31, 1996.

Nicolas P. Retsinas,

Assistant Secretary for Housing-Federal Housing Commissioner.

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24 CFR Part 3500

[Docket No. FR-3638-N-05]

Office of the Assistant Secretary for Housing-Federal Housing Commissioner; Real Estate Settlement Procedures Act (RESPA); Statement of Policy 1996-3, Rental of Office Space, Lock-outs, and Retaliation

AGENCY: Office of the Assistant Secretary for Housing-Federal Housing Commissioner, HUD.

ACTION: Statement of Policy 1996-3, Rental of Office Space, Lock-outs, and Retaliation.

SUMMARY: This statement sets forth the Department's interpretation of Section 8 of the Real Estate Settlement Procedures Act (RESPA) and its implementing regulations with regard to the rental of office space, lock-outs and retaliation. It is published to give guidance and to inform interested members of the public of the Department's position on enforcement of this section of the law.

FOR FURTHER INFORMATION CONTACT: David R. Williamson, Director of the Office of Consumer and Regulatory Affairs, Room 5241, telephone: (202) 708-4560. For legal enforcement questions, Peter Race, Assistant General Counsel for Program Compliance, or Rebecca J. Holtz, Attorney, Room 9253, telephone: (202) 708-4184. (The telephone numbers are not toll-free.) For hearing- and speech-impaired persons, this number may be accessed via TTY (text telephone) by calling the Federal Information Relay Service at 1-800-877-8339. The address for the above-listed persons is: Department of Housing

and Urban Development, 451 Seventh Street, SW, Washington, DC 20410.

SUPPLEMENTARY INFORMATION:

General Background

Section 8 (a) of the Real Estate Settlement Procedures Act (RESPA) prohibits any person from giving or accepting any fee, kickback, or thing of value for the referral of settlement service business involving a federally related mortgage loan. 12 U.S.C. 2607(a). Congress specifically stated it intended to eliminate kickbacks and referral fees that tend to increase unnecessarily the costs of settlement services. 12 U.S.C. 2601(b)(2).

Since July 1993, the Department has been seeking comments and advice concerning the final rule of November 2, 1992, implementing Section 8 of RESPA. On July 21, 1994, the Department published a new proposed rule on certain Section 8 issues. Simultaneously with the issuance of this Statement of Policy, HUD is publishing a final rule in that rulemaking. As part of that rulemaking process, the Department received comments concerning the application of Section 8 of RESPA to the rental of office space, lock-outs and retaliation in connection with real estate brokerage office practices. In addition, the Department's enforcement officials have received numerous complaints dealing with these same issues.

Rental of Office Space

In the last few years, the Department has received numerous complaints alleging that certain settlement service providers, particularly lenders, are leasing desks or office space in real estate brokerage offices at higher than market rate in exchange for referrals of business. In HUD's rulemaking docket, number R-94-1725 (FR-3638), many commenters argued that HUD should scrutinize this rental practice. The concern expressed is that real estate brokers charge, and settlement service providers pay, high rent payments for the desk or office space to disguise kickbacks to the real estate broker for the referral of business to the settlement service provider. In this Statement of Policy, the Department sets forth how it distinguishes legitimate payments for rentals from payments that are for the referral of business in violation of Section 8.

Lock-outs

The Department also received comments and complaints alleging that settlement service providers were being excluded from, or locked-out of, places of business where they might find