Joint Informational Hearing of the

Senate Committee on
Banking and Financial Institutions

Juan Vargas, Chair

and

Senate Committee on
Business, Professions and Economic Development

Curren Price, Chair

Hard Money Lending in California

Wednesday, January 18, 2012
State Capitol, Room 112

SENATOR JUAN VARGAS: …Senate Committee on Business and Professions and Economic Development as well as the Banking Committee for the state Senate. This is an informational hearing, a joint informational hearing. I want to welcome all of you here. I will make some remarks and then Mr. Chairman will also make some remarks, I believe, and then we will get to the testimony. We will be joined during the testimony by some of our friends. I also have to let you know that they are listening to us throughout the—some of the colleagues that won't be able to be here—they are listening through what we call the squawk box, what we call our sound system, so some of them may be in their rooms listening also.

So again, I want to welcome you here today, the hard lending in California, this joint informational hearing. My name is Juan Vargas. I am the chairman of the Banking Committee, the Banking and Financial Institutions Committee.

The reason we're here is to, in my view, and focusing this hearing on transparencies, I believe that the laws and regulations need to be clearer. I don't think that they're as clear as they can be and, frankly, I don't think that they're as transparent as they can be. The public doesn't benefit of those who solicit investors' money and those who broker and make loans with that money, don't clearly understand the rules of conduct. We have to have regulators informed. Regulators can't adequately oversee activities of those they oversee nor adequately protect the public if they don't know what the regulated community is doing. The regulators also have a responsibility to keep the legislature informed about changes they believe to be helpful. It's been decades since the hard money lending laws were significantly changed, so I'm taking this opportunity—I think many of my colleagues also will—to review the laws and to work together to see what can be changed and should be changed.

With respect to investors' education, I've heard now—and obviously it's been reported in the media—of many people when they come forward and they say that they've lost their life savings or they're losing their retirement or nest eggs and that too many people are falling victim to these good sales pitches. I understand that this is a very challenging area. We don't want to shut down

small business's access to investor funds. We also recognize that we need to have more transparency and we also need to make sure that investors and everyone that's involved understands what they're doing, and I think that there has been an issue here.

I will limit my comments to those I look forward to the testimony that's being brought forward today. We have read a lot of information. Also, the newspaper has kept us informed obviously. And again, I thank each and every one of you that is here to testify. When you do come forward, we'll announce who you are if you're on a committee. Otherwise, when you please come forward, when you do come forward, if you will state your name for the record, we'd appreciate it.

I would now turn it over to Mr. Chairman, Curren Price. Senator.

SENATOR CURREN PRICE: Thank you.

I want to thank Senator Vargas for agreeing to hold this joint committee meeting with the Banking Committee and the Economic Development Committee on the issue of hard money lending. And I too would like to thank the witnesses and others who are here to provide testimony and information. As the senator pointed out, the purpose of the hearing is to provide some information and to get a better understanding on the issues surrounding hard money lending.

Recent reports detailing the gross injustices, involving brokers, investors, and consumers have shown that there's an ever-increasing concern regarding regulatory gaps in hard money lending. The latest scandal, documented by the

Sacramento Bee in Nevada County, they tell of some of the gross inequalities, such as regulatory gaps, that the regulatory gaps, have created. Hundreds of valuable, vulnerable investors and consumers within the small county lost millions of dollars, due in part to corrupt behavior, lack of oversight and inefficiencies within the law.

It's the intent of both of our committees to determine what regulatory gaps exist so that we can begin to create specific solutions to reduce the concerns cited by stakeholders and to better protect California citizens. It's our goal to work with the Department of Real Estate and the Department of Corporations to develop more uniform standards and oversight of hard money lending and to assure that there will always be appropriate monitoring and restrictions placed on such practices when necessary. And, again, our intent here today is to shed some light on this issue, not heat, but to shed some light, try to identify where the regulatory gaps are, so that we can appropriately step in to make sure that these services are properly offered to investors and consumers and that the industry is appropriately regulated.

I see we've been joined by another colleague, Senator McLeod. I want to give you an opportunity to make some opening remarks if you choose to do so, Senator. None? Okay.

Well, Mr. Chair, without objection, to begin, I'd like to call forward those representing witnesses, representing the consumer, and investor perspectives. Noah Zinner, staff attorney, for the Housing and Economics [sic] Rights

Advocates, and former Gold Country Lenders, Margaret Fowler and Joan Garner—if you'll please come forward to the table.

Mr. Zinner, we'll ask you to go first. If you can maybe provide us with a little information on the Housing and Economics [sic] Rights Advocates organization and we look forward to your testimony. Thank you.

Just for the information of those in attendance, we've got three—we have two additional panels—one on regulatory perspectives and one on industry perspectives—and then open it for public comment so we encourage you to listen carefully. If you have some thoughts or questions, hold them and you'll have a chance to ask questions as well. Thank you.

Mr. Zinner?

MR. NOAH ZINNER: Good afternoon, Senators and committee members. Thank you for inviting me to speak today. I work for a nonprofit legal services organization that provides information, invites the advice and representation on housing and economic rights issues to California homeowners statewide. I've been asked to come today to provide a perspective from the consumer, from the borrower's point of view. Throughout the housing crisis, we've spoken with between 1,500 and 2,000 distressed homeowners a year, most of you whom have issues with either the origination or servicing of their mortgages.

Hard money mortgages represent a small but not insignificant number of these calls beyond what one would normally expect, based on the market share of these type of loans. Hard money lending peaked around the time that the

industry subprime market was drying up because of concerns about the sustainability of subprime lending practices. Hard money lending stepped into the existing demand for loans for borrowers with insufficient income or credit to qualify for affordable loans. In short, in our experience, hard money loans were still being given to borrowers who could not afford them, even as the rest of the industry was finally figuring out that this was a bad idea.

Obviously, because of the nature of our work, we don't hear many of the positive stories about the hard money segment of the mortgage industry, and I'm sure there's plenty. People come to us when there's a problem and so we hear, for the most part, about failed loans and loans that never should have been made in the first place. However, at this point, we've seen enough of these loans and litigated enough of these cases, that we've seen some clear patterns of abuses in the industry, at least as they relate to consumers. It's also been our experience that the investors on these loans, insofar as they're different people entirely from those who originate the loans, are often exposed to as much risk as the borrower, although it's the risk of the loss of an investment and often a significant one rather than a home.

The abuse of hard money lending practices we've seen over the last few years include the following: First and foremost, hard money loans were made based on the value of the home rather than the borrower's ability to afford the monthly payments. This type of asset-based lending is extremely damaging to consumers because, if they can't afford the payments, they'll lose their home.

It's also damaging to investors who are promised a rate of return based on the interest received through monthly payments.

Investors were being told, that if the borrower stopped making payments, they could foreclose on the home and get a full return on their investment. One website run by a hard money lender told investors that they only made loans up to a 40 percent loan-to-value ratio, suggesting that the security for the loans were virtually guaranteed. In our case with this lender, however, the appraiser had valued the home at approximately 300 percent of its market value which made this guarantee virtually meaningless to investors.

Additionally, we see that loans, that abuse of hard money loans, are expensive and contain terms that ensure that they will fail. An example of these abusive terms include non-amortizing or negatively amortizing payments which result in a huge balloon payment due in a relatively short time after origination. Prepayment penalties are penalties for refinancing a loan within a set period. And long-term payment escrows where the monthly payments for periods as long as a year are taken directly out of the loan proceeds. Payment escrows guarantee that the loan will perform as long as the set-aside money lasts, but they increase the cost and unaffordability of the loan long term, virtually guaranteeing default. Because these payment escrows are funded from loan proceeds, they operate as a kind of a Ponzi scheme for investors who are sold a performing loan and then paid monthly returns out of their own invested funds for a period of time until a loan fails.

Finally, we see that abuse of hard money loans are often structured to attempt to evade state and federal laws prohibiting abuse of lending. The federal government has recently strengthened laws related to predatory lending, notably, to address the kind of asset-based lending I just described by expanding the scope of rules requiring lenders to make loans based on their affordability to the borrower rather than on the value of the home. However, similar federal and state affordability rules have long existed for high-cost loans, such as the hard money loans seen by my office. In nearly every hard money loan case we have seen, the mortgage originator attempted to avoid these rules by defining a loan under one of the exceptions under the protective regulations. Affordability rules protect both consumers and investors. And as we have seen in the past few years, they're critical to a functioning housing market as well. For this reason, we strongly suggest amending existing state law under the Financial Code to close these perceived loopholes in the enforcement of affordability standards on mortgages.

Just a few examples of abuse of hard money loans seen by our office:

One of these loans involved a disabled borrower who cannot read and who survived on an income of roughly $800 a month. He sought a loan for $20,000 and ended up with an $80,000 loan with an annual percentage rate of 15 percent. The monthly payments on this loan exceeded his gross income but still were not enough to pay back the principal on the loan so that a $60,000 balloon payment was due after 20 years. The loan included a 12-month payment escrow of approximately $1,000, $11,000 taken out of loan proceeds,

and close to $10,000 in closing costs. In addition, the broker for the loan simply stole $30,000 of loan proceeds directly out of escrow which was managed by the lender. The lender attempted to evade federal and state regulations by getting the borrower to unwittingly sign a piece of paper saying that his home was an investment property rather than his residence. The loan was then promptly sold to private investors.

Another example involves two loans given by a hard money lender in successive years to a disabled borrower under county conservatorship. The total amount of the two loans was $50,000 of which approximately $20,000 consisted of fees and costs. In addition to the monthly payments, the loans included a balloon payment of the entire $50,000 after five years. The lender attempted to evade legal prohibitions on these terms by classifying the loan as an open-ended line of credit even though the entire loan amount was distributed at closing. When we asked why they decided to call the loan open-ended in a deposition, a principal for the hard money lender said that it was for legal reasons. This loan was also sold to investors after closing.

A final example involves a hard money loan made to an 84-year-old man who is applying for a reverse mortgage to repair his home and ended up with a hard money loan. The lenders called the loan a construction loan which they asserted was immune from legal protections. The homeowner was not even aware that he had received a loan until he began to get collection calls from the lender about a year after the loan originated. He had been charged $15,000 in closing costs, another $13,000 as a payment escrow reserve, and had a

$100,000 deed of trust against his property. The lender told him, that in order to receive any money from this loan, he would first have to pay for and complete the repairs to his home on his income of $1,500 a month. The closing documents indicated that the homeowner was to perform the repairs, including repairs to the roof himself, at 84 years old.

Based on our experience, it's apparent that borrowers and individual investors, though on different sides of the transaction, share a common interest in assuring that hard money loans are only made to people who can afford them. We agree with the efforts to increase oversight of the industry from the licensing side but would submit that both consumers and investors would benefit from amendments to state law that holes—excuse me—close the loopholes in mortgage protections assuring affordability.

Thank you for your time.

SENATOR PRICE: All right. Thank you.

Just want to note we've been joined by two colleagues, Mimi Walters and Sam Blakeslee. Welcome.

Next we'll hear from two individuals who have had some very hands-on experience with this effort—Margaret Fowler.

Margaret, you want to just tell us a little bit about yourself and then offer your testimony, please?

MS. MARGARET FOWLER: Okay. Thank you. Good afternoon.

My husband and I were investors in hard money loans. We were not savvy investors. We did like a lot of people trusted, somebody that we had known for a long time, and invested basically our life savings.

SENATOR PRICE: How much did you invest at this time?

MS. FOWLER: Three hundred and eight-five thousand. And through the course of the years that we were invested, everything was fine. And in late 2008, we received a letter stating that our borrowers could no longer afford to pay the monthly interest. Sorry, never done this before.

SENATOR PRICE: It's okay. Take your time.

MS. FOWLER: So after a course of time, one of the projects that we were invested in, we received a notice in February of 2009 that this project was going to be foreclosed on by the first. Well, we didn't even know we weren't the first. We were actually in a third position. The foreclosure proceeding had already started in September of 2008, so we asked for a meeting with the broker that was brokering these loans and we met him at his country club and his analyst to file a bankruptcy to protect the investors; and his wife, an attorney, was to represent us in this bankruptcy.

Well, it turned out that that bankruptcy would have been in conflict. And when we asked him, if he couldn't afford to make the payments in a bankruptcy reorganization, how is it that he could afford to make the payments—I mean, if he couldn't pay the payments to the mortgage holder at the time, how was he going to make payments to the bankruptcy reorganization? His response was, good question, totally blew off anything we

were asking, and he started talking about other projects that my husband and I were invested in, never really answered any of our questions. We left that meeting with a real sense of dread because every one of the loans—and there were, I believe, at least 30 hard money loans with this broker at that time—defaulted all at once. And so myself and another investor, we started doing some research. It turned out that our borrower was none other than the broker on almost every loan. He set up LLCs in different names so that we would not catch on.

So throughout all of this, we started looking into the role of the Department of Real Estate. We filed a complaint with the Department of Real Estate, and I'm not here to badmouth the Department of Real Estate or the Department of Corporations. But when I received the letter from this broker at one point saying that he had just been audited by the Department of Real Estate and he passed with flying colors, I questioned how that could be. So I went online and I found a printout from the Department of Real Estate called the *Mortgage Loan Broker Compliance Evaluation Manual*, and I started reading the requirements of this broker. And if the Department of Real Estate had been auditing this broker, how is it that that they didn't audit him based on their own regulations?

Nothing in the regulations did he abide by—not one thing. He never told us he was self-dealing; he never had an independent third-party appraiser. He acted as his own appraiser; he never had a third-party escrow. Nothing in the regulations was abided by. He never informed the investors on a yearly basis

as to the income and the disbursements on any of our loans. They just all went bad at one time.

So, of course, I filed a complaint with the Attorney General's Office, and it's been a long process. It's two-and-a-half years, two-and-a-half years. I filed in June of 2009. And because of the way the regulations are written, it's hard for them to pinpoint what they're going to prosecute on. It makes it very difficult. For a long time, I wasn't even sure what this man did wrong except he lost $40 million of investors' money, and we have no way of recovering it. He didn't—it turned out he didn't pay the property taxes since 2006, so we're now responsible for that if we want to try and recover anything.

The values of the properties far exceeded their actual value. He purchased one property in particular, paid $535,000 for it, and wrote on our disclosure statements that it was worth $8 million. How do we protect ourselves from that? Well, you can say until you turn blue in the face. Don't ever invest based on trust. But when you're being told or, you know, presented with things that, while this is going to be a great project—one in particular was 300 acres up in Nevada County. But we weren't ever told there were 75 investors on this piece of property, including his debt to attorneys and engineering companies. So what happened to the $3.8 million that the investors put up for it when nothing was done? There's no oversight for any of this, and I just recently came to find out that the Department of Real Estate's audit is, you're audited by mail.

Well, if you're doing something wrong, there's a real good possibility you've got two sets of books. So how does the Department of Real Estate know that the documents they receive are legitimate documents from these brokers? I mean, we're finding out now that there's very few investors. Just between Mrs. Garner and myself, maybe our documents would not be the same on the face so they could send anything they want. (Coughing) Excuse me. I knew this was going to happen.

We would very much like to see some type of regulation that prevents the brokers from doing this. This is not to say that all hard money lenders are corrupt or bad. But in this case, Article 6 clearly states no self-dealing, that he did that on every one of them, simply by changing his name.

SENATOR SAM BLAKESLEE: Can I ask a quick question?

SENATOR PRICE: Certainly.

SENATOR BLAKESLEE: If I may just ask a quick question. I apologize. I know your voice is troubling you.

You said you did it on trust. How long did you know this individual? I mean, I think a lot of times when we do see fraud and hear about fraud, it is the person at the church that you've known for a long time or the kind of a friend who's a trusted friend, supposedly.

MS. FOWLER: She was a trust friend. She was the CFO of this broker and the sister.

SENATOR BLAKESLEE: I'm sorry. She was the CFO of what?

MS. FOWLER: Of the company and the sister of the broker, and we had known her for about 13 years and we were very close to her. Her husband—we used to own a wrecking yard up in Grass Valley and we knew her husband quite well and he'd passed away. And when he passed away at a very young age, we stayed very close to her and her daughters and spent quite a bit of time with her. She would spend time at our house in Fremont so we were very close and we trusted what she was telling us.

SENATOR BLAKESLEE: Okay. Thank you, appreciate it.

In my community, we had a number of very large hard money lenders go under—I think a couple of them actually losing $300 million of local community money, so it's been a particularly acute problem in various parts of the state, and the conversations I've had with my constituents on this issue seem to consistently reveal, that as this conversation is sort of discovered or reinforced, many of the investment decisions were made on trust. But when I would then probe a little further and ask what sort of disclosures did you receive, what sort of documentation do you have in your possession that details your actual property rights in the asset or the investment or regular investment reports that are coming to you or audits, almost invariably the answer came back, you know, I don't remember seeing anything like that. We had to sign something that kind of agreed that we agreed with whatever the terms were and that was sort of it.

What was your experience in terms of the disclosures? When you by a mutual fund, there's something known as a prospectus, and a prospectus has

goals and objectives. It shows operating expenses. It provides ten-year histories; it has very strict requirements with regard to fees that are charged through the FCC and what used to be the NASD, now FINRA. So in dealing with traditional securities, there's enormous disclosure. And if you don't get your prospectus, you can come back a month later and kind of undo the investment because there's a duty for you to receive a prospectus.

What disclosures did you receive and did you find them adequate?

MS. FOWLER: Well, in this case, for, at least on behalf of my husband and myself and several others that I know of, we never saw any documents before they got our money. And when we did, in several cases, the documents received were already mature. For instance, one was the date on the note was 2003 to mature in 2006, but we weren't being added into this loan until 2008. So they would have the normal disclosure statements but—and they were mostly supposed to be for construction purposes and nothing happened. There was very little construction done on any of these projects.

One of the other thing I didn't address was the Department of Corporations. It took me almost a year to find out what an exemption was for this broker. And when I did find out, the way it was put to me by an attorney with the Department of Corporations, was, when our broker requested a series of exemptions, it meant that he could take—in this case, he took a $10.1 million exemption.

And I said, "What does that mean?"

And she said, "Well, what it means is, if he wanted to buy $10.1 million worth of pencils, he could."

But how is it that he can take our money that was intended for a specific purpose and use it to buy $10.1 million worth of pencils? I mean, our money was meant for a specific project. It was to be in a specific trust fund for that project, and it was meant for construction. It wasn't. And to finish with you, you know, we didn't get a lot of information. There was only one project and it wasn't done with a deed of trust. It was—you were buying units of this one project. In the original investment, there was no prospectus. It was just a list of requirements, one of them being that you couldn't invest more than 10 percent of your income.

Well, when I questioned the broker about that clause, she said, "Oh, don't worry about that. We never look at that. It just has to be in there."

I said, "Well, you know that we're not worth $3 million, right?"

She said, "Yeah, but don't worry about it."

So you get this kind of thing when you are based on trust. I mean, if you've read any of the stories on Bernard Madoff, most of the people there said they invested on trust. And it's just word of mouth. You get to know people. Everything looks good on paper. But, you know, right now, all you can do with that paper is burn it.

SENATOR BLAKESLEE: And I'll just, again, directing comments to the chairs, I think this is a potentially very fertile area for legislative action and perhaps even regulation. Clearly securities, as we traditionally think of them

for the public, is highly regulated. Private placements for high net-worth individuals, much less so. But even in the case of dealing with annuities, insurance products, reverse mortgages on your home, California's gone to great lengths to protect people with disclosures and the ability to unwind those decisions if they're not—those individuals are not happy with those decisions in the hours after they've made it.

I would suggest, that since I saw numerous instances where my constituents had come in with their attorneys and the attorneys could not figure out what was happening, that this is a problem of a failure to disclose and actually be accountable for what you're going to be use the money for, and it seems like a reasonable place for the state of California to explore a remedy.

SENATOR VARGAS: One of the things I would add, there actually are disclosure requirements in the law. If you look at Business and Professions Code 10232.5, there are disclosure requirements. The problem is that the regulators may not know that these disclosures didn't happen. So how then do you unwind the—I mean, what is the solution there? I know that some people, when they come up from the state will, I suspect, will address that issue but there are disclosure, inadequate.

SENATOR BLAKESLEE: And tougher remedies when they're complied with?

SENATOR PRICE: There are enforcement challenges. We've cut back on all the bureaus, departments, and frequently it's the enforcement units that

are inadequate to provide the kind of oversight and the investigation support that frequently is a problem.

MS. FOWLER: (Inaudible Comments)...most of my information relative to _____ online. _____. I don't that we had any loans that had less than one investor's _____. _____? How is ____ that he's self-dealing, that he's actually the broker and the borrower and the loan servicer and the escrow?

SENATOR PRICE: And the recipient of the funds. (Laughter)

MS. FOWLER: _____ and then he gets the 10 percent for loan servicing. So, you know, we didn't get interest _____ investors will have now with the Internal Revenue Service. We weren't getting interest. If you were getting interest, then the properties would have been generating their own income. You're getting a return of your principle. The only way you're getting interest is if there's some kind of income on that property. In our case, there was none.

SENATOR PRICE: Thank you, Mrs. Fowler. We're going to hear next from Joan Garner to share with us her story.

Please, Ms. Garner.

MS. JOAN GARNER: Well, I was told I was going to be asked questions so I'm kind of not prepared but that's all I can do, is tell you my story.

My daughter and her husband have a nice, successful business and they have a friend that had been investing with this Gold Country Lenders for a good ten years that I know of and he had, like, 10 percent return on his money

and my daughter and son-in-law had a little bit of money, and so they invested in this also and they were saying how good the return was. That check was there every Tuesday. It was a good investment. And so my mother passed away and I got a little inheritance from her, so I took some of this and invested with Gold Country.

SENATOR PRICE: How much, if we can ask? How much did you invest?

MS. GARNER: Ninety-five thousand. And I was very fortunate. We had built our home near Grass Valley and we ____ mortgage on it and so we thought, well, we could put this money away for our retirement. And then, as the money came in, you know, you don't ask any questions. You just accept the check and go down and cash it and they're happy for it.

Well, then we started getting these extensions to the loans. It's 2008; we're going to extend it to March of 2009. That never, ever materialized. It was all bogus until this wonderful lady brought it to our attention to a lot of investors. She had a meeting. And in one of her statements, she said look at the back page of your disclosure payment, of what that money is being used for and what position you're in. All of us get this big hunk of paper and, you know, you think you know something but, you know, you don't know everything. You don't know the rules or regulations. So I looked at the back of this and I'm going, oh my goodness.

When we went up to see these people, my husband does real estate and he said, "What position are we going to be in there?"

And they said, “You’re going to be in a first.”

He says, “I will not take anything else other than that.”

Well, they sent us all this paperwork. We just looked at it. We looked at it again when Midge brought it our attention and we’re all in second positions so we don’t have a leg to stand on. And then I felt comfortable because, when we invested, this was on property. Well, you know yourself, even though the stock market and everything else dropped, property is worth something. So we thought, okay, you know, at least we’ve got some property.

Well—there’s a little more to it—but $60,000 of our investment was on his home in Auburn and it was right next to Jim Otto—and I’m a friend of Jim Otto—and I thought, well, I know where his house is and I know it’s okay and so forth and so on. And so we started really looking into it and find out that him and his wife went down—they sent us a reconveyance and a demand for payment. And I thought, oh, good, we’re going to get our money.

So I called Phil up, Phil Lester, who’s a head of Gold Country Investors, and I said, “When are we going to get the money?”

And I was intervened by another lady saying, in the office saying, “Well, he’s having a hard time refinancing his home.”

And I said, “Well, why? Doesn’t he have any source of income?”

And she says, “No.”

And she said, “But when he refinances, you’ll get your money.”

Well, come to find out, due to this lady’s hard effort of going down to the county and finding out everything, he’s not only sent us a reconveyance that

we signed, thinking we were going to get our money and took our names, took it down to the county, took all our names off—the people that were on a first or second—put it in his and his wife's name, and then, I guess later, he took it out of his name and put it in his wife's name so we don't even have a leg to stand on, and that's my story.

SENATOR PRICE: Did you seek a loan from a traditional lender before? Did you seek a loan from a traditional lender?

MS. GARNER: I'm sorry. I didn't…

SENATOR PRICE: Did you seek a loan from a traditional?

MS. GARNER: No. I was just an investor.

SENATOR PRICE: Just an investor, just as an investor?

MS. GARNER: I mean…

SENATOR PRICE: And again, this is on the basis of a reference, a good reference, you thought you knew? You knew him; you knew of him; you knew someone who knew him and a good reference, and that's why you chose to go along; is that correct?

MS. GARNER: No. I didn't know Phil Lester.

SENATOR VARGAS: I guess the—if I can pinpoint the question—because we see a lot of people who trust the person that they give the money to, thinking that broker is going to be trusted because we've known him for 13 years. We've known the spouse. The spouse, you know is a good person. The spouse died and so we entrusted the money with this person thinking that the investment was going to be safe.

In your situation, why were you willing to invest $95,000? Did you know the individual?

MS. GARNER: No. This was just all on referrals.

SENATOR VARGAS: It was simply on the notion that there were returns and referrals that you've heard from other people?

MS. GARNER: Correct. And, I mean, you know, it looked like a fairly good investment and, again, I was dubious to do this but I thought, well, it's connected with the property.

SENATOR VARGAS: Right.

MS. GARNER: And property is usually very solvent.

SENATOR VARGAS: Right. You saw the asset and you thought the asset was safe and therefore you were willing to put your money into this deal because, as you said, the stock market went down; you still had the property there.

MS. GARNER: Correct.

SENATOR VARGAS: Your friend's house. Okay.

SENATOR PRICE: Do you have any specific recommendations for changes in the law or rules or regulations that would prevent the kind of problems that you've encountered in this situation?

MS. GARNER: Yes.

SENATOR PRICE: What would you suggest we do or be done?

MS. GARNER: Well, like you kind of brought up, there's codes that, you know, that he said that you're supposed to have. But how do you enforce that?

And that's a point you brought up too. How do you enforce that? And like Midge brought up, the DRE, she went on them and made them enforce all the things that he hasn't done. How do we, how do we regulate this, that it is done? How do you make these people accountable for what they're doing, you know? And that's your job. (Laughter)

SENATOR PRICE: Thank you. Well, and quite frankly, that's why we're here. That's why we're here, is to figure out how we can do a better job of protecting the public and making sure that services like this are fair, honest, and open.

MS. GARNER: Well, we really appreciate that.

SENATOR PRICE: Thank you.

Senator McCleod.

SENATOR NEGRETE McCLEOD: Okay. So you all invested. You invested X number of dollars. You invested $95(000). Where did all the money go to?

MS. GARNER: That's the question.

MS. FOWLER: We're not sure. That's the million-dollar question. There is a total of $40 million invested with this broker. And as of this date, there's, none of the money can be found.

MS. GARNER: There nothing in trust, in trust accounts. There's nothing nowhere, and he just lived high on the hog on the golf course and played the big role and, like she said, the attorney general's looking into where the money is. And they said he's got money but I don't know where.

SENATOR NEGRETE McCLEOD: So under the B&P codes, somebody can fleece somebody like this and they just take the money?

SENATOR VARGAS: Well, I mean, obviously the attorney general is looking at it, but I suspect that what happened here was fraud.

MS. GARNER: Well, it's basically a securities fraud, ____ construction funds, you know. In fact, before I was here this morning, I was over at the Attorney General's Office.

But, you know, one of the most important things that we can see that maybe would help, there's, you know, no guarantees in life. But I don't think the hard money lenders should be allowed to act as its own escrow. If he had not acted as his own escrow, a title office would have shown. For instance, some of our documents stated we were in a first position. And once I had someone run title reports on several of the properties that we were invested in, it turned out that there already was a first. Even though our documents say we're a first, we're not.

There was another, usually a carryback loan from the person that sold the property and, you know, so maybe an independent third-party escrow would help because they could then run a title report. A lot the APN numbers on our documents were not legitimate. They somehow got changed or had numbers added to them. In a prosecution, this makes it difficult for the Attorney General's Office because now they have to reconstruct everything and figure out exactly what did we invest in? So an escrow that has the ability to run a title search would be quite helpful.

The other one is—I'm not quite sure I understand why there couldn't be an underwriter that oversees some of these loans, just as if in the banking industry when somebody's applying for a home loan, an underwriter reviews it. Well, an underwriter would have probably caught the fact that the borrower is none other than the broker. So I'm not quite sure if that would work, a three-day right of rescission, on a hard money loan. I'm not quite sure because a lot of this broker's investors did not live in the area. There were a lot of them out of state—there were a lot from Southern California—and my husband and I are from the Bay Area. So you have three days to try and figure out, Is this legit?

But just like I said, in our case, he had several loans set up with incorrect APNs, several different names for the same property, two different LLCs for the same exact property. So as a simple person like myself, how am I going to determine if that's legitimate or not? It needs somebody who actually has experience in researching this stuff, and most of it can be done online. You don't have to hire a series of people to go out and check. It can be done online. That's how I found most of my information.

SENATOR PRICE: Okay. Thank you.

Senator McCleod.

SENATOR NEGRETE McCLEOD: I think I'm missing something here. I thought the hearing was about loans and they're investors. So how do the loans and the investors play a part together? That, I don't get.

SENATOR VARGAS: Well, I think it's important—as you will find out, I think from the next, when the regulators come up, it is somewhat of a very confusing—I don't want to say confusing—but it is an intricate process and there are investors that have lost a lot of their money. And I'll be frank too. I mean, I think it's oftentimes a case that's either a trusted friend. Or, the returns that look better than the market, so you think you will beat the market by doing these hard money investments. And then you find out that in fact it's not what you'd expected, and it is a much more risky investment than the market.

So you do have investors who oftentimes invest money not knowing everything that they probably should know and lose their money. Then you also have others that will come up and say, you know, that the people who are loaned the money, the borrowers themselves, that they were someone usurious in the amount that they charged, or they were fraudulent or a loan that they should not have received because there's no ability for them to pay it back. It was instead taking a look at the asset, not on the ability to repay so both really can be a victim. But at the same time, I mean, I think it is important to take a look at this. This is important also. I mean, to be frank too, it is an important…

MS. FOWLER: Buyer beware.

SENATOR VARGAS: …process that you have, that where some people do need to get hard money loans because they can't get it elsewhere. So I think for us, we have to figure out how not to throw the baby out with the bathwater,

make sure we go after fraud, and maybe figure out what is an adequate loan but not at the same time do away with the whole industry because I do think it has a place within our banking system.

SENATOR BLAKESLEE: Mr. Chair.

SENATOR PRICE: Thank you.

SENATOR BLAKESLEE: Of course. I mean, we're always going to go after fraud but I think this is actually a bigger problem than fraud, at least in the instances that I was exposed to. Oftentimes the people who were running these funds or these portfolios, at least in my experience, many of them did not go out with the intention of defrauding anyone. Yes, they got in over their head. Yes, they believed the real estate market would keep going up. They got themselves badly leveraged. They didn't do a very good job of tracking whether or not they were seeing progress in the construction jobs, the milestones at a rate they needed to. But some of it was simple, to be blunt, incompetence without any, you know, evil motive. Now there's plenty of fraud with evil motive. But if we're going to say this is just about catching the bad guys, I think we're missing the regulatory, the need for a smart, regulatory fix. And I continue to think we need stronger disclosures which have a more comprehensive list of, the specifics of, you know, what you're investing in and what your ownership position is.

I ran a bill two years ago very similar to the recommendation by the witness to have some sort of underwriting to require hard money lenders to go out and get a bond in some portion relative to the amount they were saying

they were going to be able to deliver on so that there'd be a bonding agency which would go out and audit their books, and then they couldn't get the bond to do business unless they could satisfy this third party.

So I think it's a lot more than fraud. It's about bringing some professionalism to this industry which is running frankly roughshod over people because there's no one mining the store. The Department of Corporations is a good group; the Department of Real Estate, good group. In my conversations with them, they're both very frustrated because there isn't a lot of clarity as who's supposed to do what, when, and there isn't enough money to run these types of audits. So I just want to add my voice. I think this is a lot more than fraud. I wish it was just bad guys. I think it's an industry that needs more professionalism and clarity on how they conduct themselves.

MS. FOWLER: Excuse me.

SENATOR PRICE: Yes.

MS. GARNER: She mentioned that you're bringing the witnesses in. You sure in heck not going to get Madoff or Phil Lester in here. So you have to go to the people that have been duped by them, you know, to say something bad to try and get something done with those guys.

SENATOR PRICE: Right.

Well, ladies, thank you both for your testimony.

MS. GARNER: Thank you.

SENATOR PRICE: We certainly are sympathetic to your plight, and we're hopeful that these proceedings will make some changes that will prevent this from occurring to others. Again, we appreciate your coming forward to share your stories with us.

Let's move on now to the regulatory perspective, see if we can get some answers, some responses, some thoughts on what more we could be doing, what we should be doing, and a little better understanding of where the gaps are.

We've got Tom Pool, assistant commissioner, Department of Real Estate; and Colleen Monahan, deputy commissioner, Department of Corporations—individuals who are in a position to know.

Mr. Pool.

MR. TOM POOL: Yes, thank you.

SENATOR PRICE: Thank you.

MR. POOL: My name is Tom Pool. I'm with the Department of Real Estate. I had been with the Department of Real Estate for 27 years, and I just want to say, every word I heard from the dais and from the witnesses and whatnot is true. I've seen it. I have seen the abuses on the borrower's side. I've seen the abuses on the investor's side. I also see gaps in regulatory oversight. But I also want to point out, we have very, very strong laws on the books. And in descriptions I'm going to go into a little bit later in terms of the investors that have lost money, basically the broker that arranged those transactions broke every rule in the book and I'm going to go over that.

I've been asked today to cover four topics—the summary of laws that the department enforces, the frequency of actions. They respond to the recommendations made in the background and perhaps provide other suggestions. As I was sitting in the audience, some suggestions came to mind.

I passed out a little packet of information that is from the Department of Real Estate. It contains pertinent information about hard money investing. And when I talk about hard money investing, what I'm really talking about, our brokers that arrange loans between private investors—in other words, non-institutional, non-sophisticated investors and place them with borrowers—quickly, in terms of a background, the Department of Real Estate, we are a regulatory agency. We license real estate agents and brokers. We also enforce the subdivided lands law which is very important in providing disclosures to potential buyers in subdivisions. The department has a budget of $47 million. We have 360 employees, half of which are dedicated to enforcement efforts. We have five offices—one in Oakland, Sacramento, San Diego, LA, and Fresno. We take a lot of actions every year. We took over 1,100 administrative actions last year. We revoked over 800 licenses and surrenders. We issued over 200 desist-and-refrain orders last year, and we're on pace to beat that this year. There's some information in the packet about our enforcement efforts. We are a taskforce up and down the state. We are plugged into what's happening in the community, and we're also able to deliver information to law enforcement through this taskforce to explain what we're seeing.

A majority of our cases over the last few years have been involved in mortgage fraud, loan-modification scams, and mortgage or foreclosure fraud, rescue schemes. We have 430,000 licensees currently licensed in the state, 144,000 of which are brokers.

I want to point out the real estate broker's license, the one that we're all familiar with, that allows you to list and sell houses. It's the same license that allows you to make or arrange loans secured by real property. What's significant about that, that means we are the regulator. We regulate a majority of the mortgage brokers in the state of California, including those that are engaged in hard money.

All right. In terms of hard money, lenders—I guess I've been around this business for 30 years. I've seen a lot of changes that I'd like to point out because how the industry worked and was regulated 30 years ago, it's a lot different now. The transactions have gotten a lot more complicated. But the market, the hard money industry, has always filled a niche within the marketplace. They provide investors with very high rates of return. At the same time, they provide capital to borrowers that either choose not go through traditional lending sources or perhaps can't use traditional lending sources. And so this is a multi-billion industry. The backgrounder did a very nice job of explaining our rules and regulations and also pointed out that brokers, our brokers, made or arranged to service to over $3.2 billion in these types of transactions last year.

So I just want to provide a quick overview of the last 30 years, if that's possible. Hard money lending used to be relegated to just providing junior liens or seconds on residential houses. For the most part, they would require 80 percent loan to value. In 1979, there was an amendment or a proposition passed. It was Prop. 2, very significant. It amended the Constitution and it stated that the loans made or arranged by real estate brokers are exempt from usury. Well, that brings in a whole new class of investors. They can now get higher returns, and so that was really a significant change in the law that kind of started the path to where we are today.

Immediately there were abuses in the industry. In 1981, we had a lot of investors losing money. That brought in a whole change of law in the background or they referred to it as Article 5 because these protections or provisions were put in Article 5 in real estate law, and it was significant because it required hard money brokers. It puts an extra layer of requirements on these brokers that report to the Department of Real Estate—and I'll get into that a little bit late.

Over time, because of changes and regulations, because of competition from traditional lending, that we kind of saw a shift over the last ten years in the industry. What used to be an industry that provided junior financing on houses started morphing into other areas, including construction lending, rehab lending, and acquisition of property in construction. We've gone from fairly straightforward transactions to highly complex transactions and

transactions that are not necessarily suitable for all investors. So that kind of gets you up to speed.

I just want to provide a summary of the laws that we enforce. The backgrounder again does an excellent job of breaking down and distilling the laws that we enforce.

I started with the Department of Real Estate in 1985. This was the law book that I started with. This is the 2011 edition and it's going to get thicker in 2012. An awful lot of the changes have occurred because of abuses in the mortgage-lending area. I would say that more laws have been changed regarding the mortgage lending and investment than any other provision in real estate law.

By way of background, before a broker can get licensed, they have to take prerequisite courses. They have to pass an examination; they get fingerprinted, and we do a thorough criminal background check, and then they have to pass an examination. As referenced by the number of laws that had been passed, a disproportionate of our resources, the amount of our resources, are spent in the mortgage-lending arena. It's that segment of our licensing population that causes the most issues and take up more of our resources.

I want to get into the laws that we enforce. And first and foremost, our brokers are fiduciaries. They have a fiduciary obligation in the transactions that they handle. What this means is, they really have a responsibility to do what's right and act in the best interest for their client, whether that be the borrower or the investor. Again, the investors that were up here—and

Mrs. Fowler describing what went on her transactions—I will tell you and I'll break it down for you, is that almost everything that she said is already against existing law. Brokers that arrange a loan between a borrower and a private investor, they provide the borrower a detailed disclosure of the terms, the conditions, the cost, and expenses of the loan. The borrower needs to fully understand what they're getting.

The same is true on the investor side. In the packet, I did provide a copy of a lender/purchaser disclosure statement. We had many iterations of those. But it provides the detail of the transaction—Senator, that you're referring to—that gives the investor the information they need to assess the risk. It includes things as priority of the loan, the address, the condition of the property, the soundness of the borrower, the type of things that you would expect in getting before investing in a transaction.

There were some questions in terms of these investors that were talking, talking up here earlier, about not necessarily knowing where their money was going. The real estate law requires the broker to identify the transaction in which the investor is going to make the loan. So there's no blind pools involved. The disclosures have to be given upfront in Article 5 where these, the rules apply to single-investor loans. There is self-dealing allowed. We don't see it much anymore in terms of single-investor loans because brokers can't typically get enough from a single investor to fund the one loan, but the broker's required to put the DRE on notice if they're going to self-deal.

Now we have another provision in real estate law, Article 6, and it's referred to the background paper, that has a whole host of additional investor protections, including it illegal to self-deal in multi-lender transactions. And when I refer to multi-lender transactions, these are investors that kind of pool their resources. They can have up to ten investors in a single transaction. So any broker that arranges a loan, that has more than one investor, they can't self-deal. It's already against the law.

The disclosures have to be given, even on multi-lender transactions, upfront, again, identifying various things about the investment, including the priority of the lean, the condition of the property. On multi-lender loans, you're required to use neutral third parties for escrows. You're required to fully fund the loan. You're required to use construction-lending drawdowns after certain benchmarks are reached in terms of the construction.

Again, in listening to Mrs. Fowler talk, again, the broker violated every provision that I've just described. When a broker does enough of these types of transactions and they reach certain thresholds of business, they're required to report to the Department of Real Estate. We call these threshold brokers because they meet certain thresholds in the law. These thresholds are pretty straightforward if a broker arranges ten or more loans in an aggregate of a million dollars or more that are funded by private parties. That triggers a reporting requirement to the DRE. In addition, if they're doing servicing, if they do $250,000 in loan collections, they're also required to notify the DRE.

Now what's significant about this is, when threshold brokers report to the department, it triggers reporting to the department. One of the things, if you do the math, we have 430,000 licensees and only 360 people that regulate them. These provisions of reporting were put in so we can monitor these threshold brokers. What we do, we get quarterly reports on their trust accounts. We get business activity reports quarterly ?? in the year, and we get a report that's reviewed by a CPA, something Senator Blakeslee was referring to, about having an independent third party look at the business. That's in current law. So it gives us the ability to monitor threshold brokers and determine whether or not they're in fact complying with the law and there is some third-party oversight.

There's other protections that kind of work in the background in all of our broker transactions, all the money has to go into a trust account. It has to be accounted for. The investors have to be told how the money is being held and how it's disbursed. Taking a look at the threshold brokers, on any given year, we have between, you know, 340 and 360 threshold brokers. And that has stayed pretty constant over the last few years. But again, the big shift has been, and the type of transactions they're getting their investors involved in, much more complex and complicated.

The typical violations include the trust fund was handling misrepresentations and fraud, I think all of which we've heard descriptions of today. The threshold brokers are disciplined at a higher rate than the rest of our licensee population. That would stand to reason, given the amount of

scrutiny that we give them. On any given year, 2 to 4 percent of those 350 brokers are going to be disciplined and that could run from a suspension to a revocation. That compares to less than 1 percent of our general license population that might receive discipline in any given year.

I kind of want to break down Gold Country. That was kind of the centerpiece of the *Sacramento Bee* article, and we've heard from the investors that invested. It actually is a classic hard money case that we see from time to time. I can point, going back 30 years, the peak in trans—or actions that we've taken in hard money transactions, and it balances perfectly or coincides or corresponds with the downturn in the real estate market. It makes perfect sense for most of these transactions. The securities loan is the value of the real property. If the real property goes down, the protection goes down. And especially if you're coming in a junior position, if it goes down far enough, the senior lien may be protected but the junior liens aren't going to have the equity available when the property's liquidated again to be made whole.

When we look at these threshold reports that come in, you know, we look for red flags. We look for problems in the trust account. We look for maybe a high number of foreclosures that are occurring. We know that when that happens, we actually send out an auditor. We don't do our audits by mail, as was previously stated.

So getting back to gold country, this typifies a typical hard money meltdown. We were actually monitoring the reports that Gold Country was sending. Mr. Lester actually did register as a threshold broker. We noted that

there was a minor trust fund shortage. We sent an auditor out. And in spite of what Mr. Lester was telling his investors that he passed that audit with flying colors, in fact, we found significant violations. We actually filed an accusation against Gold Country en route to getting their license revoked. When that became public, we received some investor complaints. Based on those complaints, we went back and audited specific transactions. And when we looked at those specific transactions—I think Mrs. Fowler's was one of them—we found the violations of the self-dealing violations, trust fund mishandling, misrepresentations, the failure to provide those lender/purchaser disclosure statements that give the investors the information that they need to assess risk.

So when we re-audited, we amended our accusation to include the additional violations. The accusation was going to go to hearing. Mr. Lester decided the better of publicly pursuing a defense. He surrendered his license, admitting to all the allegations, at least for the purposes of getting relicensed and the accusation. And then, as typical, we work with law enforcement with the most egregious cases. To take the next step as administrative agency, all we really have, in terms of a hammer, is the revocation of license. So now we're currently working with the AG and providing them information in order to successfully criminally prosecute. So that's my whirlwind view of the real estate law.

In terms of, you know, responding to recommendations, one of the things that Senator Vargas, that you talked about right up front was this notion of

transparency. Excellent idea. And one of the things that concerns me in terms of the trend is the lack of understanding of some of the investors in terms of what they're getting into. You know, as I explained, these transactions are highly complex now, especially when you're dealing with construction lending, property acquisition, and construction.

You know, one of the notions that I had talked to staff and some of the folks about is borrowing from the securities industry, about getting to know your investor. If you open a security or go to brokerage or to open an account by stocks, they take an assessment of your tolerance for risk. They take an assessment of what kind of investments that you make now—and I think that would be brokers or fiduciaries—they ought be acting in the best interests of their clients, and they ought to have a better understanding of their clients' sophistication. So I think that's a good notion that we can move forward with to help both sides of the transactions with the broker, making sure that the investor's getting into the right type of loan and ensure some sort of diversification.

You know, one of the things that is required under Article 6 is this notion of investor suitability, not investing more than 10 percent of your net worth or income. That's an existing law. I think, if that were more closely regulated and understood, that it would at least mitigate circumstances…

SENATOR PRICE: How do you propose we monitor that suitability more effectively?

MR. POOL: Well, you know, obviously, in terms of a regulator, we're not looking at every transaction. So in terms of the suitability and what I was thinking about getting to know your investor, when an investor is filling out this questionnaire in terms of their risk tolerance, at least the radar in my mind should be going up in terms of the risk.

One of the things we're seeing over and over again in hard money failure is this notion of trust. A lot of these investors have been with the same broker for a long time. And as we heard, in many instances, it gets to the point where the investor doesn't even know what they're investing in. I would like to see some sort of notion where at least the investor is put on notice in terms of the type of risk that they're entering into.

Education, I think, is critical, and this goes to the notion that I just talked about. We do have some information. I provided a brochure that we do publish. It's called *Trust Deed Investing [sic], What You Should Know*—it's in the packet—and it's just a little primer for investors to understand how these transactions work and what they can expect from their real estate brokers.

And one last thing in talking to staff and industry, currently we don't publish this list of threshold brokers that have met this criteria and are supposed to be reporting to the department. The idea of publishing it, I like. I think it's a good one. What it does, it does two things. One, for the investors, they would know there's additional oversight occurring for these brokers because they have to be submitting these quarterly reports. I should note that, you know, if a broker fails to submit a report, we're out there looking.

The other thing, from an industry perspective, if the industry knows that someone should be reporting and they're using private investors to fund loans, they can look on the list. And if they're not reporting, they can report that company or entity to the Department of Real Estate and we can go out and take a look at what they're doing.

So with that, that concludes my remarks. If you have any questions, I'll be happy to answer them. Otherwise, I'll turn it over to my colleague, Colleen.

SENATOR VARGAS: I have a quick question. It's probably natural because of what your job description is, and also because the articles that were written, most of your comments, if not all, were on the investors.

MR. POOL: Yes.

SENATOR VARGAS: Not on the borrowers?

MR. POOL: Yes.

SENATOR VARGAS: And could you say a little bit about the borrowers?

MR. POOL: Absolutely.

SENATOR VARGAS: Because, again, that's natural because obviously we had investors here that ___. That might be where the biggest abuse is, but we also, I think, are concerned about the borrowers, those people that take these loans because not all of them are very sophisticated actors, as we've heard from earlier testimony.

MR. POOL: Right. I appeared before this committee numerous times over the last six years addressing that very question.

Going back to what I said earlier about our brokers being a fiduciary and having the responsibility to put the borrower in the best possible loan, not steering a borrower into something that's going to generate the most income or be more beneficial to the broker. Over the last several years, both on the federal and state side, there's been statutes passed to actually codify what has always been case law. There's actually a provision in a civil code right now that says a mortgage broker in a real estate transaction is a fiduciary to the borrower.

As I mentioned earlier, our brokers have always had a responsibility to disclose right up front—and this is irrespective of any federal requirement—all the terms and conditions and the costs and expenses of a loan, they need to do that and application and give the borrower a chance to digest what they are in fact applying for. If there's a material change to what has been disclosed to the borrower, the broker has an obligation to re-disclose to the borrower the terms and conditions and costs and expenses of the loan.

If you would like to kind of go over some of the recent state law provisions regarding the high-cost provisions, high-cost loans, but the attorney, Zinner, did cover some of those, is that we have, as a state and federal done away pretty much with equity-based lending, that as I was describing earlier, a lot of the hard money brokers in the early days just did straight equity-based lending. They didn't care about the borrower's ability to repay. Current law, on the federal side, requires that a broker take a look at the ability of a borrower to repay.

SENATOR VARGAS: Is that just a check off on the form, or what does that mean?

MR. POOL: It actually requires the broker to do an inquiry into the person's income and verify that and in fact verify that the broker has the—excuse me—the borrower has the wherewithal to repay that loan. So there is an affirmative obligation on behalf the broker to make sure that it gets done. So there is—this the first time, frankly, in my 27 years that I haven't been up here discussing the predatory lending aspects of a transaction but instead kind of focusing on the backing on the hard money.

SENATOR PRICE: Thank you.

We are pleased to be joined by Senator Kehoe and Senator Emmerson, vice-chair of the B&P Committee.

Senator Kehoe, any questions?

SENATOR CHRISTINE KEHOE: I was late but I don't know if the committee has heard yet. How big is this market? How many Californians use hard money lending? Can it cross state lines?

MR. POOL: It cannot cross state lines under our law, and it is a billion, a multi-billion dollar industry. In the backgrounder, I think in 2010, it indicated that our brokers either serviced or made over $3.2 billion in these hard money loans. Going back a few years, I mean, I think it got up to $8 billion.

SENATOR VARGAS: Nine point five.

MR. POOL: Thank you; $9.5 billion. And then I recall in even earlier years, it might have been a little higher than that. So there's an ebb and flow in terms of the market, and a lot of it depends obviously on what's going on with the real estate values. But it is a multi-billion dollar industry.

SENATOR KEHOE: Thank you.

SENATOR PRICE: So are you suggesting to us then that adequate rules are in place, that in this situation, they just weren't being followed? Or are you suggesting that there really are some serious gaps that we need to be looking at to kind of address some of these regulatory shortcomings?

MR. POOL: Yeah. This is where the confusions come in. Everything that I've described is required of the real estate law—and thank you for the question because you reminded me of something which I think is significant from last year—is that there's another way to raise capital for these types of transactions that is regulated through the Department of Corporations. And in some instances, the way they raise the capital and loan the money out, many of the protections that I've just described aren't there. So it really depends on what door you're going into in terms of what protections that you're going to receive.

Now SB 53 of last year that was by Senator Calderon made a subtle change to the real estate law which I think is significant, and that is, a broker now has a requirement to disclose to the investor under what law that investment is being arranged. The beauty of it is, if it's not under the real estate law, under Article 5, under Article 7, I'm not saying that every investor is

going to understand what that means but it does provide—Senator Blakeslee was talking about lawyers trying to unwind transactions and not understanding how to go about it. With the new requirements, you certainly would know where to start because the broker made representation this is being done under Article 6. If you go with Article 6, then you understand what the protections were supposed to be in those types of transactions. So that was a change that was put in last year, a very subtle change but I think a very important one.

So in terms of the gaps that I see in the real estate law, I think I've described a situation where the protections are pretty good. But the suggestions in terms of recommendations, I would like to see a little more transparency, at least having a situation where the investors know a little bit better about what they're getting themselves into.

SENATOR PRICE: Surely one thing that attracts the investors is the interest…

MR. POOL: Absolutely.

SENATOR PRICE: …that they're able to achieve. What about putting a cap on what that interest is, interest rates are? That way, it'd moderate it.

MR. POOL: That would require a change to the constitution going back to Prop. 79 that I was talking about—oh, I'm sorry—Prop. 2—back in 1979. It actually amended the constitution to make loans that were arranged by a broker exempt from usury. So I don't know how you would go about putting a cap on that.

SENATOR PRICE: All right. Well, thank you for your testimony.

SENATOR VARGAS: The only thing I would correct is SB 53 was a Calderon/Vargas bill. (Laughter)

MR. POOL: That's why it was so brilliant. I apologize for that, Senator.

SENATOR PRICE: Thank you for your comment, Mr. Pool.

Let's move now to Colleen Monahan, deputy commissioner, Department of Corporations. We understand the Department of Corporations has some purviews in this area and we appreciate your comments.

MS. COLLEEN MONAHAN: Thank you. Good afternoon, Chairman and Members of the Committee. I'm Colleen Monahan, deputy commissioner with the Department of Corporations.

Thank you for the opportunity to appear before you today. We've also been asked to come and testify regarding the laws that we administer, that are related to hard money lending as well as give information regarding the enforcement actions we've taken and responses to recommendations in the background paper.

As background on the department, the Department of Corporations provides regulatory supervision to a variety of non-depository financial services industries, including the securities industries and lending institutions. We have an annual budget of $40 million and 322 staff positions at four locations. We regulate over 327,000 individuals and businesses.

Under our Securities Regulation Division, we oversee the offer and sale of securities, the registration of entities, offering and selling franchises, and the

licensure of broker, dealers, and investment advisors and the agents and representatives that they employ. Under our Financial Services Division, we license finance, lenders and brokers, residential mortgage lenders and servicers, mortgage loan originators, deferred deposit originators—also known as payday lenders—and escrow agents, among others. We administer the Corporate Securities Law of 1968 which is the state's Blue Sky Law. It provides for the oversight of the offered sale of securities as well as the licensure of securities professionals.

Consequently, we have a licensing program for securities professionals and a permitting program for the offer and sale of securities. Hard money lenders are typically real estate brokers who may rely on an exemption from our licensing requirements for their professional licensure. However, they're not exempt from the permit requirement under the securities law. In the offer and sale of a security, it must be permitted unless an exemption exists under the law.

The most common exemptions were described in the background paper for the committee and I can go over them. But in the interest of time, I'll defer to that until it comes up in the findings. But just to give us a broad overview, there are private placement exemptions which allow an exemption from our oversight where there is no advertising and sales are made to persons with a preexisting relationship or with the ability to protect their own interests. In the hard money lending context, there is also the exemption, the multi-lender exemption, that Mr. Pool described for certain public offerings where there are

ten or fewer investors in a note or deed of trust. The regulatory landscape for hard money lending has developed over time, and we just heard Mr. Pool's testimony about the development of those laws.

I'm going to bring you back to 1980 when the Business, Transportation, and Housing Agency convened a taskforce to consider the protections needed in this area which resulted from the constitutional change that was brought up. As a result of market conditions at that time, and as we've heard, single-investor lending was not providing adequate capital to fund the size of loans needed by borrowers as a result of market conditions, and so brokers began funding loans with multiple investors and a lot of problems resulted, a lot similar to what we see today. But at that time, the agencies had a taskforce to determine the regulatory ?? structure for how these deals should be done and what was the proper level of oversight, and that's when the exemption for licensing came into play from the securities broker-dealer licensure requirement. That's when the exemption for smaller lending loans came into play and a regulatory structure was developed for issuers to be able to apply for a permit, not on a single loan or a single loan with multiple investors but packaging all of the lending they're going to be doing together. A lot of the reasons for this oversight, including this structure, including the exemption, was to get compliance with the laws, to make it—real estate agents and brokers were very concerned about duplicative licensing requirements and about the need to comply with two regulatory structures. So at that time, that was how the law was divided and it continues that way today.

The ten or fewer exemption(s) currently in the real estate law was originally set forth in the regulations in the securities law. And in the mid-90s, it was transferred into the real estate code and under the jurisdiction of the Department of Real Estate. So until that time, an issuer could rely, could advertise and rely on meeting the requirements of the small fractionalized interest loan requirements without having to come in and get permitted under the exemption that was in the Department of Corporations rules.

Currently we continue to see fractionalized interests permit applications and we also see mortgage loan pool applications which we have seen throughout time. Since the advent of limited liability companies in the mid-90s, we're more and more, in fact predominantly seeing those applications as limited liability companies. The typical security is a membership interest in a limited liability company where the LLC itself holds the interest on the real estate loan but the investor's individual interest in the LLC is not secured, in contrast to the fractionalized interest where investors' individual interest is secured directly by real property.

A securities permit is issued. The statutory requirement is finding that the offering is fair, just, and equitable. So when the permit applications come to us and our council review them, that is the standard for the finding. Among other things, an application for a permit must describe the business, including the development of the business over the past three years. It must describe the use of the proceeds, the plan of distribution of the securities, the names of all directors and officers, and any conviction of a felony, a misdemeanor, past

securities violations. The applicant must provide a financial statement, a copy of the advertising, and information concerning the financial and other qualification information that will be used to determine the class of purchasers and the methods to be used in qualifying purchasers. That's usually the subscription agreement, and what that means is, when someone's applying, they will tell us what the suitability standards will be for the person who will be investing in the securities, if they're going to limit the market to folks meeting a certain suitability standard. In general, because of the high risk of these offerings, the applications always come in, setting forth a suitability standard. And if not, we would contact the issuer and request that they do so.

In reviewing the applications, as I mentioned, we review the filings based on a particular standard. California is a merit state in terms of securities review rather than a disclosure state, and the department reviews filings to ensure that the offering is fair, just, and equitable, that the applicant intends to transact its business fairly and honestly, and that the securities it proposes to issue and the methods to be used in issuing them are not such that will work a fraud upon the issuer.

The fair, just, and equitable standard doesn't guarantee that the investment won't lose money, and it can't entirely shield an investor from risk. Further, in reviewing applications, we have competing goals to ensure the fairness of the transaction while at the same time ensuring that we have a capital market, that we're not impeding in our regulatory oversight. In reviewing the applications, we generally apply a set of regulations for real

estate programs. The commissioner's rules expressly provide, however, that variations from the standards and the rules will not be—will be granted at the request of an applicant in the case of a limited offering qualification, meaning, a qualification that's not going to be offered to the entire public but limited in terms of the suitability of the investor if we can make a finding that the offering would not be unfair, unjust, or inequitable to the purchasers.

When we review securities offerings in the hard money lending context, we look for the following: We look to ensure the adequate—the applicant is adequately capitalized to inform—to perform—the obligations that it undertakes in the offerings. We look at whether the principles or the entity is appropriately licensed and whether there are any disciplinary actions against this entity or the individuals. We look at how the applicant has obtained capital, a new pass, to ensure it's in compliance with the securities.

SENATOR PRICE: Let me just cut in for a minute, if I may. Notwithstanding the whole list, where do you think the shortcomings are? I mean, it's a nice, long list of supposed things that we check for to make sure that folks are going to be protected. And obviously that protection doesn't really occur. So where is the breakdown? What should we be asking that we aren't asking, or what should we be doing differently? How would you suggest that we try to address the issues that have been raised, the deficiency in enforcement?

MS. MONAHAN: One thing we'll touch on, a lot of what we've heard is about fraud in the marketplace. And so how do you prevent fraud? We have

the laws in place to require the permitting process. We have a system available through the internet called, we call *Cal Easy* that allows any person to pull up any of the prospectuses, the exemptions that have been filed with us. All issuers, applicants, are required—hard money lenders—are required to conform their operations to the prospectus and all the documents they've submitted to us. So it becomes a question of, How do we prevent folks from not doing what they've said they would do?

SENATOR PRICE: How do we keep the bad people from being bad? I guess that's the question, right? (Laughter)

MS. MONAHAN: That is the question.

SENATOR VARGAS: Well, I guess maybe I could ask the more pointed question.

MS. MONAHAN: Okay.

SENATOR VARGAS: I looked at permits that you issued last year in 2010. There were 172. Then I looked at the exempt filings—19,018. So the permits are 172 and the exempt filings were 19,018. I mean, it seems that there's a lot of exemptions here. I mean, is that where this is happening? Is that part of the problem here, that they're not coming under the license; they're coming…

MS. MONAHAN: The private—that 19,000 is likely the number of private placement exemptions. We've been notified about limited offering exemption notices and that is the exemption, the 25102(f) exemption, for any offering of securities not offered to the public in general, offered to 35 or fewer investors

that meets the requirement that there be a preexisting relationship between the parties. No advertising is permitted.

The fraud we see doesn't necessarily track, correlate, to the exemption filing. This exemption filing is for every capital raising transaction in the state, venture capital, private equity, any mom and pop who's going to be issuing securities to themselves once they incorporate. So to equate that ongoing exemption with the potential for fraud or fraud in the marketplace is really the basic way money is raised in the state, absent applying for a permit through a process. So I'm not sure that that number alone represents the propensity for fraud, but it is reflective of where the capital markets are at in our state.

And just for information, back in 1999-2000 when internet stocks and technology stocks were very hot, we received over 50,000 of those filings. So it's a common securities exemption. All states have a similar exemption as well as the SEC for capital raising. It's not limited to hard money lenders. But in this instance, it allows hard money lenders to rely on the exemption which could be explored further as to whether certain greater regulatory requirements might, similar to the other exemption now under the real estate law, might be appropriate in those instances.

SENATOR VARGAS: Okay. I will have some questions later on about that.

SENATOR PRICE: We've been interrupting. Would you like to continue and close so that—we have one more panel before we go to public comment.

MS. MONAHAN: Okay. Well, we've had 22 enforcement cases over the past several years. If you see from our numbers, our number of permit filings is substantially lower related to hard money transactions. So our enforcement numbers are more in conformance with our numbers of oversight in this area. The types of fraud, we see fraud in nearly all the cases. The types of fraud include failure to disclose disciplinary actions, violations of the terms of the permit, failure to obtain permits and build and on and on.

Our enforcement actions result in desist and refrain orders, criminal referrals, civil actions. For those that are licensed as broker-dealers, revocation of broker-dealer, licenses, our investigations, similar to DREs, can involve a substantial amount of time to unwind trust accounts and see where the money flowed to find the fraudulent activities.

I can address any of the findings in the background paper if necessary. Otherwise, I'd like to say that the issues of how to best protect investors in the hard money lending area is, it's a complex issue and we remain committed to bringing enforcement actions against bad actors whose actions expose investors to losses and continuing to coordinate with the Department of Real Estate and other law enforcement agencies in these efforts. Thank you.

SENATOR PRICE: We're going to ask our last panel to come forward, Industry Perspectives panel—Glenn Goldan, chief executive officer of ReProp Financial; and George Eckert, legislative chair of the California Mortgage Association.

Gentlemen. We're going to hear an earful this afternoon.

MR. GLENN GOLDAN: Thank you.

SENATOR PRICE: _____.

MR. GOLDAN: Yes, I'm Glenn Goldan, and I think sitting here today, what strikes me the most is that our industry suffers from the crooks, and cases like Mrs. Fowler's, that's an investor I will never have and everybody she talks to will never have. So thank you for the opportunity to address you today.

My company is ReProp Financial. We've been doing private mortgage investor loans since 1986. I'm the vice-president of the California Mortgage Association. I was its first elected president. I've served as its legislative chair in the past. In fact, Tom and I have worked on a couple of pieces of legislation together and I currently serve on the Education Committee.

I have read the briefing, the backgrounder, that was prepared by staff. It was circulated to our board of directors late last week at our board meeting. We did not have the opportunity to opine formally on the recommendations there. But I can tell you that based on the emails I've received, that particular backgrounder is, from the point of the geeks who make up my board, probably the best piece of writing we've ever seen, most comprehensive on the industry, both from the Department of Real Estate's side and the Department of Corporation's side.

The thrust of my comments are not going to be on the recommendations that are made, although I may comment on a couple of them. It's about a

recommendation that has not been made yet, and that's what I'd like to speak, to do.

Just a little of the background there, I was personally involved in the last four pieces of private-investor mortgage reform legislation, and this dates back to a well-publicized case involving the then independent Senator Kopp and other politicians, as well as prominent people who were taken by a huckster out of Santa Rosa. At that same time, I just completed work for the Northern California Judicial District investigating a much larger fraud case. I worked with the FBI and federal trustee appointed to that case. And what I can tell you is, they were very, very similar and similar to what I'm hearing in this room today. These were people who were not licensed. They were not reporting to the Department of Real Estate, even though they purported to be. They were not giving their clients secured trustee information, you know, securing their interests, so all of their—when they went bankrupt, eventually all of their creditors, all of their investors, were unsecured creditors. Had they been doing their work correctly and they had gotten into trouble for some reason, their investors could have walked their trustees to someone else to service.

Basically they were classically Ponzi. They were raiding their trust accounts; they were converting and comingling money. So at that time, we wanted—the idea was to try to take away the hiding places from the crooks. I mean, plain and simple, that was the mission. So at that time, there was no easy way to determine whether somebody was licensed or unlicensed. So that's, for the first time, as a result of Senator Kopp's legislation, licensees were

required to put their names on their advertising. And then the department was tasked with making sure that that became public. And as the internet became more popular, that became very public. And now it's standard. It started in California. It's basically standard in every state.

They were also required to show property, title reports. Those were best practice but it wasn't required, to show your clients your title reports, show them certified independent appraisals. In a few cases, you could—an investor could waive that requirement, but the broker had—the burden of proof was not on the broker to prove the value of the property, and many other safeguards were also put in place at the same time. And I know the day is going long so I'm going to keep my comments as brief as I can. And if you have any questions, it'd be great.

Senator Kopp also tried to eliminate what were threshold requirements, and there are really two threshold requirements. The first one is mentioned, I think, beginning of page 2 of your report, and that has to do with threshold brokers. We've discussed that a great deal. And the other one starts on page 5 of your report, I believe, and that has to do with multi-lender thresholds, so there's a level of reporting there.

These require us to self-report to our regulator, and the key words here is *self-report*. We've got to tell them that we've reached these certain thresholds. And as a result of reaching these, we now have to file quarterly reports, annual reports; our trust accounts are reviewed by CPAs, certified public accountants, third party, and our business activities are also subject to third-party scrutiny.

There were two other pieces of legislation that we worked on specifically with Tom Pool in 2003. That was—let's see. It was Assemblymember Leno, 620, AB 620, and what that did was, it took what were best practices in the construction lending area and codified those. And so the number of regulations—I think Mr. Pool has mentioned that. Also, we worked on a bill known as AB 7, 679—that was Chavez—and that took care of another problem area in the industry which was making sure the loan-to-value ratios were correct when you used multiple types of property and multiple, multiple real estate transactions. In other words, a piece of land should not have the same loan-to-value ratio as a building, for example; and if you use both of those, making sure that your loan-to-value ratios, on behalf of the investors, were correct.

Let's fast forward to the individuals that were the subject of the *Sacramento Bee* articles this summer. So you have to ask yourselves, okay. Mr. Goldan is telling me about all the wonderful safeguards that have been put in place over the last 15 years. How did these guys get away with it?

Plain and simple, they didn't self-report—okay?—under the theory that, if you are not a great operator, let's say, why would you put yourself under the department's scrutiny? I mean, you just won't do it. And in the cases that I mentioned that I investigated in the '90s and in a couple of cases—and in one of the two cases I'm sure Senator Blakeslee was referring to, which I'm familiar with, they were not self-reporting.

So I have an elegant solution for this problem and probably a more practical solution. The perfect solution, I think, is obvious to everyone in the room—you eliminate the thresholds; everybody plays by the same rules. The thresholds were placed, put in place, to protect the small operators from the burden of the paperwork, okay? But I think the department would agree with me that at least hundreds of operators who should be reporting are not reporting. So if the thresholds were streamlined, removed, and the list of all operators was published, those would not get out of the business on their own volition would be taken care of by operators like us and the California Mortgage Association because we know what goes on in our own neighborhoods. We know who's operating. We just can't tell who's small or not small.

Now the practical solution, which was introduced by Mr. Pool, which it's a step in the right direction—if we publish the list on the Web of all operators, okay, that certainly will deter some people from operating but we can't police that. We could self-police the others. We can't determine who's too small, so I can see an operation across the street from me, but I can't tell if they're too small to operate. And when you think about that rule, imagine that you are a small community bank and the FDIC gives you a free pass because you're small. In fact, they don't even audit you and then you get to self-report when you're big enough. It's been an issue that I know that the association that's been fighting for 15 years—I've been fighting personally for 15 years.

So to conclude, to turn it over, I wanted to keep—I cut much of this out…

SENATOR PRICE: Thank you.

MR. GOLDAN: …in deference to the time.

SENATOR PRICE: Thank you.

MR. GOLDAN: It really isn't any coincidence that all five individuals that were subject to the *Sac Bee* article decided reporting just wasn't right for them because they needed to fly under the radar.

Now I have to mention full disclosure. Two of those individuals only had accusations filed against them, and one of them was already mentioned by name. I believe the self-reporting that that individual did not do was the multi-lender self-reporting which is even a higher standard than the threshold. Thank you for your time.

SENATOR VARGAS: Thank you.

Mr. Eckert.

MR. GEORGE ECKERT: Yes. Chairman Vargas, Chairman Price, esteemed committee members, I want to thank you for inviting me to participate in this very important discussion.

My name is George Eckert. I am the current legislative chair for the California Mortgage Association, or CMA, having served previously two terms as a president. I want to reiterate the compliments that Dr. Goldan gave to the committee staff for this background report. It is in fact the most comprehensive study on our industry that I personally have ever seen, and I've been involved in this industry since 1987.

SENATOR VARGAS: Thank you.

MR. ECKERT: Kudos to Eileen Newhall and her staff for putting it all together. As Mr. Goldan—well, in his prepared remarks, he stated that CMA is probably the only trade association that is devoted exclusively to representing private-money lenders. This committee hearing is about hard money lending. Hard money lending and private-money lending in our minds are synonymous. Hard money lending is not really a pejorative term, but we prefer private-money lending because really that's the essence of what we're doing. We're using private investor money to make loans.

CMA's primary mission is to educate our members which currently number more than 200 in best practices in the industry to help them keep up with the ever-changing regulatory landscape in which they're choosing to operate. The past six or seven years have been particularly challenging for those in our industry. New laws and regulations that were alluded to previously admit that state and federal levels have severely restricted our members' ability to do what used to be their bread and butter, which is residential mortgage loans—first, second mortgages on homeowners' homes. Marginal borrowers that typically utilize private-money lending in the past can no longer qualify based on equity loan. It's become illegal to actually make a consumer loan without verifying for sure the borrower's ability to repay. These restrictions have the effect of creating a class of permanent renters who only dream of home ownership no longer exists. Someone argued that such people are better left not mortgaging their future. I believe that's a decision best left to the individual rather than being imposed by government regulation.

These laws and regulations, together with a bad economy, have forced many of our members to abandon the business. And those who remain have shifted their focus to non-consumer lending, including financing investor purchases of properties for resale or for rent, as well as commercial and industrial property types. So as Mr. Pool mentioned, the type of loans that we're now selling to our investors has changed. They are a lot more complicated than they used to be. It's not just a simple first or second mortgage secured by your next-door neighbor's house. It's a lot different landscape than it used to be.

My company, like many of my fellow CMA members, originates its loans under a DRE broker's license but then sells those loans to investors pursuant to a permit issued by the Department of Corporations. We report our trust account activity to the Department of Real Estate. We have to submit quarterly trust account reports reviewed by our CPA. We have to submit an annual trust account audit as well as providing all types of different reports. We are a threshold broker. We make multi-lender loans, so we report both as threshold brokers and as multi-lenders.

The business plan permit that we obtained from the Department of Corporations has to be renewed annually. We pay a fee. We have to submit reports on our activities from the previous year, including a number of loans originated, the dollar amount of those loans, the servicing statistics, including how many loans have gone bad and how many have come back in foreclosure, as well as submitting audited financial statements for our company. And the

requirements—one of the requirements—of the permit is that we provide investors, in addition to the offering circular, which is about ye thick, and a subscription agreement, which is five or six pages—it includes the investor suitability standards and things like that—we also have to provide them with all of the mortgage loan disclosures, the lender/purchaser disclosures, that are prescribed by the Department of Real Estate, for a servicing agreement, the investor/purchaser disclosure statement, all of those things. So by selling our loans to investors pursuant to the DOC permit doesn't excuse us from all of the disclosure requirements that the Department of Real Estate imposes on its licensees.

As for regulatory oversight, let me just compliment Mr. Pool and his department for the tenacity of its auditors. Late last year, we received a call from the Department of Real Estate asking when it would be convenient for their auditor to come and spend about six or seven weeks in our office to audit our books.

One of the reports that we filed…

UNIDENTIFIED SPEAKER: _____?

MR. ECKERT: Pardon me?

UNIDENTIFIED SPEAKER: ____ Sunday?

MR. ECKERT: Well, how about Monday? (Laughter)

It wasn't the most pleasant process but it was endurable and it was handled on a very professional basis.

One of the reports that we have to file is the Quarterly Trust Account Report. And due to a software glitch, which resulted in an investor getting paid twice for the same borrower payment—it happened at the end of the quarter; it appeared on our quarterly report; we had a negative balance in one of our trust accounts—the Department of Real Estate looks at these reports. They actually look at them and they said, well, you know, there's a problem here. Maybe we ought to go out and take a look.

So they came out and took a look and they reviewed—we have multiple trust accounts. We have a fairly large operation. We service about $60 million in loans. They looked at every trust account, all of the check registers. They looked at the checks. They tracked the money through the account statements. Then they started pulling loans files and making sure that we had all the proper disclosures on the borrower's side, on the investor's side. And the rare consumer loan that we made, they made sure that we hadn't exceeded the thresholds for Financial Code 4970, the predatory loan law. And after six, almost seven weeks of intermittent visits to the office, we were written up, is the wrong word, but we were told, don't let your trust account go negative again. Make sure that your software does the right thing.

The point of the discussion is, the Department is looking over our shoulder. And because we have these threshold broker reports and because we have to report on a quarterly basis, the Department is keeping track of what we're doing. And what Mr. Goldan suggested is a way to subject all of the brokers who are doing any type of this business to the same type of scrutiny

that we were subjected to. Sunlight is the best disinfectant. Okay. You put everybody out there in the light of day and the bad things are going to come to light. If the bad people know that somebody's looking over their shoulder, maybe they won't do so many bad things.

The Gold Country Lending fiasco, as Mr. Pool said, that broker did everything wrong. He violated every possible law that he could, in originating loans and selling the loans and self-dealing and not disclosing. All of those things are prohibited by existing laws. I don't know that any additional laws are required other than maybe just to subject more people to the scrutiny that people like myself who voluntarily self-report are subjected to because of that voluntary reporting.

One of the recommendations that is contained in the report is somewhat troubling for folks in my association, and that is, the possible restriction on the percentage of a person's net worth that they would be allowed to invest cumulatively in real estate secured investments, whether they're real estate investment trusts or notes and deeds of trust. I don't think anybody in our industry would argue with the 10 percent per individual transaction. But to put a limit of 10 percent of the person's total net worth, thus limiting their ability to diversify their portfolio, any multiple loans and maybe achieve greater yields than they can achieve anywhere else today, I think that might be a mistake. It might be a little bit of overkill.

If you're putting your money in a CD today, if you put it in a jumbo CD, the bank is going to charge you to keep your money in the warehouse.

Anybody else is getting maybe 1 percent or less than that, a return on their investments. An awful lot of our investments are retired folks, retired school teachers, people like that. They need to supplement their retirement income with the type of yields that my secured trust deeds can offer them and to limit their ability to invest prudent amounts of money, more than 10 percent but not 100 percent of their net worth, in my trust deeds. I think that would be a mistake.

With that, I will conclude and invite questions. Thank you.

MR. GOLDAN: And may I add one comment that I forgot in cutting down my comments, the protections that I had mentioned are almost all found in Article 6. That's if you fractionalize the loans. So if you use two investors on a transaction, you've got this box of rules and regulations you have to follow. But if you use one investor, which you do under Article 5, you don't have to follow those rules. So the recommendation—I think it's recommendation number eight, I believe, certainly is worthy of discussion and that's transferring some of the—sorry—the rules found under Article 6 and Article 5.

SENATOR VARGAS: Thanks, Mr. Chair.

I do have a question for you, Mr. Eckert. It sounds like the Department of Real Estate like camping out at your office. How about the Department of Corporations? Have you heard from them?

MR. ECKERT: The Department of Corporations has not audited our, the loans that we sell pursuant to the permit, and I'm not sure why, but that was one of the suggestions, is that perhaps those loans could be subjected to some

regulatory oversight. We maintained dual licenses. We have an REB license; we also have a CFL license issued by the Department of Corporations. It's inactive. We don't originate any loans under that; we just keep it in case some day we want to. And we do receive a visit approximately every three years from the Department of Corporations. They come in. We tell them we haven't originated any loans. They make sure that our license is prominently posted and send us a bill for about $400 for the visit. That's the only time we ever see the Department of Corporations.

I don't see any reason that those of us who are doing things the right way would object to being subject to audits, whether they're periodic audits, just on a regular basis—they're going to come in every couple years—or whether it's complaint based or, you know, based on the reports that we've given them for last year, they want to come and look at us this year.

SENATOR VARGAS: Thank you.

MR. GOLDAN: May I comment on that, Senator?

SENATOR PRICE: Sure.

MR. GOLDAN: I do hold a CFL license, California Finance and Lenders license. And so they do audit those license. Ours was just completed, so it is—they are—it's a different kind of audit. It's one where you must submit tons of schedules, and then they pick out loans they want to review, that sort of thing. And what triggered the audit out of—there was a triggering mechanism on the audit, just very similar to his. We don't do any residential lending, but we're still servicing two residential loans and so you must disclose that, and

there's no way for the department—so the department thought I was originating but not reporting residential loans. That's what triggered the audit and we explained that.

SENATOR VARGAS: Thank you.

SENATOR PRICE: Thank you. Well, let's—gentlemen, thank you very much for your perspectives and for your industry leadership.

MR. ECKERT: If I may give this to the sergeant. You know, we talked about all the regulations that we're subject to when we try and originate a loan. I have a chart—it's two pages, legal size, very fine print—you'll need your reading glasses. This is the exercise we have to go through when we take a look at a loan to see just which regulations and laws we're subject to.

SENATOR PRICE: All right. Thank you.

MR. ECKERT: I only have one copy of it. Thank you.

SENATOR PRICE: That's all right. We'll share.

We want get some time now for public comment. I know the hour's late, but there's nothing more important than your comments, observations, feedback. And let me invite anyone who wishes to come forward. Please state your name. If you have a question or a comment or an observation, now is an excellent time to share it.

MR. DENNIS FOWLER: My name is Dennis Fowler. I'm Margaret Fowler's husband. I'd say, after listening to all the testimony that we got, we probably have lots of rules and regulations, just like we have traffic laws that get obeyed or they don't get obeyed. You have a punishment if you get caught

breaking the law. I think the biggest thing you can do here, not because I'm involved with this one here, but for everybody, is the punishment should suit the crime. Now when you have X number of dollars that just disappeared and it takes three years to even bring it to some sort of conclusion while the person that we've talked about today is enjoying life—I'm 72 years old and I'm still working because of this—I think that the best thing you can do is pass some laws and say, if you do this, you'll get this and not, well, you can plead out and you're only going to get a couple of years and we're going to let you go. I think that's where you guys ought to be looking at it. It's all about—it cost everybody in this room, the money that we lost, and the taxes we would have paid or whatever. Somebody got away with a lot of money, and it appears that there's still a lot of people doing that.

If I go home tonight and I drive 75 miles an hour and I get a ticket, I'm going to pay for it. I know I'm only supposed to go 65 miles an hour or whatever the closest speed limit is. So laws are just made to be broken. Locks are only good to keep honest people honest. So if you have people that are going to be dishonest and do what they did, and once they get caught, then they need to be punished because that's going to defer—isn't that what we think about the death penalty and things like that? Hopefully that's going to stop somebody from doing something? If we don't have those laws, then we'd all be out shooting each other and it wouldn't be a big deal. Now that still is happening but I'm just saying, there are laws in place to punish people that do things and I think that's probably what needs to be happening here, is if we get

arrested, you get prosecuted, you did this, you do time for what you did. You pay the penalty for doing what you did. That's what laws are for, but it sounds to me like we've got lots of laws. But if people don't adhere to them, it's no different than if we drive down the freeway faster than I know that I'm supposed to. That's all I have to say.

SENATOR PRICE: Thank you. Thank you very much for your comments.

Anyone else? Senator Emmerson, any closing thoughts?

Well, I personally just want to thank all the witnesses for your attention and participation. I know for many, these have been issues that we've been going around and around with for many years. Obviously we have some problems. Obviously there are lots of laws. Enforcement has been a real issue, and apparently there appear to be some gaps that those who are unscrupulous and those who are intent on doing wrong have been able to find and work these loopholes to their advantage, and so we certainly need to do all we can to stop that activity.

We heard lots of good suggestions in addition to the number of suggestions in our packet. I think the issues of transparency kept coming back—the issues associated with investor suitability, publishing the list of threshold brokers again on the transparency side, more transparency for multi-lender thresholds, review of the, maybe a further review of exemptions, another area that we should be investigating. But I want you to know that all these suggestions and ideas are going to be taken to heart. We'll be working

closely. The Business, Professions and Economic Development Committee and the Banking Committee continue to work closely to figure out how we can better provide the kind of protection and oversight to the industry and also to consumers in a way that serves, best serves, the people of the state of California.

So I just want to thank again everyone for participating. Mr. Chairman, I appreciate your leadership as chair of the Banking Committee, and look forward, continue to work with you as we try to resolve, address these issues that have been raised today that have been negatively impacting citizens who've been trying to do the right thing and whose life savings have all been put in jeopardy again by the unscrupulous acts of a few.

So again, we thank you for your leadership.

UNIDENTIFIED SPEAKER: We thank you for _____.

SENATOR PRICE: Thank you.

SENATOR VARGAS: Mr. Chairman. Well, I guess I would just conclude by saying what I said first of all, and that is, thank you, each and every one of you, that was here to testify and, again, sorry for the people who got defrauded ____. I mean, I do feel badly for you, obviously. I wish it wouldn't have happened.

You know, we are trying to figure out ways to make the law more transparent in trying to figure out how to protect people like yourselves that are innocent investors and at the same time also, innocent borrowers. And at the same time, I have to say, you have an industry here, you have a lot of good

players. They're honest people too. You know, they're making their livelihood at this in an honest way, and then you have the unscrupulous guys. We've got to figure out how to go after them.

Again, I think that the penalty should fit the crime. I mean, listening to this and listening to how badly you've been affected and saying, well, they can't have a license now. So what? I mean, you know, like, so what? That's all?

UNIDENTIFIED SPEAKER: They took it away for three years.

SENATOR VARGAS: And so that's what I'm saying. There's got to be more than that. And so anyway, I look forward to working with everyone and, again, thank everyone that testified here. I do have to say this, though, a Latin term, *caveat emptor*, buyer beware. You know, if you think that a deal is too good to be true, it's too good to be true. You know, you do have to beware.

But anyway, again, thank you very much. I thank the chairman for bringing this forward and I appreciate that and I look forward…

UNIDENTIFIED SPEAKER: Can I say something? This is just a thought. Why can't you have the BBB that regulates, you know, the oversights? Is there something that we can set up in a real estate business that maybe can protect someone that might want to _____? Do you know what I'm saying?

SENATOR VARGAS: It's a good idea. It's worth exploring.

UNIDENTIFIED SPEAKER: It's just a thought.

SENATOR PRICE: I think one theme that's come through is that we need to provide greater oversight. Even if you have a lot of oversight, we need

to do some more apparently. And so that may be one way to approach that and I think it's something we will look at.

SENATOR VARGAS: Thank you.

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