DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

24 CFR Part 3500

[Docket No. FR–3638–F–06]

RIN 2502–AG26

Office of the Assistant Secretary for Housing—Federal Housing Commissioner; Amendments to Regulation X, the Real Estate Settlement Procedures Act: Withdrawal of Employer-Employee and Computer Loan Origination Systems (CLOs) Exemptions

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

ACTION: Final rule.

SUMMARY: In this final rule, the Department of Housing and Urban Development is revising Regulation X, which implements the Real Estate Settlement Procedures Act of 1974 (RESPA). This rule completes a process that started with a public hearing and comment period on August 6, 1993, followed by a proposed rule published on July 21, 1994.

In the interest of protecting consumers from practices prohibited by RESPA, while making available to consumers the potential benefits of innovative business arrangements, this rule withdraws an exemption for employer-employee payments, introduces two more-limited exemptions for payments that would otherwise be prohibited by the statute—employer payments to managerial employees and employees who do not perform settlement services in any transaction. In addition, to relieve any uncertainty, the rule adds an additional exemption to clarify that payments made to an employer's own *bona fide* employee for generating business for that employer are permissible. The rule also revises certain controlled business disclosure requirements. HUD has chosen to use its exemption authority under Section 8(c)(5) of RESPA, having consulted with other Federal agencies as required by that provision, as well as the authority under Section 19(a) of RESPA, to permit these payments.

The rule also withdraws an exemption for payments made by borrowers for computer loan origination (CLO) services, because the exemption was found to be of little benefit to consumers or the loan origination industry. However, in order to assure that consumers in the mortgage lending marketplace continue to benefit from technological innovation, simultaneously with the publication of this rule, the Department is issuing a Statement of Policy analyzing payments for CLOs under the RESPA regulations. In addition, the Department is simultaneously publishing two other Statements of Policy on issues raised by comments on the proposed rule, although not directly related to the proposed rule, and which involve interpretation rather than new rulemaking.

EFFECTIVE DATE: This rule is effective on October 7, 1996.

FOR FURTHER INFORMATION CONTACT: David Williamson, Director, Office of Consumer and Regulatory Affairs, Room 5241, telephone (202) 708–4560; or, for legal questions, Kenneth Markison, Assistant General Counsel for GSE/RESPA, or Grant E. Mitchell, Senior Attorney for RESPA, Room 9262, telephone (202) 708–1550. (The telephone numbers are not toll-free.) For hearing- and speech-impaired persons, this number may be accessed via TTY (text telephone) by calling the Federal Information Relay Service at 1–800–877–8339. The address for the above-listed persons is: Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, DC 20410.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act Statement

The information collection requirements regarding controlled business disclosures (Appendix D of this rule) have been approved by the Office of Management and Budget, under the Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520), and assigned OMB control number 2502–0265. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection displays a valid control number.

The Department has eliminated the CLO disclosure statement which previously was contained in Appendix E to the RESPA rule. Based on prior cost estimates, the Department estimates the annual savings to business from eliminating this paperwork requirement to be $3,247,100.

I. Events Leading to Today's Final Rule

A. History of CBAs and CLOs

1. Controlled Business Arrangements

In 1983, Congress enacted the ''controlled business arrangement'' amendment to RESPA. This amendment, codified under section 461 of the Housing and Urban-Rural Recovery Act of 1983 (HURRA) (Pub. L. 98–181, 97 Stat. 1230) established that controlled business arrangements do not violate RESPA, provided that:

(a.) The relationship between the person performing settlement services and the person making the referral is disclosed, along with the estimated charges of the provider;

(b.) Consumers are not required to use an affiliated settlement service provider, except under certain specified exemptions under Section 8 of RESPA; and

(c.) Nothing of value is received by the referring party, beyond a return on ownership interest or franchise relationship or payments otherwise permissible under Section 8(c) of RESPA.

Following the enactment of these amendments, HUD issued several informal legal opinions concerning the extent to which employers could pay referral fees to employees. The opinions stated that *bona fide* full-time employees could be compensated for generating business for their own employers, as this would be within the scope of their employment. These opinions also made clear that uncompensated referrals to affiliated companies were not prohibited. HUD did *not*, however, broadly approve compensation to employees for referrals to affiliated companies.

2. Computer Loan Origination Systems (CLOs)

During the 1980's, a number of private companies and trade organizations began to develop systems where some or most of the usual mortgage origination services could be performed by computers. These computer services frequently linked real estate brokerage offices to lenders or other settlement service providers. Concerns were raised to HUD regarding the interplay of these systems with Section 8 of RESPA, particularly whether the existence of such systems could result in illegal steering or compensation for referrals of business, or whether the use of the systems would allow the operators to impose charges for activities which represented little or no actual services. Several developers of such systems and potential competitors asked HUD for its views on payments made in connection with these systems under RESPA.

In the mid-1980's, HUD issued several informal interpretations generally concluding that payments for CLO systems did not violate Section 8 of RESPA. The opinions stated that, so long as payments by the lenders (or real estate brokerage offices) went to cover ''operational fixed costs'' of the CLO services, no referral fees existed. Moreover, the opinions stated that

borrower payments to CLOs were analogous to arrangements whereby borrowers voluntarily pay mortgage brokers for locating lenders. Accordingly, the Department concluded that such payments were not pursuant to a prohibited ''agreement or understanding'' under Section 8(a) of RESPA and thus, were not proscribed by Section 8(a) of RESPA.

On two subsequent occasions, the Department revisited RESPA's role in payments for CLO services through informal opinions. Both cases involved payments to CLO operators from either lenders or real estate brokers. In these two opinions, the Department concluded that such fees did not violate Section 8(b) of RESPA so long as the fees were reasonably related to services actually rendered. Controversy continued to surround the use of CLO systems, with many mortgage bankers opposing, and realtors supporting, HUD's position. All opinions were withdrawn pursuant to a final rule published on November 2, 1992 (57 FR 49600) under RESPA (hereinafter ''final rule'' or ''1992 final rule'').

In May 16, 1988, HUD opened up this matter for review and discussion without specifically mentioning CLOS, by proposing a rule (53 FR 17428, 17438) that would have added an exception under § 3500.14, to allow the following:

> Voluntary payment by a borrower to a person who has acted as a mortgage broker or has otherwise assisted in bringing the lender and borrower together, provided that such voluntary payment is disclosed on both the good faith estimate of settlement costs and the HUD–1 settlement statement and is not a condition of the loan or other settlement service.

The 1992 final rule did not adopt the so-called ''mortgage broker exception'', but did adopt a CLO exemption.

B. The 1992 Rule

On November 2, 1992, HUD published the 1992 final rule, which became effective on December 2, 1992. The 1992 final rule contained provisions implementing congressional amendments to RESPA regarding controlled businesses and created an exemption for payments by borrowers to computer loan origination systems. The final rule also updated the original RESPA regulations, which had not been amended since 1976.

1. Employer-Employee Exemption

The 1992 final rule went beyond HUD's previous positions, as articulated through informal legal opinions that were withdrawn by the 1992 final rule, and created an exemption for payments by an employer to its own employees for any referrals of settlement service business. Employees were thus allowed to receive compensation from their employers for generating business for their own employer or for any other business entity (including affiliates). The final rule contained a stricture, in § 3500.14(b), that the business entity receiving the referrals of settlement business could not directly or indirectly compensate anyone for such business. The rule did not limit this exemption to controlled business arrangements. The exemption, however, had little utility for entities outside an affiliate business setting, since it was unlikely that an employer would pay its own employees for making referrals to unaffiliated individuals or companies. As noted, while the rule permitted an employer to compensate its own employees for referrals, it also indicated that if the business entity receiving the referral reimbursed the employer of the employees making the referrals, Section 8 of RESPA would be violated.[1]

Following the 1992 final rule's issuance, two lawsuits were filed objecting to provisions of the revised regulations as inconsistent with the statute and claiming failure by the Department to comply with the Administrative Procedure Act in the rule's promulgation.[2] In addition, upon assuming office, HUD officials in the new Administration were inundated with comments about the final rule.

The Department received allegations that the final rule created uncertainty about whether referral fees were in fact prohibited by RESPA. Some entities critical of the 1992 final rule characterized the provision permitting employers' payments to their own employees for referrals as broadly sanctioning referral payments. The trade and business press frequently restated this position without examination. Also, some commenters claimed that the creation of an employer-employee exemption from the prohibition on referral fees prompted some persons to set up sham employer-employee relationships to shield prohibited referral fees, and it prompted others to ''extort'' referral fees from other settlement service providers on the premise that HUD now allowed such compensation. While the final rule was not intended to permit sham arrangements, neither did it clarify the extent of the employer-employee exemption. Commenters argued that the final rule failed to establish a bright line, comprehensible to industry participants, between permissible and impermissible activities.

2. CLO Exemption

The 1992 final rule also introduced a CLO exemption, which provided that borrower payments to CLO systems were exempt from Section 8 so long as a specified disclosure was made. The 1992 final rule did not adopt the mortgage broker exception proposed in the May 1988 proposed rule. The Department reasoned that well-informed choices by consumers did not require special protection under RESPA. Moreover, this exemption was intended to prevent RESPA's restrictions against unearned fees from unduly inhibiting the development of technology which could permit consumers to shop, apply for and/or obtain mortgage loans electronically. CLO systems were not specifically defined in the 1992 rule.

C. A Public Dialogue

Given the controversy over the 1992 final rule, the Secretary determined that a review of the previous policy—primarily concerning the exemptions for employer payments to employees and borrower payments to CLOs—was needed. The review would particularly focus on the final rule's impact on consumers. The Secretary articulated three principles to guide that review:

1. HUD's responsibility is to protect the consumer—not to mediate among industry interests.

2. HUD should regulate multimillion dollar industries responsibly—principally by acting quickly to end uncertainty.

3. Technological and business arrangement innovations have the potential to provide significant consumer benefits, and HUD does not serve consumers well if its regulations unduly stifle such advancements.

On July 6, 1993, in an effort to ensure that the views of all interested parties

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[1] The 1992 final rule was a marked departure from HUD interpretations in recent years. After the issuance of the May 1988 proposed rule, which led to the 1992 final rule, HUD's position, expressed in a number of General Counsel's opinions, was that an employer could not compensate its employee for referrals to other business entities (including affiliates). These opinions only indicated that an employer could compensate its employees for generating business for that employer (not to affiliates).

[2] Plaintiffs in *Mortgage Bankers Association of America* v. *United States of America*, No. 92–2699 (D.D.C.), and *Coalition to Retain Independent Services in Settlements (CRISIS)* v. *Cisneros*, No. 92–2700 (D.D.C.), filed separate actions seeking a declaration that the ''employee exception'' provision was invalid and injunctive relief enjoining implementation of this provision. The MBA suit also alleged that the CLO provision was invalid. These suits were dismissed without prejudice, that is, subject to reinstatement. A hearing regarding the Department's progress in issuing revised regulations is scheduled for October 1996.

were heard, the Department published a ''notice of written comment period and informal public hearing'' (58 FR 38176), inviting testimony and written comments on the following four provisions of the final rule:

- *Issue 1—The ''employer-employee'' exemption.* Section 3500.14(g)(2)(ii) of the 1992 final rule, which provided that Section 8 of RESPA does *not* prohibit ''an employer's payment to its own employees for any referral activities * * *.''
- *Issue 2—The ''computer loan origination'' (CLO) exemption.* Section 3500.14(g)(2)(iii) of the 1992 final rule, which provided that Section 8 of RESPA does *not* prohibit ''any payment by a borrower for computer loan origination services, as long as the disclosure set forth in appendix E is provided the borrower.''
- *Issue 3—Preemption policy.* Section 3500.13(b)(2) of the 1992 final rule, which provided that ''in determining whether provisions of State law or regulations concerning controlled business arrangements are inconsistent with RESPA * * * the Secretary may not construe those provisions that impose more stringent limitations on controlled business arrangements as inconsistent with RESPA, as long as they give more protection to consumers and/or competition.'' [3]
- *Issue 4—Controlled business disclosure policy.* Section 3500.15(b)(1) of the 1992 final rule, which provided for a written disclosure in controlled business situations regarding the ownership and financial relationships between referring and referred-to parties, and for certain timing and other methods for disclosure.

On August 6, 1993, HUD conducted a public hearing, which produced testimony and documents from 36 interested parties. The request for written comment generated 1,526 public comments on these four issues.

D. The 1994 Proposed Rule

Following a detailed examination of the testimony and comments, HUD published a proposed rule (59 FR 37360, July 21, 1994) [4] containing substantial revisions to the RESPA regulation. The proposed rule discussed the views expressed in response to the pre-rule solicitation of public comment and took positions on each of the earlier-presented four major issues, inviting further public comment in light of the additional revisions to the RESPA regulation that HUD was proposing.

The proposed rule reflected the Secretary's conclusion that the 1992 final rule's employer-employee exemption was too broad. In the proposed rule, HUD proposed to withdraw this exemption because it compromised the statute's purpose of protecting the consumer from being referred to settlement service providers because of financial gain to the referrer, rather than because of the quality and price of the services. The proposed rule would have removed an exemption that permitted an employer to pay employees referral fees for referrals to an affiliate business entity.[5] The proposed rule rejected the view that all employer payments to its employees for referrals to third-party settlement service providers should be exempt. When HUD viewed the payments from the perspective of the consumer, it was clear that payments by the employer to an employee, who performs settlement services, for third-party referrals were indistinguishable from payments directly from the third-party settlement service provider. While HUD has the authority to exempt all employer payments for third-party referrals under its Sections 8(c)(5) [6] or 19(a) authority, the Secretary concluded in the proposed rule, as a policy matter, that such a broad exemption was inconsistent with the purposes of RESPA. In this final rule, the Secretary is exercising this authority under Sections 8(c)(5) and 19(a) to exempt employer payments to their employees in those circumstances where adequate consumer protection exists.

In adopting the proposed rule, the Department also recognized that Congress had clearly established that controlled business arrangements were permissible under certain conditions. In the interest of avoiding undue interference with the internal operations of controlled businesses, expressly permitted under the 1983 amendments to RESPA, the proposed rule would not have prohibited the payment of bonuses and compensation to managerial employees in controlled businesses for such purposes as the generation of business among affiliates provided, however, that:

1. No employee or agent could receive compensation from his or her employer or any other source when the compensation is tied on a one-to-one basis to, or is calculated as a multiple of the number or value of, referrals of business to an affiliate business entity; and

2. The compensation of agents or employees who routinely are in direct contact with the public could not be based, in whole or in part, on the value or number of referrals made to affiliated entities.

These clarifications were designed to minimize any incentive that a person in a position to make or influence a referral might have to make a referral based on his or her own, or his or her employer's, financial interests, without requiring HUD to interfere unduly with the internal operations of controlled business arrangements.

As it relates to the regulation of payments to CLO systems, the proposed rule reflected a determination that it was desirable to amend the final rule to establish minimum standards for qualified systems, payments to which would be exempt from Section 8. Under § 3500.14(g)(3) of the proposed rule, ''qualified'' systems would have had to meet a number of specific regulatory requirements.[7] The proposed rule also asked for advice as to whether to create a similar exemption for payments by lenders to operators of ''qualified'' CLOs.

To assist in the promulgation of a final rule, the Secretary requested comments and invited information on the effect of all of the above proposals on the settlement services industry and consumers. As an additional vehicle for obtaining public input, on September 30, 1994, as part of the rulemaking process, the Department conducted an open house for operators of CLO systems to demonstrate their systems to HUD and to the public.[8]

Later in the rulemaking process, in August and September 1995, the Department convened two working group meetings of interested industry, government, and public officials, to obtain their individual input and to

[3] As discussed, *infra,* HUD announced in a July 21, 1994, proposed rule that it would not propose new rules on this issue and would consider preemption questions on a case-by-case basis. Since HUD has not changed its position on this issue, this final rule does not address the issue further.

[4] A more comprehensive discussion of the issues presented, the Secretary's initial position on further amendment of the RESPA regulations, and a summary of the hearing testimony and the comments received are contained in the preamble of the proposed rule.

[5] This proposal was consistent with congressional admonitions. *See* H.R. Rep. No. 123, 98th Cong., 1st Sess. 76 (1983) (controlled business provisions are not intended to change current prohibitions against unearned fees, kickbacks, or other things of value in return for referrals of settlement service business).

[6] In accordance with section 8(c)(5) of RESPA, HUD consulted with the other agencies listed before exercising its authority under section 8(c)(5).

[7] These requirements are described in Part II, Section C, of this preamble.

[8] Twenty-one CLO operators accepted the Department's invitation and demonstrated their systems to officials of the Department and to the public during an all-day session on September 30, 1994.

further explore the development and use of CLOs.

E. Today's Final Rule

Today's final rule addresses the comments received in response to the proposed rule and considering the comments, promulgates rules relating to Issues 1 (the employer-employee exemption), Issue 2 (payments to CLOs), and Issue 4 (controlled business disclosure format). With respect to Issue 1, the rule withdraws the employer-employee exemption and introduces three more-limited exemptions designed to recognize the variety of business organizations without doing damage to RESPA's core objective of consumer protection. On Issue 2, the rule withdraws the CLO exemption and issues a related Statement of Policy that illustrates how CLO payments and activities are analyzed under the existing and new RESPA regulations. As discussed, supra, respecting Issue 3, the proposed rule did not propose any changes to the preemption provisions, for the reasons explained in the proposed rule, and, therefore, requested no comments. On Issue 4, the rule revises the Controlled Business Arrangement Disclosure Statement.

In reading this preamble, the reader should be aware that HUD's RESPA rule was recently streamlined through a separate rulemaking (61 FR 13232, March 26, 1996). This streamlining caused several provisions of the RESPA rule to be renumbered. Except as is otherwise indicated in the context of the preamble, this rulemaking refers to provisions by their current section number, incorporating all revisions to date as a result of the streamlining and today's rulemaking.

II. Analysis of Issues in Final Rule

A. Overview of the Public Comments

The Department received 354[9] comments on the July 21, 1994, proposed rule. Of these, 100 were from attorneys, most of whom stated that they were, or previously had been, actively engaged as settlement lawyers. Only 2 comments from attorneys were identified by the writers as written on behalf of clients; the remaining 98 appeared to be individually originated comments by the attorneys or law firms on their own behalf.[10] An additional 73 comments came from bank holding companies, banks, or other mortgage lenders; comments were received from 46 real estate brokers; 34 comments were from mortgage brokers; 19 were identifiable as multi-service real estate service organizations; [11] 14 comments were from title company executives, 9 comments came from credit unions; 8 from CLO service providers; and 6 commenters identified themselves as consultants. One comment was received from a journalist, one from a mortgage insurance firm, one from a credit reporting service, and one from a student, and three comments were received from persons whose professional interest in the rule could not be determined.

Twenty-two State, local, or regional organizations representing portions of the real estate brokerage, lending, and settlement industries provided comments, as did 16 organizations classified as national advocacy organizations.

Attitudes toward the proposed rule varied greatly, not only according to the professional background of the commenters, but also according to whether a commenter was engaged in a controlled business arrangement. For this reason, lenders and other settlement service providers expressed a wide variety of views concerning the rule. The majority (but by no means all) of the comments received from real estate brokers and agents favored the existing regulatory structure (the 1992 final rule) and sought to discourage changes in the rule which, they argued, would impede their ability to provide benefits to consumers.

Issue 1 (the employer-employee exemption) attracted the greatest attention among commenters. Virtually all commenters, on both sides of the issue, were at least moderately dissatisfied with the proposed rule's revisions. Commenters who opposed *any* authorization of referral payments frequently thanked the Department for the effort made in the proposed rule to limit the practice, but virtually all of these commenters were displeased that the Department was proposing to exclude from RESPA coverage certain compensation to managerial employees in controlled businesses.

On the other hand, commenters who wanted referral payments to employees to continue to be allowable expressed strong opposition to the proposed rule's limitation on such payments. Additionally, many of these commenters asked for clarifications concerning the scope of the ''managerial'' exemption.

Issue 2 (the CLO exemption) was the second-most-frequently addressed subject. A significant minority of the commenters who addressed the issue credited the Department with a good effort at better defining ''CLO services'' in the proposed rule, and there was some positive support for the HUD definition. However, most commenters who addressed the CLO question found fault with HUD's proposed disposition of the issue, with the proposed CLO definition, or both. A wide variety of suggestions for further refinement of the definition was provided.

Issue 3 (the preemption issue) drew a few comments, even though the Department had not requested any comments on it and had determined in the July 21, 1994 proposed rule not to propose new rules on this issue. The Department stated in the proposed rule that ''setting out comprehensive and informative preemption standards present[ed] an almost insurmountable task, in the absence of a wide array of specific fact situations that are raising preemption issues.'' The Department determined to consider preemption questions on a case-by-case basis. Accordingly, the final rule does not address this issue.

Issue 4 (the controlled business arrangement disclosure statement) attracted a significant amount of comment. In general, commenters on both sides of the other issues were undisturbed by what they perceived as the somewhat minor changes in the controlled business disclosure statement that HUD proposed to adopt. There were, however, a number of technical suggestions, and significant criticism of what was regarded as the unduly negative tone of language proposed to be employed in the Appendix D format to suggest that consumers shop for services. Additionally, commenters continued to identify unresolved questions about the disclosure form and to suggest modifications of both its language and its applicability.

What follows is a more comprehensive discussion of the views expressed by the commenters on Issues 1, 2, and 4, together with the Department's rule-making decisions.

B. Issue 1: Withdrawal of Employer-Employee Exemption

1. In General

In the proposed rule, the Department proposed the *withdrawal* of the existing regulatory exemption that permits

[9] Three-hundred fifty-seven comments were received, but three were found to be duplicate copies of other comments.

[10] Not included as ''attorney comments'' were comment letters written by house counsel for banks, lenders, or other organizations communicating, through counsel, on their own behalf.

[11] It was not always clear from a commenter's remarks, or from the commenter's business letterhead, whether the commenter spoke for a multiple-service entity. Accordingly, some commenters classified here as lenders, mortgage brokers, real estate brokers, or other categories may also, in fact, be multiple-service business entities.

employers to pay referral fees to their own employees for referring settlement service business to business entities, including those within an affiliate relationship. This exemption applied whether or not employers were in an affiliate or ''controlled business'' relationship, but practically only benefited affiliate arrangements, as an employer was unlikely to compensate its employees for referrals to unaffiliated providers. The proposal included a limited exemption for payment of bonuses for managerial employees who did not deal with the public, provided such bonuses were not correlated on a one-to-one basis or calculated as a multiple of the number or value of any referral of settlement service business by the employee or the employee's organizational unit to an entity affiliated with the employer or principal.

2. The Public Comments

Virtually all of the comments from attorneys approved of the proposal to eliminate the employer-employee exemption. (About 30 percent of all the comments received on the proposed rule were from law firms providing settlement services, and the overwhelming majority of attorney comments were focused upon the employer-employee exemption.) The combined comments of the Attorneys General of 11 States commended the Department for focusing the rule's impact on consumers and for articulating, as the first of HUD's guiding principles, the protection of the consumer, rather than the mediation of industry interests. They called the proposed rule a ''vast improvement'' over the November 2, 1992, rule.

Some major industry organizations expressed support for the withdrawal of the exemption. For example, the Mortgage Bankers Association expressed its ''substantially favorable reaction'' to the changes HUD was proposing. MBA called employer-paid referral fees ''fundamentally inconsistent with the purposes of RESPA,'' and approved the proposed rule's elimination of the exemption for fees paid to employees with direct contact with consumers.

The basic premise of these commenters, who wanted a total withdrawal of the employer-employee exemption, was that Section 8(a) of RESPA should be construed to prohibit all ''compensated referrals,'' and any standard less than this bright line test opened up this civil and criminal statute to unnecessary ambiguity and uncertainty. These commenters generally maintained that no exceptions or exemptions should be made.

In contrast, comments favoring the retention of the employer-employee exemption argued that the 1992 formulation of the regulations had not yet had time to work and be measured, much less to be found insufficient. One diversified real estate, finance, management, and insurance company from Illinois argued that ''controlled business arrangements'' was an unfortunate misnomer that left the impression that great control was being exercised over consumers. The commenter's own company, it was claimed, had a ''capture rate'' of only around 14 percent of its real estate customers choosing to use its mortgage services:

> This means that at least 86 percent of those customers still seek a different mortgage provider. This hardly represents a coercive customer problem that's needing more regulation * * *. The real danger in attempting to further regulate companies such as ours [is that it] will result in reduced customer choice which we clearly provide, and retarding competition * * *

An Illinois local office of a nationwide finance organization argued strenuously that the elimination of employer-employee referral fees would change little.

> * * * [I]n the absence of any referral compensation, employees will not discontinue referring consumers to affiliate settlement service providers. This is because, when dealing with the consumer, the employee is an agent of the employer and, as such, acts in accordance with [his] employer's direction. * * * [A]rguments that not paying a referral fee to an employee will result in an employee acting independently of the employer's interests [are] simply not based on reality.

The Real Estate Services Providers Council (RESPRO), an advocate of the 1992 final RESPA rule, stated its continuing support of a regulatory environment that would permit unfettered ''one-stop shopping'' for real estate services. RESPRO favored both management compensation and front-line employee compensation based upon profits or on the amount of referred business the manager/employee was responsible for producing. HUD's proposed rule suggesting the withdrawal of the exemption in the 1992 final rule has, RESPRO commented, stifled companies from developing one-stop shopping programs in the most cost-efficient manner. The new proposed rule ''would significantly decrease cost efficiencies within diversified companies by preventing them from utilizing their own management to carry out the company's one-stop shopping goals.''

HUD's apparent objective in regulating referrals, RESPRO argued, was to eliminate the possibility of *adverse steering.* However, HUD's principal concern appears to be focused on perceived abuses in the *real estate sales industry,* and the examples of abuses cited by HUD (and by commenters responding to the earlier request for comments) involved real estate brokers and salespersons. RESPRO argued that the 1994 proposed rule's prohibition on employer-employee referral payments goes far beyond any rule necessary to reduce adverse steering, and that the rule deprives diversified companies of the efficiencies they need to lower costs to consumers and would place diversified companies at a competitive disadvantage, relative to independent competitor companies.

Comments from the National Association of Federal Credit Unions (NAFCU) also opposed the elimination of the RESPA exemption for employer-employee referral fees.

Another commenter who opposed the elimination of the exemption and stated its support for the 1992 RESPA regulation was the National Association of Neighborhoods (NAN). NAN's comments expressed concern that the proposed rule's changes would reduce competition and consumer choice by limiting the ability of one class of providers—diversified companies—to offer homebuyers services on a cost-efficient basis. NAN also expressed concern about the effect of the revisions on the Community Reinvestment Act, noting the Federal Reserve Board's earlier comments that restrictions on employee referral-based compensation might be ''detrimental to future innovations and developments in community lending.''

A mortgage finance consultant from Virginia cited recent legislative proposals in Pennsylvania that would restrict the percentage of business referrals permitted in a realtor-mortgage banker controlled business arrangement. The commenter noted that Congress had rejected similar proposals in the 1983 amendments to RESPA:

> In my experience, all of the attempts to limit CBAs have been motivated by industry, not to protect consumers or to provide lower fees or better service, but to keep another industry from entering the business. I would urge HUD to ensure that congressional intent is followed by allowing CBAs to exist in the states unfettered by the kinds of restrictions that were rejected in the 1983 CBA amendments to RESPA.

Many supporters of controlled business arrangements reiterated their earlier contentions that ''one-stop

shopping'' leads to greater efficiency in the settlement process and to cost-savings for borrowers. Several of these commenters objected strongly to the proposed withdrawal of the employer-employee exemption, and urged that the Department reconsider and retain the existing employer-employee exemption.

The National Association of Realtors (NAR) supported HUD's clarification of the meaning of the November 2, 1992 rule, as set forth in the preamble of the July 21, 1994 proposed rule, which indicated that real estate agents were normally ''independent contractors'' and therefore not employees within the meaning of the rule. Such agents, therefore, could not receive referral-based compensation. NAR counsel, however, requested clarification that an employer *may* legitimately compensate its own employees ''for the generation of its own business.'' Another commenter (Commercial Credit Corporation) wanted a clarification in the final rule that RESPA did not apply to the compensation arrangements for the generation of settlement service business by either an employee or an agent of a settlement service provider, in a particular multi-layered business structure, who originated settlement services business exclusively for that settlement service provider.[12]

3. The Final Rule's Approach—Overview

After a complete review of all comments and points of view, the Department withdraws the broad employer-employee exemption. HUD has determined that a broad exemption, as contained in the 1992 rule, unnecessarily allows persons who serve consumers and gain their trust to receive referral fees, in contravention of the express intent of Congress in enacting Section 8(a). However, to allow controlled business arrangements to operate and provide beneficial services and packages of services to consumers, the rule establishes three exemptions for permissible payments by employers to *bona fide* employees. Specifically, the exemptions permit employer payments to their own *bona fide* employees for referrals of business *if*:

(a.) The employee is a managerial employee, and the payment is not calculated as a multiple of the number or value of referrals.

(b.) The employee does not perform settlement services in any transaction; prior to the referral the employee provides the person being referred a written disclosure in the format of the Controlled Business Arrangement Disclosure Statement, set forth in Appendix D to this part; and the referral is to a settlement service provider which has an affiliate relationship with the employer or in which the employer has a direct or beneficial ownership interest of more than one percent. For purposes of this exemption, the marketing of a settlement service or product of an affiliated entity, including the collection and conveyance of information or the taking of an application or order for the services of an affiliated entity, does not constitute the performance of a settlement service. Under the exemption, marketing of a settlement service or product also may include incidental communications with the consumer after the application or order, such as providing the consumer with information about the status of an application or order; marketing may not include serving as the ongoing point of contact for coordinating the delivery and provision of settlement services.

(c.) The payment is to that employer's own employees for generating business for the employer itself—but not its affiliates. The Department believes that it was clear that such payments were permissible payments under RESPA. However, because some commenters indicated uncertainty regarding this position, and it is HUD's intent that such payments continue to be permissible, the rule clarifies the issue with a new exemption providing that payments made to *bona fide* employees for generating business for their employer are permissible under § 3500.14(g)(1)(vii). This exemption means that an employee may accept payments for referrals to its own employer. In an affiliated relationship, the employer is only the business entity for whom the employee directly works.[13]

These new exemptions provide that payments must be to a *bona fide* employee. Individuals may not be hired on a part-time basis to make referrals because of their access to consumers as settlement service providers. Sham employment arrangements, such as a title company paying a one hour ''salary'' to a real estate agent who provides a referral, and issuing a W–2 for ''services'' rendered to justify compensating a referral, are, and will continue to be, violations of RESPA.

The Secretary has authority to create exemptions under Section 19(a) of RESPA for classes of transactions as may be necessary to achieve the purposes of the Act. 12 U.S.C. 2617(a). In addition, under Section 8(c)(5) of RESPA, the Secretary may create regulatory exemptions for ''such other payments or classes of payments,'' after consulting with various Federal agencies. 12 U.S.C. 2607(c)(5). The three exemptions created under this final rule are issued pursuant to the Secretary's clear authority to create reasonable exemptions to further the purposes of the Act.

In creating these new exemptions, HUD is not directly regulating wages to *bona fide* employees. Rather, HUD is creating an exemption for certain payments within an employment context that otherwise would be prohibited by Section 8(a). The Secretary believes that such payments to *bona fide* employees are not designed as a subterfuge to facilitate kickbacks among affiliated companies.

The exemptions for managerial employees and employees who do not perform settlement services in any transaction are explored in detail below.

4. Managerial Employees

a. The Public Comments. Several commenters supported allowing compensation to managerial employees based on referrals and criticized the formulation regarding managerial compensation in HUD's proposed rule. NAR supported the idea of compensation for managerial employees or others who are not sales agents or otherwise involved in the direct provision of settlement services. At the same time, NAR asked that the proposed definition of ''managerial employee'' clarify that mere possession of a broker's license or a salesperson's license to sell real estate would not affect an individual's status as a managerial employee. Many States, NAR indicated, require managers in the real estate

[12] The commenter described a circumstance in which a mortgage broker entered into an exclusive agency agreement with a lender to deliver mortgage loan applications to the lender. The mortgage broker used its exclusive agents (who were not otherwise engaged in performing settlement services) to generate these loans. The commenter represented that the consumer was at all times aware of the exclusive relationship between the agent and the mortgage broker and lender principals.

Payments by a mortgage lender to its exclusive agents reasonably related to services actually performed, in the circumstances described, fall under the exemption in Section 8(c)(1)(C) and 24 CFR 3500.14(g)(1)(iii). Thus, HUD concluded that the requested clarification to address the issue raised by the commenter was not necessary.

[13] In addition, pursuant to 24 CFR 3500.14(g)(3), any person who is in a position to refer settlement service business, such as an attorney, mortgage lender, real estate broker or agent, or developer or builder, may continue to receive payments for providing additional settlement services as part of a real estate transaction, if such payments are for services that are actual, necessary, and distinct from the primary services provided by that person.

business to hold licenses as brokers or sellers.

NAR counsel, responding separately to the proposed rule on behalf of the organization, further elaborated on the national organization's position regarding referral payments. He distinguished ''primary services'' from ''secondary services,'' and argued:

> NAR recognizes that the historic and legitimate thrust of Section 8(a) of RESPA has been to prohibit compensation for referrals by persons who are ''in a position to refer settlement business,'' understood as referring to real estate professionals providing settlement services (''primary services'') to whom consumers may look for advice regarding sources of other required settlement services (''secondary services'') with the expectation that such advice will be based on professional knowledge and experience and not tainted by additional compensation payable by the highest bidder for the referral.

He suggested that HUD prohibit referral-based payments for any individual who has significant contact with consumers regarding the provision of a settlement service, where a principal part of the individual's income consists of compensation based on settlement services performed for the person's employer or an affiliate. The prohibition against sharing of compensation related to a ''secondary service,'' NAR counsel argued, could apply to all services performed by the secondary service provider and not just to specific referrals. He asserted that HUD could more easily enforce his suggestion than HUD's proposal, since HUD's rule evidently required proof of an actual ''referral'' by the initial service provider.

> * * * [A] regulation based on identification of actual referrals will likely prove unworkable, leading either to no enforcement or to adoption of presumptions that might exceed HUD's authority.

Additionally, NAR counsel argued that the proposed rule's ''managerial exemption'' would unduly complicate the ability of a diversified company to devise workable incentive compensation schemes for managers. NAR counsel further suggested a change to the definition of ''managerial employee'' to exclude situations wherein a managerial employee may, from time to time, act as a direct service provider. (In such circumstances, the NAR-suggested definition would not permit referral-based compensation in addition to the sometime-manager's commission.) NAR counsel added, in comments varying somewhat from the stated NAR position:

> In general, we do not believe that the permissibility of compensation should turn on status as an ''employee'' vs. ''independent contractor,'' provided that the independent contractor is one whose services are provided exclusively for a single principal and who is, therefore, in the eyes of the consumer, indistinguishable from an employee.

MBA stated its concern about the lack of clarity in the ''managerial employees'' exemption in the proposed rule, seeking to narrow the category of persons eligible for payments for referrals:

> We believe it is imperative to have more detail in the definition, so that the lending and real estate broker industries will know exactly where the line is between 'managerial employees' and those that have 'routine contact with the public.' For example, if a person manages a branch office and consequently has supervisory control over all of the staff that deal directly with the public, in which category does that person fall? We strongly urge that such a person [not be] eligible for the exemption because of his or her involvement with the public implicit in the supervisory role * * *.
>
> * * * [U]sing real estate offices as examples, office managers and real estate brokers can exercise considerable influence over the activities of the independent agents through manipulation of the terms and conditions of their work * * *.

MBA asked that the term ''managerial'' be further defined to include only individuals working at ''higher corporate levels'' where there would be no opportunity to steer consumers. It was urged that the definition be amended to clarify that only employees who do not work in offices where consumers regularly visit could qualify for the managerial exemption. The National Association of Mortgage Brokers (NAMB) also asked that HUD revise the rule to elaborate on the definition of ''employees'' to make clear that the term *excludes* independent contractors and real estate agents.

RESPRO favored both management compensation and front line employee compensation based upon profits or on the amount of referred business the manager/employee was responsible for producing. RESPRO claimed that the proposed rule's restrictions on compensation for managerial personnel were so vague that they would, effectively, prohibit all management compensation in one-stop shopping programs. One of HUD's Fact/Comment Illustrations in the proposed rule indicated that ''Nothing in the RESPA rule prohibits bonuses or other compensation based, in part, on the generation of business by A (a lender) to B and C (a title company and escrow company) being paid to managerial employees who are not routinely in contact with customers.'' However, RESPRO claimed, the text of the proposed rule is not consistent with the statement in the quoted Fact/Comment illustration.

The American Bankers Association (ABA) objected to the managers' compensation provision of the proposed rule as ''too narrow,'' and advocated that all employees of banking institutions should be able to receive compensation or bonuses based on their referral of business within the bank or to affiliates. Even if HUD were to retain only the managerial exemption, the rule needs modification, ABA said, to clarify the circumstances under which an employer could legitimately compensate a manager.

In contrast, many of the attorneys commenting on the rule (virtually all of whom supported the withdrawal of the employer-employee exemption) were highly critical of the proposal to allow the payment of referral-related bonuses and compensation to managerial employees in controlled businesses, under conditions set out in the proposed rule. The managerial exemption was regarded as an ''enormous loophole'' in the new rule that would substantially overwhelm the benefits these commenters expected from the proposed elimination of the exemption for fees to line employees. Typical of attorney comments received was one from an Alabama practitioner who said he ''applauded'' HUD's partial change of position ''to eliminate the objectionable 'employee bonus/kickback scheme'.'' However, the commenter said, ''by creating the manager bonus loophole, you have simply encouraged and promoted indirect schemes to circumvent basic consumer protection.'' The attorney ''implored'' HUD to ''stop playing politics with the basic rights of consumers that the Real Estate Settlement Procedures Act was designed to safeguard.'' Similar views were expressed by a Memphis attorney:

> If HUD allows bonuses to be paid to real estate managers even though the bonuses are not strictly calculated on the basis of the referral business, but merely takes it into account as a factor, the managers and the agents will find a way to tie the bonuses directly to the amount of business generated. HUD will have ''opened the door'' to the abusive practices of kickbacks, tie-ins, fee splittings, controlled business practices, and conflicts of interest that existed prior to RESPA and which RESPA has largely eliminated.
>
> Once the door is opened, everyone will stampede through it.

The American Bar Association's General Practice Section and Standing Committee on Lawyers' Title Guaranty Funds echoed the ''loophole'' complaint of other practitioners:

Prohibiting ''one-to-one'' Basis Referral Fees will not eliminate the payment of referral fees* * *. Allowing [managerial] payments* * * would be a dramatic departure from the Act's congressional intent and basically would render the previously mentioned withdrawal of the employer-employee exemption impotent.

The combined comments of the Attorneys General of eleven States opposed the proposed new ''managerial'' exemption.

HUD cannot allow compensation systems, even for managerial employees, which depend, even in part, on the level of employee referrals to affiliated companies* * *. [Managerial referral compensation] will still create strong incentives within the company to make as many referrals to affiliated companies as possible, regardless of whether those referrals are in the consumers' best interest or not.

A large number of other real estate professionals also submitted objections to the proposed modified managerial exemption. These commenters, along with most of the lawyer-commenters, believed that controlled business arrangements constituted unfair competition, or that they invariably would lead to increased costs for consumers. Whether the payment is to an employee who is in contact with the consumer for a business referral generated by that employee to the employer or to an affiliate business entity, or whether the referral-related payment is to a managerial employee, the objectors believed that the effect would be the same: A determination would be made to refer business based on the dollar benefit of the referral, rather than on considerations of what would be most advantageous to the consumer.

Similar views were expressed by a New Jersey real estate broker who said that he was ''strongly in favor of any changes in RESPA which would ban payments for referrals from mortgage lenders, title insurers, escrow agents and other real estate settlement service providers.'' ''[I]t would seem very obvious,'' the realtor wrote, ''that payment of referral fees would result in the agent selecting the service provider.''

The Coalition to Retain Independent Services in Settlements (CRISIS), an organization of independent settlement service providers, responded to the proposed rule's referral provisions arguing for a *total* ban on referral fees and referral-based compensation factors to employees *and* managers. Consumer Federation of America also called for a total ban on referral-based compensation involving affiliate entities, as did the National Association of Mortgage Brokers (NAMB).

b. The Final Rule's Approach. The rule revises the proposed rule's formulation and defines a ''managerial employee'' as one of a limited class of employees who do not routinely deal with the public, but who function in a management or executive capacity. It makes permissible certain bonuses and payments to these managerial employees. Active real estate agents, who are independent contractors, cannot be managerial employees, although a managerial employee can hold a real estate brokerage or agency license. HUD agrees with NAR counsel that managers' ''mere status as licensed brokers or salespersons should not exclude them from being 'managerial employees' if their principal functions'' are the types of managerial functions indicated in the definition, rather than face-to-face dealings with consumers.

The rule provides that managerial employees in controlled business arrangements may be paid bonuses based on performance criteria, including profitability, capture rate or other thresholds, but the bonus may not be directly calculated as a multiple of the number or value of settlement transactions referred to a business entity in an affiliate relationship. Thus, for example, the final rule does not prohibit a managerial employee from receiving an annual bonus based on an affiliate business entity capturing a percentage of the business from the managerial employee's unit (*e.g.*, a $1,000 bonus for an affiliated lender's 10% capture rate of real estate brokerage customers and a $2,500 bonus for a 20% capture rate). Managerial employees may not, however, receive a bonus or other compensation calculated as a multiple of the number or value of referrals of settlement service business to a business entity in an affiliate relationship. Thus, a compensation system that awarded a managerial employee $20 for every referral continues to be prohibited, as would a compensation system that awarded a managerial employee $100 for every 5 referrals.

In the rule, the phrase ''does not routinely'' is used to establish a ''*de minimis*'' standard for consumer contact. HUD intends the phrase ''does not routinely'' to mean that managerial employees who occasionally deal with consumers, which is almost inevitable in small offices, are not precluded from receiving year-end bonuses because of this minimal contact. Similarly, HUD intends this phrase to allow a managerial employee who performs and is compensated for occasional settlement services (not more than three transactions a year) to be eligible for this exemption. This standard will effectively limit the class of managerial employees who may receive these types of bonuses to those ''whose contacts with consumers are only casual or peripheral, at most, and who do not occupy the special positions of trust, arising from their relationship to consumers as well as the arcane nature of certain of the services required, that are developed by real estate agents or the comparable providers of other services,'' as suggested by NAR.

HUD has chosen to use its exemption authority under Section 8(c)(5), having consulted with other Federal agencies as required by that provision, as well as the authority under Section 19(a) of RESPA to permit these payments which would otherwise be prohibited by the statute. As noted in the proposed rule (59 FR at 37365), Congress has clearly determined that RESPA does not prohibit controlled business arrangements, with certain conditions. The final rule's exemption permitting managerial employees to receive payments of a bonus based on criteria relating to performance conforms with Congress's intent to permit controlled business arrangements to operate.

This exemption is appropriate because managers do not routinely deal directly with consumers. Therefore, the manager is not in a position of trust with the consumer to directly influence the consumer's choice of settlement service providers. By providing this exemption, the regulation will not require HUD to interfere unduly with the internal operations of controlled business arrangements. The exemption reflects the Department's acknowledgement that it would be difficult to enforce RESPA in circumstances which would require detailed scrutiny of complex compensation arrangements for management in affiliated settings.

The exemption draws a line, however, for payments to managers that are transaction based. This regulation does not allow payments to managerial employees which mimic referral fees. Thus, where a payment of a bonus to a managerial employee is calculated as a multiple of the number or value of referrals of settlement service business to an entity in the controlled business arrangement, it would appear to be a payment in violation of the Act and contrary to the intent of Section 8(a).

The foregoing provisions have been amplified by a revised Illustration 12 that is being added to Appendix B.

5. Employees Who Do Not Perform Settlement Services in Any Transaction

a. The Public Comments. Several commenters advocated, either directly or indirectly, that the rule allow businesses to pay bonuses for referrals to business entities in affiliate relationships to those employees who do not perform settlement services. Many of these comments focused on the way in which a host of Federal and State regulations affect the way particular industries do business and are structured. These comments urged HUD to allow compensation systems which are sensitive to these structures.

ABA criticized HUD's proposed rule as insensitive to the structure of banks, noting that, under the proposed rule, if the loan were made by the bank itself, employees could be compensated for generating that business, but if the loan were made by a subsidiary mortgage company, such compensation would be a prohibited referral fee.

> Individuals seeking a residential mortgage loan who enter a bank and inquire as to the availability of such a loan do so voluntarily with the goal of receiving information and possibly applying for and obtaining such a loan. Whether or not the bank is structured * * * to process such loans within the bank, the bank holding company or a subsidiary or affiliate of each makes *absolutely no difference to the consumer and in no way affects his or her decision * * * whether or not to do business with the bank * * *.* Providing information in order to expedite the customer's objective is appropriate and beneficial to all parties. The structure of the mortgage lending operation within the bank, its affiliate, or within the bank holding company is inconsequential and shouldn't trigger any RESPA activity.

Other banker-commenters echoed the ABA's concern that the proposed rule's referral-related modification was a poor fit for the varied structures of banks and their integrated or affiliated real estate service entities. A Minnesota bank holding company was among several banking organizations arguing that there was a fundamental difference between a referral by a bank employee to the bank's mortgage lending affiliate, and the type of referral that might involve another party to a real estate transaction, *e.g.*, from a real estate agent to a mortgage lender:

> If an individual contacts a bank to inquire about a mortgage loan * * * it is because the individual perceives the bank as a lender that would offer that type of loan. The customer is not going to the bank because he or she is seeking an objective, unbiased referral to another lender. The customer * * * expects that whatever bank they talk to will promote its own products. If that bank *does* offer [mortgage loans] they would simply proceed to give information to the potential customer * * * If, however, a bank holding company [has formed] a separate subsidiary to handle * * * mortgage lending[,] the proposed rules add additional burdens to that bank by limiting its ability to design a compensation system for managers that promotes the affiliate relationship and by requiring an additional layer of disclosure.
>
> * * * [E]xcessive requirements place the bank with a separate mortgage lending subsidiary at a disadvantage compared to banks that * * * offer such products within the bank itself.

ABA also asked that HUD reconsider this aspect of the rule in light of the strong framework of existing bank regulation, State and Federal:

> Unless appropriately modified, this proposed regulation penalizes banks, their affiliates, bank holding companies * * * solely because of their corporate structures. These structures have been specifically authorized by statute, implemented by state or federal bank regulatory authorities and constantly monitored and examined for safety and soundness and compliance purposes.

ABA asserted that the HUD regulation effectively applies only to banks and other banking institutions:

> It is only these institutions which will be examined on a periodic basis by bank examiners for compliance with this regulation. HUD does not maintain its own compliance examiners for non-bank settlement service providers. Other settlement service providers do not and will not face this intensive examination process.

ABA recommended that bank examiners not be required to examine for this aspect of RESPA compliance—unless HUD intends to provide similar supervision and enforcement for settlement service providers other than banks.

Finally, ABA's comments indicated that banks are encouraging employees to focus attention on compliance with the Community Reinvestment Act (which encourages residential lending activity in the banks' immediate service areas and neighborhoods). Many banks, ABA claimed, find it advantageous to structure lending programs to provide financial incentives to their employees to promote Community Reinvestment Act objectives. The proposed rule would eliminate these incentives arbitrarily, ABA stated.

A comment from the Securities Industry Association (SIA) similarly objected to the proposed change in the referral fee rule. Some SIA members, the comment said, are part of diversified services firms, with mortgage lending affiliates. SIA believed that referrals made by securities firms' representatives should be distinguished from those made by employees of entities whose business is to perform settlement services. The commenter argued that the potential harm to consumers that HUD is attempting to deal with as ''inherent'' in referrals made by persons performing settlement services is *not* present when the referring individual is a registered securities representative. SIA requested reconsideration, or an express exemption from the rule applicable to employees of securities firms.

Virtually all commenters who objected strongly to the proposed withdrawal of the existing employer-employee exemption, also approved of the proposed rule's retention of an exemption, albeit in a modified form. For example, RESPRO recommended that the (old) employee compensation exemption be retained, but modified to exclude any real estate agent, sales associate, or other person who assists consumers with the listing or purchase of a home, and who has regular and meaningful contact with consumers. This, RESPRO argued, would achieve the HUD policy objective of discouraging adverse steering *by real estate agents*, without interfering with the cost efficiencies of diversified companies.

Several commenters also specifically advocated that the rule allow businesses to pay bonuses for referrals to business entities in affiliate relationships, to those employees who are financial service representatives (FSRs), *i.e.*, persons employed in affiliate businesses to cross-market products. RESPRO argued that HUD's proposed rule would place diversified companies at a competitive disadvantage to their independent competitors by preventing them from compensating salespersons who offer more than one of the company's products or services, in the same manner as their independent competitors. Whereas independent mortgage, title, and homeowners insurance companies follow the traditional practice of encouraging a salesperson's productivity by paying him or her on a commission basis, HUD's proposed rule would result in diversified companies either having to hire less productive salespersons (persons who could not be compensated based on commissions which encourage productivity), or to pay three separate employees (instead of one) to offer three separate services (so they can properly motivate the FSR). RESPRO urged that HUD's final rule allow a broad array of compensation to management and employees for developing and implementing one-stop shopping, including: (1) the hiring and compensating of a financial services manager, *i.e.*, a branch manager who is

responsible for supervising the performance of the real estate agent, title agent, mortgage loan officer, and other persons performing settlement services; and (2) the hiring and compensating on a commission basis of a ''customer services representative'' or ''financial services representative'' who is not a real estate agent, but ''who markets more than one settlement service (not real estate brokerage)'' either in or outside of a real estate office.

NAR counsel urged that HUD place no restrictions on the compensation of employees whose function is to promote sales of ''secondary services'' (*i.e.,* other settlement services) provided by affiliates at the point of sale of ''primary services.'' NAR counsel commented, ''Notwithstanding that these individuals have direct contact with consumers, we do not believe that they are in positions to develop the special relationships of trust and expectation that are developed by the 'primary service' providers.''

b. The Final Rule's Approach. In response to these comments, the final rule allows a limited exemption for an employer's payment to *bona fide* employees who do not perform any settlement services,[14] so long as prior to the referral, the consumer is provided with a written disclosure in the format of Appendix D. This exemption will cover at least two situations frequently mentioned in the comments. First, this exemption will allow employers to pay their own *bona fide* employees who are not involved in the provision of settlement services, such as securities sales persons or bank tellers, for referrals of settlement service business to business entities in affiliate relationships. This approach achieves substantially the same result recommended by counsel to the NAR.

Second, this exemption will allow employers to pay their own *bona fide* employees, whose primary function is to market the services of the affiliates of the employer. Employees who perform settlement services remain subject to Section 8's prohibitions. However, as with a managerial employee who holds a real estate license, a securities sales person or bank teller who holds a mortgage broker license would not be precluded from qualifying for the exemption, if the securities sales person or bank teller is not actually involved in the provision of settlement services.

The exemption created here establishes a test: if an employer's payment is to an employee who does not perform settlement services in any transaction, the exemption applies and payments are not subject to Section 8 scrutiny so long as the disclosure is made.

A primary purpose of RESPA is to prevent consumers from being unwittingly steered (in exchange for referral payments) by one settlement service provider to other particular settlement service providers. Although the statute, on its face, covers all referrals of settlement service business, regardless of who makes the referral, Congress did not express as high a level of concern about the referral activities of those who do not perform settlement services. The Department believes that the structure of affiliated businesses, particularly in the financial services industry, wherein services are often divided among different affiliates, is frequently a response to State and Federal laws, such as the Bank Holding Company Act, rather than an attempt to circumvent RESPA. The Department believes that the industry should not be unnecessarily disadvantaged in competition by its mandated or chosen business structure. Thus, HUD has chosen to use its exemption authority under Section 8(c)(5) and Section 19(a) of RESPA to permit these payments otherwise prohibited by the statute.

This exemption only covers payments made by the employer, not by the party to whom the settlement service business is referred. It also only applies to payments for referrals to affiliate business entities. Further consideration should be given to a broader exemption for payments to those who do not perform settlement services received directly from either: (1) An affiliated party receiving the referral; or (2) an unaffiliated party receiving the referral. However, these issues were not raised by this rulemaking and the record is insufficient to determine the impact of such changes.

A similar proposal is included in legislation currently under consideration in the United States Senate. This legislation would allow anyone who does not receive another fee in the particular transaction to receive a referral fee from any source. The stated purpose of the proposal is to exempt from RESPA coverage ''co-branding'' and ''affinity marketing,'' as such payments are known in the industry. The Department believes that this proposal also could be accomplished by regulation, using HUD's exemption authority under Section 8(c)(5) and Section 19(a) of RESPA. However, both approaches—an exemption for all payments to those not performing settlement services or an exemption for all payments for those not receiving another fee in the transaction—require further scrutiny. While it is desirable to facilitate business generation where there is little danger of the adverse steering that RESPA was designed to prevent, it is important to ensure that loopholes are not created through which such adverse steering can slip. HUD intends to undertake further rulemaking on this subject and to seek public comments.

The Department also recognizes the market trend, described particularly in RESPRO's comments, that many companies are choosing to hire one or more individuals whose primary function is to generate business for his or her employer and affiliated companies. Such individuals are sometimes referred to as marketers or customer or financial service representatives.

In response to these realities, the Department has created an exemption sufficiently broad to allow an employer's payments to its *bona fide* employees whose primary function is to generate business for entities within an affiliated relationship with that employer. The Department has restricted this exemption to payments to those who do not perform settlement services in any transaction including, for example, those settlement services of a real estate agent, loan processor, settlement agent, attorney, or mortgage broker. For purposes of this exemption, the marketing of a settlement service or product, including the collection and conveyance of information or the taking of an application or order for the services of an affiliate does not constitute the performance of a settlement service. Under the exemption, marketing of a settlement service or product also may include incidental communications with the consumer after the application or order, such as providing the consumer with information about the status of an application or order; marketing may not include serving as the ongoing point of contact for coordinating the delivery and provision of settlement services.

As discussed above, the Department's review of the legislative history revealed that steering of unsophisticated consumers from one settlement service

[14] Section 3(3) of RESPA (12 U.S.C. 2602(3)) and 24 CFR § 3500.2 define the term ''settlement services''. However, for purposes of this exemption, the marketing of a settlement service or product of an affiliated entity, including the collection and conveyance of information or the taking of an application or order for the services of an affiliated entity, does not constitute the performance of a settlement service. Under the exemption, marketing of a settlement service or product also may include incidental communications with the consumer after the application or order, such as providing the consumer with information about the status of an application or order; marketing may not include serving as the ongoing point of contact for coordinating the delivery and provision of settlement services.

provider to other settlement service providers was a substantial congressional concern. A settlement service provider frequently is trusted by the consumer and appears to the consumer to be an expert in the settlement process and to have the consumer's interests in mind. If a person performing settlement services is also receiving compensation for referring business to another settlement service provider, there is a potential conflict of interest. The consumer's trust in the person performing settlement services may cause the consumer to lose any natural wariness he or she might otherwise have of following the advice of a salesperson who derives income from sales performance. The consumer might ignore the conflict of interest because of trust that has accrued from the provision of another settlement service. A person who is not performing a settlement service, but is merely marketing the affiliated companies, is less likely to attain trusted-advisor status concerning the transaction. The consumer is more likely to be aware of and weigh carefully the incentives of a person who is not performing a settlement service but is generating business for that person's own employer and its affiliates. The application of the rule's prohibition to *all* settlement service providers, whether involved in the specific settlement or not, prevents two providers from swapping referrals.

The Department is also requiring that disclosure of the affiliate relationship be provided to the consumer when the referral is made, so that the consumer will be alerted to the affiliate relationship, be informed of the potential business interest of the employee making the referral, and be able to make an educated decision about whether to use the recommended provider or another. Finally, the Department is requiring that, for the exemption to apply, the referral of settlement service business be to a settlement service provider that has an affiliate relationship with the employer or in which the employer has a direct or beneficial ownership interest of more than one percent. This requirement is consistent with congressional intent to allow controlled business arrangements and is responsive to comments indicating that the circumstances described in the exemption are those in which an exemption would be most beneficial. Where these requirements are met, the Department believes the consumer is adequately protected. The Department, therefore, has used its exemption authority under Section 8(c)(5) and Section 19(a) of RESPA to permit these payments otherwise prohibited by the statute.

The foregoing provisions have been amplified by revised Illustrations 11 and 12 which are being added by this rule to Appendix B.

C. Issue 2: Computer Loan Origination Systems (CLOS)

1. Background

The 1992 final rule specifically exempted from RESPA's coverage any borrower payment for computer loan origination systems or CLOs. The exemption was intended to prevent RESPA's restrictions against unearned fees from unduly inhibiting the development of technology which could permit consumers to shop, apply for or obtain mortgage loans electronically. A CLO system was not defined in the 1992 rule.

2. The Proposed Rule, CLO Demonstration and CLO Working Groups

In response to the earlier comments, the proposed rule undertook to establish minimum standards for a system falling within the exemption. HUD proposed to designate such CLO systems as ''qualified CLOs.'' Payments by consumers to such systems would not then be ''scrutinized under RESPA.'' A ''qualified'' system would:

(a.) Provide openings for 20 or more lenders offering various loan products;

(b.) Utilize selection factors for lenders that are fair and impartial and are designed to contribute to the efficiency and quality of the system;

(c.) Provide borrowers information in a lender-neutral manner;

(d.) Provide borrowers a CLO disclosure form before CLO services are performed;

(e.) Charge all borrowers using the system the same CLO access fee(s) for the same service or the same components of service; and

(f.) Be allowed to charge lenders for access only if charges are set forth in a written schedule of charges, charges for the same services and components of services are the same for all lenders on the system, and charges for the same services are reasonably related to the costs of maintenance and operation of the qualified CLO system.

The proposed rule asked for advice on whether to create a similar exemption for payments by lenders to ''qualified lender'' CLOs, or whether to leave such systems to be governed by the general rules of RESPA regarding kickbacks, unearned fees and referral fees.

As an additional vehicle for obtaining public input, on September 30, 1994, as part of the rulemaking process, the Department conducted an open house for operators of CLO systems to demonstrate their systems to HUD and to the public. Twenty-one CLO operators accepted the invitation and participated in this all-day demonstration in Washington, D.C. At the demonstration, the capabilities of the systems, the number of lenders displayed, the arrangements for payment, among other characteristics, differed widely.

3. The Public Comments

The public comments received on the proposed rule reflected a wide array of criticisms that suggested continuing problems with the rule's approach, or that indicated that the CLO definition HUD had arrived at would not work under particular circumstances. Additionally, a few commenters (including RESPRO, NAR, and separate comments by NAR counsel) not only questioned the particulars of HUD's CLO proposal, but also suggested that the Department lacked adequate authority under Section 8(b) of RESPA to establish ''qualified'' or ''non-qualified'' CLO systems by regulation, as proposed.

NAR and several individual commenters advocated that the rule should distinguish computer systems that merely provided basic information about prospective lenders (*e.g.*, a comparison of current interest rate quotations for particular mortgages) and those systems that actually may be said to ''originate'' loans by means of qualification (or at least, pre-qualification) of borrowers.[15]

Many commenters objected to the proposed rule's requirement that a borrower's payment for CLO services be made ''outside of and before closing,'' arguing that this requirement would dampen or completely destroy the market for CLO services, and that determining the appropriate timing of the borrower's payment would create ambiguities and resulting compliance difficulties. The combined comments of the State attorneys general objected to the proposed rule's concept of ''qualified'' and ''non-qualified'' CLOs and suggested, instead, that HUD permit *only* qualified CLOs to operate at all.

The several most-frequently raised CLO issues are summarized below.

a. The Legal Issue. RESPRO, NAR, and others raised the issue of HUD's authority to establish minimum standards (i.e., a ''safe harbor''

[15] See further discussion later in this Issue 2 section, under heading (g), ''Other CLO Issues Raised by Commenters''.

exemption) and to subject non-qualifying CLO systems to scrutiny. Noting that the proposed rule cited Section 8(b) of RESPA as a basis of HUD's authority to regulate in this area and to prohibit a CLO operator from accepting a payment from a borrower for a sham or duplicative charge, these commenters argued that Section 8(b) of RESPA was inoperative as authority for regulating CLO payments unless the CLO operator shared fees with a third party.

According to the commenters, Section 8(b) governs *only* a ''portion, split, or percentage'' of any charge made or received. If the CLO operator is the only party charging or receiving a fee for CLO-related services, the commenters argued, then Section 8(b) cannot be the authority for the proposed borrower payment exemption ''safe harbor'' or for regulating non-qualifying CLOs. The commenters cited as authority for this position certain judicial precedents.

HUD is aware of these cases, which never involved HUD as a party, but finds their reasoning not to be persuasive or their holdings not to be determinative of the issue. HUD believes that Section 8(b) of the statute and the legislative history make it clear that no person is allowed to receive ''any portion'' of charges for settlement services, except for services actually performed. The provisions of Section 8(b) could apply in a number of situations: (1) where one settlement service provider receives an unearned fee from another provider; (2) where one settlement service provider charges the consumer for third-party services and retains an unearned fee from the payment received; or (3) where one settlement service provider accepts a portion of a charge (including 100% of the charge) for other than services actually performed.

The interpretation urged, that a single settlement service provider can charge unearned or excessive fees so long as the fees are not shared with another, is an unnecessarily restrictive interpretation of a statute designed to reduce unnecessary costs to consumers. The Secretary, charged by statute with interpreting RESPA, interprets Section 8(b) to mean that two persons are not required for the provision to be violated. HUD, therefore, had adequate authority to promulgate the rule it proposed, although it has chosen not to do so.

b. Impact on Mortgage Brokers. On the merits of the CLO proposal, the Mortgage Bankers Association and many other commenters were alarmed about possibly unintended effects of the CLO provisions on mortgage brokers. First, MBA feared that merely by using a computer in its activities, a mortgage broker could be deemed a CLO operator, since mortgage brokers typically perform many or all of the functions set out in the ''CLO system'' definition contained in § 3500.2 of the proposed rule. MBA anticipated that mortgage brokers might therefore find themselves faced with a new disclosure requirement (relating to CLO systems) that HUD probably did not intend. Revision of the definition was urged to clarify this point.

c. Time of Payment for CLO Services. RESPRO, NAR, and many other commenters strenuously objected to the requirement in the proposed rule that for a system to qualify, payment for CLO services be ''outside of and before'' loan closing.

d. Twenty-Lender Requirement. RESPRO and a large number of individual commenters objected to the proposed rule's requirement that CLO systems provide access to at least 20 lenders. RESPRO asserted that its members, as well as CLO operators, uniformly believed that 20 lenders would constitute ''information overload'' and would discriminate against small and local CLO operators. Other commenters reflected that 20 lenders, each offering, perhaps, multiple variations of mortgage loan packages, would overtax a CLO system and increase its operating costs, to no useful purpose. Consumer Federation of America was among the very few commenters who suggested that access by 20 lenders would be inadequate.

e. Lender-Pay Systems. The Attorneys' General comment objected to the fact that the rule did not prohibit lenders from paying for CLO services, viewing lender-paid services as ''harboring the same potential for consumer abuse as direct kickbacks.'' MBA also opposed permitting lender-paid fees, arguing that they constitute hidden costs to the consumer. Consumer Federation of America strongly objected to lender payments, saying that they would place consumers at ''great risk of being steered into noncompetitive products.'' Conversely, comments from the National Association of Federal Credit Unions (NAFCU) urged HUD not only to create a parallel exemption for payments by lenders for qualified CLO systems, but suggested that HUD not intervene in setting lender-CLO operator fee schedules. NAFCU believed that negotiated fees for CLO services to lenders would promote competition.

f. ''Information'' vs. ''Origination''. NAR and numerous other commenters urged that a sharp distinction be made in the rule between computer loan *information* systems (dubbed by NAR and others as ''CLIs'') and computer loan *origination* systems (''true'' CLOs), with which a computer link-up can be made with lenders and a genuine loan-application-approval process originated. Another commenter similarly explained that vast differences existed in the functions and sophistication of ''loan origination technology,'' ranging from relatively simple information transmittal systems to ''electronic decision makers'' that utilize artificial intelligence. These latter systems, the commenter claimed, were essentially computer underwriting systems. The commenter went on to recommend that HUD narrow its CLO definition to require that qualified systems not only collect data, but evaluate it.

g. Other CLO Issues Raised by Commenters. A nationwide finance organization believed that the CLO system definition should *not* require the transmission of information concerning a prospective property. CLO systems offer the same benefits to consumers in the *pre-qualification* stage, the commenter asserted.

Comments on the issue of CLO-related disclosures varied greatly. Commenters sympathetic to the regulatory scheme proposed for CLOs were also supportive of the form of disclosure, although some additional disclosures were occasionally suggested. Commenters otherwise critical of HUD's definition, the proposed CLO regulatory scheme, or other aspects of the proposal tended to object as well to the form of disclosure proposed. Generally, objections to the CLO disclosure format were mild, except the American Bankers Association and a few other commenters specifically objected to the ''acknowledgement box'' requirement for the same reasons that consumer-acknowledgement procedures were objected to in connection with the controlled business arrangement disclosure statement.[16]

4. Working Group Meetings

After review of all of the comments and the information gleaned from the technology demonstration, HUD believed that it did not have sufficient information on CLOs and how they were actually functioning in the provision of services to consumers. Accordingly, HUD convened the first of two CLO working group meetings on August 11, 1995, in Washington, D.C. Participants included CLO vendors, related industry associations, State regulators, consumer groups, and

[16] See discussion of CBA disclosure statement format under the heading ''Issue 4'' elsewhere in this preamble.

individual advocates. The purpose was to get their individual input on CLO issues.

The working group examined a number of CLO trends and CLO systems and identified the types and characteristics of CLOs currently operating. Presentations were made regarding several operating systems, as well as the Federal National Mortgage Association's (Fannie Mae's) Desktop Underwriter and the Federal Home Loan Mortgage Corporation's (Freddie Mac's) Loan Prospector. Views expressed by one or more members of the group included:

- CLOs are merely a technology for automating the loan process and not necessarily an independent settlement service.
- There should not be a special exemption for CLO services.
- A separate set of disclosures for CLOs and CLIs should not be created, but consumers should be given understandable and meaningful disclosures.
- HUD should not attempt to set rates.
- HUD should define the level of service that must be performed in the origination process in order to receive compensation.

Many participants argued that HUD should not attempt to regulate, define, or set standards for an evolving technology. Many argued that greater clarity about how the RESPA regulations applied to loan originations would be preferable to a separate exemption or ''safe harbor,'' for which HUD set required characteristics by regulation. At the conclusion of the first meeting, the group agreed to meet again and discuss further the development of CLO technology.

HUD held a second working group meeting on September 26, 1995. At this meeting, many also argued again that the RESPA regulations should apply equally to all participants in the market, regardless of their use of technology, and that the applicable test should be whether the fees paid were for services actually performed. Many in the group believed that HUD should provide additional guidance about how this basic RESPA test applies in the CLO context. Some participants criticized a distinction between services paid for by lenders and services paid for by borrowers, arguing that the borrower was the final source of funds for all services. State regulators also discussed the licensing and other requirements applicable to CLOs in many jurisdictions.

5. The Final Rule's Approach

After further internal review and discussion, the Department determined to abandon the approach taken in the proposed rule, withdraw the CLO exemption that had been contained in 24 CFR 3500.14(g)(1)(viii),[17] and replace it with guidance analyzing the application of RESPA and the RESPA regulations to common CLO issues. The final rule also withdraws Appendix E, the CLO disclosure.

Simultaneously with the publication of this final rule, the Department is issuing a Statement of Policy. That Statement of Policy, issued under § 3500.4(a)(1)(ii), is being published in today's Federal Register and constitutes a ''rule, regulation, or interpretation'' within the meaning of Section 8.

D. Issue 4: CBA Disclosure Form

1. The Public Comments

Proposed changes in the controlled business disclosure form also attracted significant attention from commenters. Eleven Attorneys General commended the Department for accepting most of the suggestions made by State Attorneys General in the earlier round of public comment on RESPA regulations. However, the Attorneys General questioned whether the addition of a borrower acknowledgement box on the form is helpful and suggested it may actually prove harmful:

> * * * While it may appear that such a box induces the consumer to read the disclosures, in fact, it may be just one more document in a blizzard of such forms which the consumer signs. It is likely that lenders will find this acknowledgement more useful than consumers and will attempt to use the acknowledgement in defending any suits by consumers who feel they have been misled.

A few commenters affirmatively supported the revised disclosure statement requirement as appropriate and useful.

Other commenters, however, were more critical of the content of the revised disclosure statement. Especially singled out for criticism was the required statement ''YOU MAY BE ABLE TO GET THESE SERVICES AT A LOWER RATE BY SHOPPING WITH OTHER SETTLEMENT SERVICE PROVIDERS, AND THIS IS SOMETHING YOU SHOULD CONSIDER DOING.''

A multi-service company in Massachusetts called the quoted sentence a ''negative statement'' that would discourage consumers from using an affiliated service. ''If HUD is serious about allowing diversified service providers to compete, *this statement should be eliminated.''* (Emphasis in original.) Another commenter, a Missouri attorney, objected in particular to the last phrase, ''* * * and this is something you should consider doing.''

> * * * This phrase clearly denotes that there are better services available, and that the service which will be provided by the referred settlement service would be inadequate * * *. To suggest * * * that buyers would be better off looking elsewhere, *is far beyond* protection of the consumer and actually is hinting to the consumer that there is something inherently wrong with the controlled business arrangement * * *. (Emphasis in original.)

An Iowa realty company urged that the statement be made more ''provider neutral,'' and that all mortgage service providers be called upon to provide similarly worded disclosures regarding the value of comparison shopping.

A Kansas lender complained that ''No other industry in this country is required to urge its customers to seek services elsewhere* * *.''

A Chicago title guaranty company expressed sympathy for the objectives of the disclosure statement, but agreed that the proposed rule's version implied that substandard service was being provided. The following alternative statement was offered:

> There are many providers of settlement services providing quality products at competitive rates. You are encouraged to shop around to ensure that you are receiving the best quality product at the best rate available for the same or similar services.

NAR's comments echoed the concerns of the above-quoted individual commenters by asking for a ''provider neutral'' statement and that all mortgage settlement service providers be called upon to provide similarly worded statements, ''thus preventing multiple service * * * firms from being placed at a relative disadvantage vis-a-vis other mortgage service providers.''

Several banker-commenters again pressed the point that the required disclosure statement was inappropriate for the circumstances of banks and bank holding companies. Because these organizations commonly conduct their residential mortgage lending activities through mortgage company affiliates, ''* * * the consumer that contacts the bank * * * expects to be referred to the bank's mortgage lending operations, whether that consists of a department of the bank or an affiliate.''

The American Bankers Association objected to the elaborate disclosure statement in the context of the kind of incidental and uncompensated referrals

[17] Prior to HUD's regulatory streamlining, this provision was codified at 24 CFR § 3500.14(g)(2)(iii).

involved in the bank/affiliate mortgage company operation. ''It is sufficient consumer protection,'' ABA argued, ''for banks to indicate that there might be services provided at a lower rate and not to add a statement that such shopping is recommended.''

ABA and a few individual commenters also protested the requirement that the disclosure be acknowledged in writing. A title guaranty firm made the point that documents are frequently mailed to consumers to be signed and returned, and that it is difficult to secure the return of such documents, possibly raising unnecessary doubts concerning the validity of the disclosure actually given. ABA raised several questions:

> * * * [W]hat is the status of a bank's compliance with the acknowledgment and signature requirement if only the applicant and not the co-applicant signs the acknowledgment?
>
> What efforts does the bank have to expend in order to obtain the co-applicant's signature?
>
> Should not the applicant's acknowledgement be sufficient for compliance purposes?

The process of obtaining these signatures, ABA concluded, ''creates compliance burdens for banks while providing negligible benefits to consumers.''

2. The Final Rule's Approach

After review of all comments, the Department retains the requirement of the applicants' acknowledgement. In addition to focusing the attention of the applicant on the document, the acknowledgement also protects the lender from charges that it had failed to inform the prospective borrower of the controlled business arrangement. In response to comments, only one signature is now required.

The Department has not adopted the NAR's suggestion that HUD require all settlement service providers to provide a statement encouraging consumers to shop around. The statute requires such a statement in the context of controlled businesses, but has no such requirement for any other situation. This rule only requires the disclosure in the context of controlled business arrangements.

Also, the Department reformulates the discussion of the desirability of borrowers shopping for settlement services. In response to criticism that the proposed language intimated that the services offered by the disclosing servicer might be substandard or overpriced, the Department adopts more neutral wording that continues to inform consumers of their freedom to seek the most advantageous rates or services in a competitive market. The Department remains committed to the policy that ample disclosure, a preeminent principle of the RESPA statute, is a valuable means of informing consumers and promoting competition in the settlement services industry.

The new formulation for the CBA disclosure is set forth in Appendix D. It now reads:

> You are NOT required to use [provider] as a condition for [settlement of your loan on] [or] [purchase, sale, or refinance of] the subject property. THERE ARE FREQUENTLY OTHER SETTLEMENT SERVICE PROVIDERS AVAILABLE WITH SIMILAR SERVICES. YOU ARE FREE TO SHOP AROUND TO DETERMINE THAT YOU ARE RECEIVING THE BEST SERVICES AND THE BEST RATE FOR THESE SERVICES.

E. Other Matters Raised by Commenters

1. The Public Comments

In addition to the specific comments received in response to the Department's request, some commenters raised concerns that some employers were engaging in practices of retaliation or discrimination against employees and agents for not referring business to affiliate entities. Other commenters complained that settlement service providers were being excluded from, or locked-out of, places of business where they might find potential customers. They also alleged that high-priced real estate office space arrangements with particular lenders, frequently coupled with lock-out arrangements, raised RESPA concerns.

2. The Final Rule's Approach

The Department determined that these issues were distinct from those raised by the proposed rule. Moreover, they do not require rulemaking, but rather an interpretation, applied to specific circumstances, of the statute and the implementing regulations. Therefore, HUD is issuing a separate Statement of Policy on the issues of retaliation, lock-outs, and appropriate office rents to provide the guidance sought by so many commenters. That Statement of Policy is being published in today's Federal Register, simultaneously with the publication of this final rule.

Other Matters

Environmental Impact

A finding of no significant impact with respect to the environment has been made in accordance with HUD regulations in 24 CFR part 50 that implement section 102(2)(C) of the National Environmental Policy Act of 1969 (42 U.S.C. 4332). The finding is available for public inspection during regular business hours in the Office of General Counsel, the Rules Docket Clerk, room 10276, 451 Seventh Street, SW, Washington, DC 20410.

Executive Order 12866

This final rule was reviewed by the Office of Management and Budget under Executive Order 12866, Regulatory Planning and Review. Any changes made to the rule as a result of that review are clearly identified in the docket file, which is available for public inspection at the Office of the Rules Docket Clerk, Office of General Counsel, Room 10276, Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, D.C. 20410–0500. An Economic Analysis (EA) performed on this proposed rule is also available for review at the same address.

Regulatory Flexibility Act

The Secretary, in accordance with the Regulatory Flexibility Act (5 U.S.C. 605(b)), has reviewed this rule before publication and by approving it certifies that this rule does not have a significant economic impact on a substantial number of small entities, other than those impacts specifically required to be applied universally by the RESPA statute. An Economic Analysis prepared in connection with this rule considers the impact on small entities.

Executive Order 12612, Federalism

The General Counsel, as the Designated Official under section 6(a) of Executive Order 12612, Federalism, has determined that the policies contained in this final rule will not have substantial direct effects on States or their political subdivisions, or the relationship between the Federal government and the States, or on the distribution of power and responsibilities among the various levels of government. As a result, the rule is not subject to review under the Order. Promulgation of this rule expands coverage of the applicable regulatory requirements pursuant to statutory direction.

Executive Order 12606, the Family

The General Counsel, as the Designated Official under Executive Order 12606, The Family, has determined that this final rule does not have potential for significant impact on family formation, maintenance, and general well-being, and, thus, is not subject to review under the order. No significant change in existing HUD policies or programs will result from promulgation of this rule, as those policies and programs relate to family concerns.

List of Subjects in 24 CFR Part 3500

Consumer protection, Condominiums, Housing, Mortgages, Mortgage servicing, Reporting and recordkeeping requirements.

Accordingly, for the reasons set out in the preamble, part 3500 of title 24 of the Code of Federal Regulations is amended as follows.

PART 3500—REAL ESTATE SETTLEMENT PROCEDURES ACT

1. The authority citation for shall continue to read as follows:

Authority: 12 U.S.C. 2601 *et seq.*

2. Section 3500.2(b) is amended by adding, in alphabetical order, a definition of ''managerial employee'', to read as follows:

§ 3500.2 Definitions.

* * * * *

(b) * * *

Managerial employee means an employee of a settlement service provider who does not routinely deal directly with consumers, and who either hires, directs, assigns, promotes, or rewards other employees or independent contractors, or is in a position to formulate, determine, or influence the policies of the employer. Neither the term ''managerial employee'' nor the term ''employee'' includes independent contractors, but a managerial employee may hold a real estate brokerage or agency license.

* * * * *

3. Section 3500.8(c)(2) is amended in the fourth sentence by removing the reference ''Appendix F'' and adding in its place the reference ''Appendix E''.

4. Section 3500.14 is amended by revising the last sentence of paragraph (b), the heading of paragraph (g), and paragraph (g)(1), to read as follows:

§ 3500.14 Prohibition against kickbacks and unearned fees.

* * * * *

(b) * * * A business entity (whether or not in an affiliate relationship) may not pay any other business entity or the employees of any other business entity for the referral of settlement service business.

* * * * *

(g) *Exemptions for fees, salaries, compensation, or other payments.*

(1) The following are permissible:

(i) A payment to an attorney at law for services actually rendered;

(ii) A payment by a title company to its duly appointed agent for services actually performed in the issuance of a policy of title insurance;

(iii) A payment by a lender to its duly appointed agent or contractor for services actually performed in the origination, processing, or funding of a loan;

(iv) A payment to any person of a *bona fide* salary or compensation or other payment for goods or facilities actually furnished or for services actually performed;

(v) A payment pursuant to cooperative brokerage and referral arrangements or agreements between real estate agents and real estate brokers. (The statutory exemption restated in this paragraph refers only to fee divisions within real estate brokerage arrangements when all parties are acting in a real estate brokerage capacity, and has no applicability to any fee arrangements between real estate brokers and mortgage brokers or between mortgage brokers.)

(vi) Normal promotional and educational activities that are not conditioned on the referral of business and do not involve the defraying of expenses that otherwise would be incurred by persons in a position to refer settlement services or business incident thereto;

(vii) A payment by an employer to its own *bona fide* employee for generating business for that employer;

(viii) In a controlled business arrangement, a payment by an employer of a bonus to a managerial employee based on criteria relating to performance (such as profitability, capture rate, or other thresholds) of a business entity in the controlled business arrangement. However, the amount of such bonus may not be calculated as a multiple of the number or value of referrals of settlement service business to a business entity in a controlled business arrangement; and

(ix)(A) A payment by an employer to its *bona fide* employee for the referral of settlement service business to a settlement service provider that has an affiliate relationship with the employer or in which the employer has a direct or beneficial ownership interest of more than 1 percent, if the following conditions are met:

(*1*) The employee does not perform settlement services in any transaction; and

(*2*) Before the referral, the employee provides to the person being referred a written disclosure in the format of the Controlled Business Arrangement Disclosure Statement, set forth in Appendix D to this part.

(B) For purposes of this paragraph (g)(1)(ix), the marketing of a settlement service or product of an affiliated entity, including the collection and conveyance of information or the taking of an application or order for an affiliated entity, does not constitute the performance of a settlement service. Under this paragraph (g)(1)(ix), marketing of a settlement service or product may include incidental communications with the consumer after the application or order, such as providing the consumer with information about the status of an application or order; marketing shall not include serving as the ongoing point of contact for coordinating the delivery and provision of settlement services.

* * * * *

5. Section 3500.15 is amended by revising the introductory text of paragraph (b)(1), to read as follows:

§ 3500.15 Controlled business arrangements.

* * * * *

(b) * * *

(1) Prior to the referral, the person making a referral has provided to each person whose business is referred a written disclosure, in the format of the Controlled Business Arrangement Disclosure Statement set forth in Appendix D of this part. This disclosure shall specify the nature of the relationship (explaining the ownership and financial interest) between the person performing settlement services (or business incident thereto) and the person making the referral, and shall describe the estimated charge or range of charges (using the same terminology, as far as practical, as Section L of the HUD–1 or HUD–1A settlement statement) generally made by the provider of settlement services. The disclosure must be provided on a separate piece of paper no later than the time of each referral or, if the lender requires the use of a particular provider, the time of loan application, except that:

* * * * *

§ 350017 [Amended]

6. Section 3500.17 is amended as follows:

a. In paragraph (b), in the definitions of ''Aggregate (or) composite analysis'' and ''Single-item analysis'', by removing the reference ''Appendix F'' in the last sentence of each definition and adding in its place the reference ''Appendix E''.

b. In paragraph (c)(1)(i), in the second sentence, by removing the reference ''Appendix F'' and adding in its place the reference ''Appendix E''.

c. In paragraph (d)(1)(ii), in the last sentence, by removing the reference ''Appendix F'' and adding in its place the reference ''Appendix E''.

7. Appendix B is amended by revising Illustration 11, redesignating Illustrations 12 and 13 as Illustrations

13 and 14 respectively, and adding a new Illustration 12, to read as follows:

Appendix B to Part 3500—Illustrations of Requirements of RESPA

* * * * *

11. *Facts:* A, a mortgage lender, is affiliated with B, a title company, and C, an escrow company, and offers consumers a package of mortgage, title, and escrow services at a discount from the prices at which such services would be sold if purchased separately. A, B, and C are subsidiaries of H, a holding company, which also controls a retail stock brokerage firm, D. None of A, B, or C requires consumers to purchase the services of its sister companies, and each company sells such services separately and as part of the package. A also pays an employee T, a full-time bank teller who does not perform settlement services, a bonus for each loan, title insurance binder, or closing that T generates for A, B, or C. A pays T these bonuses out of A's own funds and receives no reimbursements for these bonuses from B, C, or H. At the time that T refers customers to B and C, T provides the customers with a disclosure using the controlled business arrangement disclosure format. Also, Z, a stockbroker employee of D, occasionally refers her customers to A, B, or C; gives a statement in the controlled business disclosure format; and receives a payment from D for each referral.

Comments: Selling a package of settlement services at a discount is not prohibited by RESPA, consistent with the definition of ''required use'' in 24 CFR 3500.2. Also, A is always allowed to compensate its own employees for business generated for A's company. Here, A may also compensate T, an employee who does not perform settlement services in this or any transaction, for referring business to a business entity in an affiliate relationship with A. Z, who does not perform settlement services in this or any transaction, can also be compensated by D, but not by anyone else. Employees who perform settlement services cannot be compensated for referrals to other settlement service providers. None of the entities in an affiliated relationship with each other may pay for referrals received from an affiliate's employees. Sections 3500.15(b)(3)(i)(A) and (B) set forth the permissible exchanges of funds between controlled business entities. In all circumstances described a statement in the controlled business disclosure format must be provided to a potential consumer at or before the time that the referral is made.

12. *Facts:* A, a real estate broker, is affiliated with B, a mortgage lender, and C, a title agency. A employs F to advise and assist any customers of A who have executed sales contracts regarding mortgage loans and title insurance. F collects and transmits (by computer, fax, mail, or other means) loan applications or other information to B and C for processing. A pays F a small salary and a bonus for every loan closed with B or title insurance issued with C. F furnishes the controlled business disclosure to consumers at the time of each referral. F receives no other compensation from the real estate or mortgage transaction and performs no settlement services in any transaction. At the end of each of A's fiscal years, M, a managerial employee of A, receives a $1,000 bonus if 20% of the consumers who purchase a home through A close a loan on the home with B and have the title issued by C. During the year, M acted as a real estate agent for his neighbor and received a real estate sales commission for selling his neighbor's home.

Comments: Under § 3500.14(g)(1), employers may pay their own *bona fide* employees for generating business for their employer (§ 3500.14(g)(1)(vii)). Employers may also pay their own *bona fide* employees for generating business for their affiliate business entities (§ 3500.14(g)(1)(ix)), as long as the employees do not perform settlement services in any transaction and disclosure is made. This permits a company to employ a person whose primary function is to market the employer's or its affiliate's settlement services (frequently referred to as a Financial Services Representative, or ''FSR''). An FSR may not perform any settlement services including, for example, those services of a real estate agent, loan processor, settlement agent, attorney, or mortgage broker. In accordance with the terms of the exemption at § 3500.14(g)(1)(ix), the marketing of a settlement service or product of an affiliated entity, including the collection and conveyance of information or the taking of an application or order for the services of an affiliated entity, does not constitute the performance of a settlement service. Under the exemption, marketing of a settlement service or product also may include incidental communications with the consumer after the application or order, such as providing the consumer with information about the status of an application or order; marketing may not include serving as the ongoing point of contact for coordinating the delivery and provision of settlement services.

Thus, in the circumstances described, F and M may receive the additional compensation without violating RESPA.

Also, employers may pay managerial employees compensation in the form of bonuses based on a percentage of transactions completed by an affiliated company (frequently called a ''capture rate''), as long as the payment is not directly calculated as a multiple of the number or value of the referrals. 24 CFR 3500.14(g)(1)(viii). A managerial employee who receives compensation for performing settlement services in three or fewer transactions in any calendar year ''does not routinely'' deal directly with the consumer and is not precluded from receiving managerial compensation.

* * * * *

8. Appendix D is revised to read as follows:

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APPENDIX D TO PART 3500
Controlled Business Arrangement Disclosure Statement Format

NOTICE

To: _____ **Property:** _____

From: _____ **Date:** _____
(Entity Making Statement]

This is to give you notice that ___[referring party]___ has a business relationship with ___[provider receiving referral]___. [Describe the nature of the relationship between the referring party and the provider, including percentage of ownership interest, if applicable.] Because of this relationship, this referral may provide ____[referring party]____ a financial or other benefit.

Set forth below is the estimated charge or range of charges by [provider] for the following settlement services:

_____: $_____

_____: $_____

_____: $_____

You are NOT required to use ___[provider]___ as a condition for [settlement of your loan on] [or] [purchase, sale, or refinance of] the subject property. THERE ARE FREQUENTLY OTHER SETTLEMENT SERVICE PROVIDERS AVAILABLE WITH SIMILAR SERVICES. YOU ARE FREE TO SHOP AROUND TO DETERMINE THAT YOU ARE RECEIVING THE BEST SERVICES AND THE BEST RATE FOR THESE SERVICES.

[A lender is allowed, however, to require the use of an attorney, credit reporting agency, or real estate appraiser chosen to represent the lender's interest.]*

ACKNOWLEDGMENT

I/we have read this disclosure form, and understand that ___[referring party]___ is referring me/us to purchase the above-described settlement services from ___[provider receiving referrals]___, and may receive a financial or other benefit as the result of this referral.

_____
[Signature]

* Add this paragraph only if the lender is requiring an attorney, credit reporting agency, or real estate appraiser to represent its interests.

[INSTRUCTIONS TO PREPARER: Specific timing rules for delivery of the controlled business disclosure are set forth in 24 CFR 3500.15(b)(1) (Regulation X).]

BILLING CODE 4210-27-C

9. Appendix E is removed and Appendix F is redesignated as Appendix E.

Dated: May 31, 1996.

Nicolas P. Retsinas,

Assistant Secretary for Housing-Federal Housing Commissioner.

[FR Doc. 96–14329 Filed 6–6–96; 8:45 am]

BILLING CODE 4210–27–P

24 CFR Part 3500

[Docket No. FR–3638–N–03]

Office of the Assistant Secretary for Housing-Federal Housing Commissioner; Real Estate Settlement Procedures Act (RESPA); Statement of Policy 1996–1, Regarding Computer Loan Origination Systems (CLOs)

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

ACTION: Statement of Policy 1996–1: Computer Loan Origination Systems (CLOs).

SUMMARY: This Statement of Policy sets forth the Department's interpretation of Section 8 of the Real Estate Settlement Procedures Act (RESPA) and its implementing regulations with regard to the applicability of RESPA to payments for services from certain computer systems, frequently called CLOs, used by settlement service providers in connection with the origination of mortgage loans or the provision of other settlement services covered by RESPA. This statement explains the statutory and regulatory framework for HUD's treatment of payments to CLOs.

In reading this policy statement, the reader should be aware that HUD's RESPA rule was recently streamlined through a separate rulemaking. 61 FR 13232 (Mar. 26, 1996). This streamlining caused several provisions of the RESPA rule to be renumbered. Except as is otherwise indicated in the context of the policy statement, this policy statement refers to provisions by their current section number, incorporating all revisions to date as a result of the streamlining and today's rulemaking, published elsewhere in the Federal Register.

FOR FURTHER INFORMATION CONTACT: David Williamson, Director, Office of Consumer and Regulatory Affairs, Room 5241, telephone (202) 708–4560; or, for legal questions, Kenneth Markison, Assistant General Counsel for GSE/RESPA, or Grant E. Mitchell, Senior Attorney for RESPA, Room 9262, telephone (202) 708–1550. (The telephone numbers are not toll-free.) For hearing- and speech-impaired persons, this number may be accessed via TTY (text telephone) by calling the Federal Information Relay Service at 1–800–877–8339. The address for the above-listed persons is: Department of Housing and Urban Development, 451 Seventh Street, SW, Washington, DC 20410.

SUPPLEMENTARY INFORMATION: Individuals and firms have developed and are developing various systems that employ computer technology to assist consumers in finding a lender, selecting a mortgage product, originating a mortgage, or choosing among other settlement service providers and products. These systems are sometimes called computer loan origination systems (hereafter ''CLOs''), although other terminology may be used, such as computer loan information systems. These systems differ in the way they interact with consumers, in the way they collect and display information on mortgage options, in the range of choices of products and services they provide to consumers, and in the extent to which they share work with other providers in the settlement service process. HUD expects product diversity to increase as technology evolves and new telecommunication options become available.

The following exemption was set forth in the November 2, 1992 final rule, effective December 2, 1992: Section 8 of RESPA does not prohibit * * * any payment by a borrower for computer loan origination services, so long as the disclosure set forth in Appendix E of this part is provided to the borrower. 24 CFR 3500.14(g)(2)(iii).

This exemption from Section 8 was for ''any payment by a borrower for computer loan origination services,'' as long as certain disclosures were provided. This rule did not address payments made by lenders, thus leaving such payments subject to Section 8 scrutiny. Although the term ''CLO exemption'' is frequently used, including in the preamble of the 1992 final rule, the exemption was not for the CLO itself, but only for payments made for CLO services by borrowers. The 1992 final rule did not speak to other issues; notably it did not define a CLO or explain how RESPA applies to payments by lenders to CLOs for CLO services. The November 2, 1992 rule also withdrew all previous informal legal opinions, including those stating the Department's views on various CLO issues.

In response to numerous expressions of concern about the new exemption and other aspects of the revised regulations, HUD requested public comments in a Federal Register Notice on July 6, 1993, and held public hearings on August 6, 1993.

On July 21, 1994, HUD issued proposed regulations that would repeal the general CLO exemption for borrower payments and, in its place, establish an exemption for borrower payments to certain ''qualified CLOs'', that is, CLOs having characteristics that HUD considered beneficial to consumers. The proposed exemption would apply only to payments by borrowers, but HUD did solicit public comments on whether to provide a similar exemption for payments by lenders to qualified CLOs. Under the proposed rule, payments by borrowers to CLO systems that did not qualify for the exemption were subject to scrutiny under section 8 of RESPA. HUD also invited those with active CLOs or those developing CLOs to demonstrate their systems at a Technology Demonstration Fair on September 30, 1994. Twenty-one CLO operators accepted the invitation and participated in this all-day demonstration in Washington, D.C.

The public comments in response to the proposed rule raised a number of specific questions about the proposed exemption for payments to qualified CLOs, and generally displayed skepticism or uncertainty about the usefulness of the proposal. Concerned that the comments did not adequately address all the issues, HUD held two informal meetings with industry and consumer groups to seek additional individual input on the likely future development of CLOs. These meetings were held on August 11, 1995, and September 21, 1995. While HUD learned many things from the public comments and the meetings with industry and consumer groups, one message seemed to predominate. All parties wanted clearer guidance from HUD on how RESPA's disclosure and anti-kickback provisions apply to borrower and lender payments for CLO services.

Both the 1992 and the proposed 1994 exemptions for borrower payments to CLOs were offered because of concern that uncertainty about how RESPA applied to payments to CLOs might be impeding the development or use of potentially beneficial technology. However, by limiting the exemptions to borrower payments, in both cases, HUD did not address the primary issue of how RESPA's anti-kickback provisions applied to lender payments to CLOs.

Many participants in the informal meetings urged that it was impossible to