SECURITIES REGULATION OF REAL ESTATE INVESTMENTS:
THE CALIFORNIA MODEL

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I. INTRODUCTION

Limited partnership interests in real estate syndications have traditionally been utilized as tax shelter vehicles by wealthy investors. The popularity of these interests in recent years, however, has spread to the less affluent and less sophisticated public investor. Not infrequently such syndicates have been inadequately financed, poorly managed, and deceptively advertised from the outset. Hence the necessity for adequate regulation of real estate syndicate offerings has become all too apparent.

In 1972 the committee on real estate limited partnerships of the Midwest Securities Commissioners' Association attempted to draft regulations to meet this need. The committee conferred with representatives of the National Association of Securities Dealers (NASD) and with the SEC and eventually formulated a model set of rules. The California regulations in general conform to this model.1

In the following pages I will attempt to briefly sketch the California requirements pertaining to limited partnership real estate syndications. Particular attention will be given to the requirements as to suitability, compensation, and disclosure, since the regulations in these areas are designed to prevent the real estate investment syndicate from becoming a trap for the unsophisticated investor. California's rules pertaining to partnership democracy are also described, as are the tax questions which they have raised.

II. JURISDICTION OF DEPARTMENT OF REAL ESTATE

In the first place, it is necessary to note that in California not all real estate limited partnership syndicates are subject to the 1973 California Real Estate Syndication Rules. Certain securities, labelled "real estate syndicate securities," come under the jurisdiction of the Department of Real Estate rather than the Department of Corporations.2

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1 The California Real Estate Syndication Rules became effective in May, 1973.

2 CAL. BUS. & PROF. CODE §§ 10250 et seq. (West 1974).
real estate syndicate security may be sold to no more than 100 investors. It must be "formed for the sole purpose of, and engaged solely in investment in or gain from an interest in real property, including, but not limited to, a sale, exchange, trade, or development." The types of activities involved may include both the ownership of non-income-producing land held for development or appreciation, as well as the ownership and operation of income-producing properties (such as apartment buildings or other multi-family developments, commercial and professional buildings, shopping centers or industrial parks, motels, mobile home parks or similar facilities), and agricultural activities that do not involve the conversion or processing of the products into a different form.

A distinction is drawn between these types of activities and those activities in which the utilization of the land is merely incidental to the conduct of a business enterprise, such as the ownership and operation of hotels, convalescent hospitals, recreational facilities such as golf courses or amusement parks, shopping centers, industrial parks, motels, and mobile home parks where the syndicate conducts a business on the facilities. Included, too, would be agricultural activities that involve the conversion or processing of the products into different forms. If the utilization of land is incidental to the conduct of a business enterprise, the offering is subject to qualification under the Corporate Securities Law. This is true notwithstanding the fact that sales will not be made to more than one hundred persons.

In many offerings, however, the ownership and use of real property are significant factors, but such offerings nonetheless are not within the definition of "real estate syndicate security" and thus are not subject to the jurisdiction of the Department of Real Estate. The manner in which title is held, for example, can be an indication of whether the security is a real estate syndicate security. Where title to the property is vested in the individual purchasers rather than in the entity forming the syndicate and management of the property is performed by a manager, the resulting security is an investment contract. Investment contracts do not come within the statutory definition of a real estate syndicate security, and therefore must be qualified under the Corporate Securities Law.

If a security comes within the definition of a real estate syndicate security, it is exempt from the qualification requirements of the Corporate Securities Law. The remainder of this article will be concerned

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3 CAL. BUS. & PROF. CODE § 10251 (West 1974).
4 CAL. CORP. CODE § 25100(e) (West 1974). Where a syndicate proposes to acquire two or more properties where one of them would be subject to qualification under the
with securities which are subject to the jurisdiction of the Department of Corporations.

III. STANDARDS

Real estate securities offerings can take many different forms, and for that reason California law attempts to be flexible in prescribing the standards to be met by diverse types of offerings. Among the most critical standards to be met by an offering, and those where flexibility is most important, are the standards relating to suitability of the participants, expenses and compensation to be paid to developers and promoters, and conflicts of interest and self-dealing.

A. Suitability

The requirement that purchasers of securities meet certain investor suitability standards may be imposed in any securities offering if circumstances warrant. Such standards, however, have particular relevance to high-risk or tax-oriented offerings and are, therefore, most frequently imposed in tax-sheltered limited partnership offerings. The Department of Corporations has long taken the position that the sale of tax shelter securities should not be made to the public generally, but only to those who can take advantage of the tax benefits to be conferred by the program. Accordingly, such offerings must be limited to a class of suitable investors, with suitability measured by net worth and annual income.

The justification for the imposition of suitability standards stems from two rather unique characteristics of limited partnerships. First, participants in partnership offerings do not have the same rights and protections which have been afforded shareholders as a result of substantial experience over long periods of time. The statutory and case law dealing with the rights of corporate shareholders provides a vast inventory of rights, remedies, procedures, and guarantees designed to protect shareholders and their investments. Secondly, a partnership investment generally lacks liquidity, perhaps the single most important feature of a corporate security. In the usual case a partnership investment cannot be readily and conveniently converted to cash through the sale or transfer of the partnership interest. Requirements of the Internal Revenue Service further complicate the disposition of a limited partnership interest.5

Again, consistent with the desire for flexibility, suitability standards

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Corporate Securities Law, the Department of Corporations assumes jurisdiction and the offering must be qualified pursuant to that law.

5 Treas. Reg. § 301.7701.
are imposed commensurate with the nature of the investment, the risks involved, and the degree of protection required. The suitability standard to be imposed, therefore, depends greatly on the nature of the offering, and may vary significantly even within a given category. When it appears that the class of investors to be approached is capable of protecting itself, considerable flexibility may be exercised by the Department of Corporations in relaxing certain of the guidelines suggested by the rules. Basically the rules require that participants in real estate syndications have a minimum annual gross income of $20,000 and a $20,000 liquid net worth or, in the alternative, a minimum liquid net worth of $75,000. "Liquid net worth" is defined as net worth determined exclusive of home, furnishings, and automobiles. In very high-risk or principally tax-oriented offerings, higher standards may be imposed.\(^6\) By comparison, in oil and gas offerings a $50,000 liquid net worth is required and a 50 percent tax bracket or, in the alternative, a $200,000 net worth; in cattle syndications, a $30,000 to $35,000 net worth and income; and in agricultural syndications, although there is no set standard, as a general rule the standards tend to be higher than those applied to real estate offerings.

The California regulations do not specify any typical minimum suitability standards in the case of real estate investment trusts or corporations. Suitability standards are there imposed where the degree of speculativeness and other factors indicate that the imposition of such a requirement is appropriate.

B. Compensation

1. Limited Partnership Real Estate Syndicates

The area of compensation is perhaps one of the most difficult with which the Department deals. The reasonableness of the promoters’ compensation is subject to review under the statutory fair, just, and equitable standard.\(^7\) The underlying premise of this review is that the interests of the promoters and the public investors should coincide, and each should look to the success of the venture for his reward. In the limited partnership real estate syndication, the rules and policies of the Department are designed to achieve a balance among front-end fees, compensation generated from profits or cash flow, and rear-end compensation. Compensation generated from profits and rear-end compensation may be subordinated to a return to the investors of their capital contribution or a preferential return on their investment.

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\(^6\) 10 CAL. ADMIN. CODE § 260.140.112.5.
\(^7\) 10 CAL. ADMIN. CODE §§ 260.140.113.1 et seq.
The rules require that front-end compensation in real estate syndications be limited to an acquisition fee of not more than eighteen percent of the gross proceeds of the offering.\(^8\) Included within this eighteen percent limitation is any real estate brokers' fee paid by the seller to third parties, the real estate brokers' commission, contractors' fee, developers' fee, or any other fee paid in connection with the acquisition of the real property.

As a fee for his services as a promoter, the sponsor may choose one of two alternatives, the most common of which is ten percent of cash available for distribution plus fifteen percent of the proceeds from the sale or refinancing of the program's properties (which must be subordinated to a return of one hundred percent of the investors' initial contribution, plus a six percent cumulative return on that investment).\(^9\) The other alternative is twenty-five percent interest in the undistributed amounts remaining after payment to investors of an amount equal to one hundred percent of capital contribution.\(^10\) The program may also incur certain selling expenses not exceeding fifteen percent of the offering.\(^11\)

A committee was specially appointed to consider changes to the Real Estate Syndication Rules, and several revisions have been proposed in the area of compensation.\(^12\) One major proposal pertaining to development and construction contracts would prevent sponsors from constructing or developing properties or rendering any services in connection with such development or construction unless certain conditions were satisfied. These conditions include the following: (a) The transactions must occur at the program's formation; (b) specific terms of the development and construction of identifiable properties must be ascertainable and fully disclosed in the prospectus; (c) the purchase price

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\(^8\) 10 CAL. ADMIN. CODE § 260.140.113.3(b).
\(^9\) 10 CAL. ADMIN. CODE § 260.140.113.5(b)(1) and (2).
\(^10\) 10 CAL. ADMIN. CODE § 260.140.113.5(a).
\(^11\) 10 CAL. ADMIN. CODE § 260.140.113.5(b).
\(^12\) Consideration is currently being given to amending the definition of "Acquisition Fee" so as to delete construction fees. The effect of this would be to exclude from the maximum percentage limitation on acquisition fees all fees paid in connection with the construction of a project, whether paid to the sponsor or to a third party. The total compensation for acquisition services may be reduced from eighteen percent to fifteen percent of the gross proceeds of that offering.

Section 260.140.113.5(b) is also the subject of a proposed amendment, changing the word "distributions" to "Cash Distributions" to remove the ambiguity in that phrase. In addition, two new subdivisions have been added making it clear that distributions to investors from proceeds of the sale of properties is a return of capital which reduces the investor's original capital contribution. A related new subsection designated "(4)" would eliminate a current ambiguity in the rules by requiring that the distribution of assets upon dissolution and liquidation conform to the subordination provisions of subsections (a) and (b) of this rule.
paid by the program must be based upon a firm contract price which, in no event, can exceed the sum of the cost of the land and the sponsor's cost of construction; (d) in the case of construction, the only fee paid to the sponsor in connection with such activity must consist of a construction fee for acting as a general contractor, which fee must be comparable and competitive with the fee of disinterested persons rendering comparable services; and (e) the sponsor must demonstrate the presence of extraordinary circumstances.13

2. Internal Revenue Service Requirements and Requests for Rulings

Some recent decisions by the Internal Revenue Service have injected additional complexity and controversy into this already complex area. Several months ago the Internal Revenue Service apparently assigned lowest priority to those requests for private rulings for partnership shelter offerings where the general partner did not have at least a five percent interest in partnership profits and losses. While the Internal Revenue Service's position on this matter has frequently undergone change, our latest information is that, for purposes of obtaining an advance ruling, the general partner must have a one percent interest in the profits, losses, deductions and credits of the partnership.14 The obvious purpose of this requirement is to insure that the general partner is truly financially interested in the success of the partnership and that his interest has been paid for and subjected to taxation in the same manner as the interests of limited partners.

A problem arises when the general partner wants this one or five percent interest as part of his promotional consideration. California rules require that such promotional consideration be subordinated to a return of capital to limited partners.15 The Internal Revenue Service does not consider such a subordinated return adequate for its purposes. The Department's current position is that where a promoter is willing either to pay for such an interest or reduce some other forms of his compensation, the Department will allow such an interest on a nonsubordinated basis.

3. Real Estate Investment Trusts

California rules limit the amount of compensation in real estate in-

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14 The effect of the inability to obtain an Internal Revenue Service ruling is potentially significant, since California rules require that the prospectus contain a "summary of an opinion of tax counsel acceptable to the Commissioner and/or a ruling from the Internal Revenue Service covering major tax questions relative to the program. . . ." 10 Cal. Admin. Code § 260.140.117.1(o). See also text accompanying n.26, infra.

vestment trusts by providing that the annual expenses of the trust, including any investment advisor's fees, should not exceed $5,000 or two percent of its base assets (which is defined in the rules), whichever is larger, with respect to base assets not in excess of ten million; compensation is limited to one percent of base assets with respect to base assets in excess of ten million.\(^\text{16}\)

The policy statement issued by the Midwest Securities Commissioners' Association is frequently useful in the analysis of real estate investment trust offerings. In the compensations section of that statement the Association provides a slightly different expense limitation in that it bases its formula on either average net assets or trust net income, as those terms are defined in the statement. Lastly, the selling expenses for a real estate investment trust are limited to fifteen percent of the aggregate offering price.\(^\text{17}\)

4. Corporations

Perhaps the most frequent compensation problem that arises in connection with the offering of shares by corporations involves the question whether the percentage of shares being received by the promoters of the company for their promotional services is excessive. In connection with the financing of an unseasoned corporation, a number of promotional shares which does not exceed twenty-five percent of all the common shares issued and proposed to be issued by the corporation is presumptively reasonable. Again, as in most cases where a percentage figure creates a "presumptively reasonable" standard, the rule provides flexibility by stating that additional promotional shares may be authorized where circumstances warrant.\(^\text{18}\)

Like real estate investment trusts and partnership offerings, the selling expenses of corporate securities are presumptively reasonable if they do not exceed fifteen percent of the aggregate offering price.\(^\text{19}\)

C. Conflicts of Interest and Self-Dealing

The rules of the Department that deal with situations presenting a possible conflict of interest attempt to minimize those areas where the promoter seeks to serve divergent interests, i.e., his own and those of the investors. There are detailed provisions prohibiting certain transac-

\(^{16}\) 10 CAL. ADMIN. CODE § 260.140.94.
\(^{17}\) 10 CAL. ADMIN. CODE § 260.140.90.
\(^{18}\) 10 CAL. ADMIN. CODE § 260.140.31.
\(^{19}\) 10 CAL. ADMIN. CODE § 260.140.20.
tions between the sponsor and the program. The specific areas covered by these provisions include sales and leases to the program, sales and leases to the sponsor, loan dealings with related programs, exchanges of limited partnership interests, exclusive sales agreements, commissions on reinvestment, services rendered by the sponsor, rebates, kick-backs or other reciprocal arrangements, commingling of funds, expenses of the program, investments in other programs, lending practices, development or construction contracts, and completion bonds and appraisals.

Potential conflict of interest situations are scrutinized quite closely during the analysis of applications. In those situations where transactions are permitted between sponsor and programs, the rules seek to ensure that the terms of such transactions are at least as favorable to the program as those expected to be obtained from independent third parties.

Blind pool syndications present special problems in this area, and in general, transactions between the program and the sponsor relating to sales and exchanges of property, leases and most other dealings are prohibited. Real estate commissions and certain other compensations for services rendered, however, are permissible under certain circumstances.

With respect to real estate investment trusts and corporations, there are no specific self-dealing or conflict of interest provisions in the California rules. In both situations, however, the Department does apply the statutory fair, just, and equitable standard to such arrangements and the Department also requires that there be adequate disclosure to potential investors. Additionally, in the case of real estate investment trusts, the Department takes into consideration the Statement of Policy on Real Estate Investment Trusts promulgated by the Midwest Securities Commissioners' Association, which deals at length with self-dealing and other conflict situations.

IV. PARTNERSHIP DEMOCRACY

The rules relating to partnership democracy and participation reflect the general effort to provide protection for participants in limited partnerships in several ways. The California rules require, for example, that the limited partners holding ten percent of the outstanding limited partnership interests may call meetings of the limited partners for any matter upon which the partners may vote. The rules also require that certain reports be made available to holders of limited partnership inter-

21 For special requirements applicable to non-specified property programs see 10 CAL. ADMIN. CODE §§ 260.140.115.1-7.
ests and that limited partners be accorded the right of access to all records of the program at reasonable times.\textsuperscript{23}

Perhaps the most important rules in the field of investor protection, and also the most controversial, are found in the provisions requiring partnership democracy. California rules require that the partnership agreement must provide that a majority of the then-outstanding limited partnership interests may without the necessity for concurrence by the general partner vote to (1) amend the limited partnership agreement, (2) dissolve the program, (3) remove the general partner and elect a new general partner and provide a method of valuation of the general partner's interests that would not be unfair to participants, and (4) approve or disapprove the sale of all or substantially all of the assets of the program.\textsuperscript{24}

The Department of Corporation's insistence upon these "partnership democracy" provisions has created a controversy with the Internal Revenue Service. The Internal Revenue Service has taken the position that California's version of the Uniform Limited Partnership Act, by providing that the partnership could be continued by less than a one hundred percent vote of all limited partners, does not conform to the Uniform Limited Partnership Act in that such a partnership possesses the corporate characteristic referred to as "continuity of life." The result, according to the Internal Revenue Service, is that the limited partnership will be taxed as a corporation.

Since the Department is strongly committed to the necessity for partnership democracy, I have participated in a number of meetings with officials of the Internal Revenue Service in an effort to persuade the Service to reverse its position on California partnerships. The Internal Revenue Service, however, has not, as yet, changed its position.\textsuperscript{25} The Department has taken an interim position providing that the partnership agreement may provide for (a) removal of the general partner by a majority vote of the limited partners, and (b) continuation of the partnership upon occurrence of a specified event, such as removal, death or insanity of the general partner, by a unanimous vote of all limited partners.

In such cases, and because this is an interim position, there should be a provision in the partnership agreement that a majority of the limited

\textsuperscript{23} 10 CAL. ADMIN. CODE § 260.140.116.3-4.
\textsuperscript{24} 10 CAL. ADMIN. CODE § 260.140.116.2.
\textsuperscript{25} The legislature attempted to meet the problem of unfavorable Internal Revenue Service Rulings by passage of Assembly Bill 1339 in October of 1973. That bill amended CAL. CORP. CODE § 15520 by providing temporary alternative provisions governing the continuation of partnerships, but does not appear to have resolved the difficulty.
partners may elect to continue the partnership, if prior to the occurrence
of a terminating event, it has been established by either (a) a final ap-
PELLATE court decision, or (b) a published Internal Revenue Service rul-
ing or other pronouncement, that for tax purposes the continuation of a
partnership by a vote of less than all of the limited partners will not
cause the partnership to have the corporate characteristic of continuity
of life. Full disclosure, of course, mandates that the prospectus discuss
the consequences which may flow if, for example, a unanimous vote
of continuation cannot be obtained.

V. STANDARDS OF DISCLOSURE

Adequate disclosure of the features and ramifications of any offering
is, of course, critical in making an informed judgment as to whether to
participate in such an offering or not. Accordingly, over the last several
years the Department has made a concerted effort to require maximum
levels of adequate disclosure.

In regard to tax aspects, the prospectus must contain a discussion of
the federal income tax consequences of the investment and any pending
or proposed legislation on the federal or state level which, if enacted,
would affect the benefits to be derived from such an investment.26 Cal-
ifornia rules also now require that the prospectus contain a summary of
the opinion of tax counsel acceptable to the Commissioner and/or a
ruling from the Internal Revenue Service covering major tax questions
relative to the program.27

VI. LICENSING

Part 3 of the Corporate Securities Law of 1968 deals with the licens-
ing and regulation of agents, broker-dealers and investment advisers.28
This section is modeled almost entirely upon the Federal Act of 193429
and the Investment Advisers Act of 1940.30 Use of the federal regula-
tory pattern as a model for the California corporate securities law was an
attempt by the drafters to eliminate the conflicts that would arise from
inconsistent requirements under two laws. California law was thus de-
signed to complement and supplement federal regulation. In some in-
stances, however, the drafters of the Corporate Securities Law of 1968
thought it necessary to increase the regulation in certain areas involv-

26 10 CAL. ADMIN. CODE § 260.140.117.3(o).
27 Id.
28 CAL. CORP. CODE § 25200 et seq. (West 1974).
ing the licensing and training of personnel. An example of this would be California's requirement that investment advisers take an examination.\textsuperscript{31} No such examination requirement exists under the 1940 Act.

California law requires that broker-dealers, agents, and investment advisers be licensed by the State of California if such persons conduct a business within the State of California and are not otherwise exempt under California law.\textsuperscript{32} The definitions of broker-dealers, agents, and investment advisers are quite specific and contain certain narrowly defined exclusions.\textsuperscript{33} In general, a broker-dealer must be licensed if he directs an offer to sell or to buy a security to a person in this state, regardless of whether or not the broker-dealer is located within the state.\textsuperscript{34}

Unless specifically exempted under the code or under the rules, no broker-dealer or agent shall effect any transaction in, or induce or attempt to induce the purchase or sale of, any security in this state unless such person has first secured a certificate from the Commissioner authorizing such person to act in such capacity. The procedure and application form necessary to obtain a license are contained in rules, and vary slightly depending upon whether the applicant is registered with the SEC under the 1934 Act.

An investment adviser, too, is forbidden to conduct business in this state unless he has first secured a certificate from the Commissioner or

\textsuperscript{31} \textit{CAL. CORP. CODE} 25236 (West 1974).

\textsuperscript{32} \textit{CAL. CORP. CODE} §§ 25210 & 25230 (West 1974).

\textsuperscript{33} \textit{See} \textit{CAL. CORP. CODE} § 25204 (West 1974).

\textsuperscript{34} \textit{CAL. CORP. CODE} § 25008 (West 1974).

There are certain exemptions contained within the statute that allow broker-dealers, agents, and investment advisers to transact business if certain requirements are met. Very generally these exemptions are as follows:

1. The person is a broker-dealer or agent of a broker-dealer registered under the Federal Act of 1934 or registered under the Investment Advisers Act of 1940; and
2. No certificate has been denied or revoked pursuant to any California Corporate Securities Law; and
3. The person has no place of business in this state; and
4. The parties with whom he deals meet certain requirements. For example, the person deals only with broker-dealers, banks, savings and loan associations, insurance companies, registered investment companies, governmental agencies, or other institutional investors; or
5. In the case of a broker-dealer or agent, the person deals with no more than fifteen customers in this state during any twelve consecutive month period who had an existing account with the broker-dealer prior to any offer being made to them in this state; and in the case of an investment adviser, during any twelve consecutive month period does not direct business communications in this state, in any manner, to more than five clients other than the institutional investors specified above, whether or not he or any of the persons to whom the communications are addressed is then present in the state. \textit{CAL. CORP. CODE} §§ 25200-05 (West 1974).

An additional exemption is available to persons whose only clients are investment companies registered under the Investment Company Act of 1940 or insurance companies. \textit{CAL. CORP. CODE} § 25203 (West 1974).
is otherwise exempted under the statute or rules. The application to obtain a license as an investment adviser is contained in the rules and one form is used regardless of whether or not the applicant is registered with the SEC.

VII. Regulation of Fraudulent, Deceptive and Manipulative Sales Practices

The provisions of California law prohibiting fraudulent and manipulative practices by agents and broker-dealers were substantially borrowed from the Securities Exchange Act of 1934. The Commissioner is authorized to designate fraudulent and deceptive practices by rule. Violations do not under the California statute give rise to civil liability, but do subject the violator to possible criminal liability, and to injunctive or disciplinary action by the Commissioner.

Related to the regulation of sales practices by agents are the so-called "housekeeping rules" regarding the supervision of agents, record keeping, and the necessity for maintaining a written authority for the exercise of discretionary powers by a broker-dealer. These rules are modeled substantially on rules 15(b)10-4 through 15(b)10-6 of the 1934 Act.

A. Supplemental Selling Material

The California statute basically provides that no person shall publish any advertisement concerning a security in this state unless it has first been filed with the Commissioner of Corporations. The rules prescribe specific standards relating to advertisements to insure that advertisements of securities disclose fairly and accurately such relevant facts as are necessary to make the advertisement not misleading, and provide all the information required to make an informed investment decision. In order to facilitate review of advertising, advertisements are normally assigned to the staff counsel who analyzed the original offering to which the advertisement relates. The counsel then reviews the contents of the advertisement for factual accuracy. Supplemental sales literature such

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36 CAL. CORP. CODE § 25216(b) (3) (e) (West 1974).
37 See CAL. CORP. CODE §§ 25230 et seq. and 25540 et seq. (West 1974).
38 CAL. CORP. CODE §§ 25230 et seq. (West 1974).
40 CAL. CORP. CODE § 25300(a) (West 1974).
41 10 CAL. ADMIN. CODE § 260.140.117.1.
as pamphlets and brochures are subject to the same standards imposed with respect to an offering circular or prospectus.

B. Projections

One area in which there has been a great deal of concern, and in recent months several significant changes, is the area of projections. The Department recognizes that in real estate syndications, projections of net after-tax income can be a very significant factor in an investor's decision to invest in a particular program. The Department's rules allow projections of earnings if based on a past earnings record, if the projection is for a reasonable period only, and if it is substantiated by data which clearly support such estimates. The Department has not required disclosure of projected earnings or operating results under the rule, and such projections have rarely been submitted.

The Real Estate Syndication Rules currently state that the presentation of predicted future results of operations is permitted, but not required, and its inclusion in the prospectus, offering circular or other sales material is allowed if it complies with the following requirements:

1. Projections must be realistic in their predictions and clearly identify the assumptions made with respect to material features of the presentation.
2. Projections should be prepared by a qualified person or firm, which person should be identified in the prospectus or offering circular.
3. Only projections which appear in the prospectus or offering circular may be used in connection with sales literature, and if such projections are included in the sales literature, all such projections must be included.
4. The projections must include certain material information, for example, annual predicted revenue and its sources, annual predicted expenses, mortgage obligations, the required occupancy rate in order to meet debt service and all expenses, predicted annual cash flow and depreciation, predicted annual taxable income, and predicted construction cost.
5. The projections must contain a caveat prominently displayed to the effect that they represent a mere prediction of future events based on assumptions which may or may not occur and may not be relied upon to indicate the actual results which will be obtained.
6. The rules provide additional guidelines regarding format which require additional disclosure in certain areas, for example, the tax consequences for the period for which the projections are made.

The rules do not allow projections for unimproved land. They do, however, permit a table of deferred payments, and where the program's in-

42 10 CAL. ADMIN. CODE § 260.140.117.4.
tent is to develop and sell the land as a primary business, a detailed cash flow statement showing the timing of expenditures and anticipated revenue.\footnote{10 CAL. ADMIN. CODE § 260.140.117.4(b).}

For several months a committee composed of members of the Department, members of the bar, accountants, and industry representatives have met for the purpose of making recommendations regarding needed changes to be made in the Track Records and Projections Sections of the rules. The committee recently submitted its report recommending certain substantial changes in §§ 260.140.117.3(k) and 260.140.117.4 dealing with track records and projections, respectively. In the track records area, the most important proposed changes are those revising the format for presentation and requiring certain disclosures where distortions may exist due to the fact that previous programs had sold properties to affiliated parties. Additional disclosures will have to be made if any previous program had a default in meeting any of its obligations in excess of thirty days, there has been a foreclosure, or a sale or conveyance in lieu of foreclosure, or if there has been any bankruptcy, insolvency, or like proceedings.

Rule 117.4 dealing with projections is also the subject of numerous recommendations. Among them are the recommendation that the currently optional status of projections be eliminated and that projections be mandatory in any real estate syndicate offering. Other proposals require substantial revisions in the format including, for example, that certain tables be presented, such as a table showing revenues and expenses as a function of the vacancy factor. It has also been recommended that the predicted overall results of the program be shown in terms of a discounted rate of return. One particularly controversial proposal is the recommendation that certain limited projections be allowed in blind pools.