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Investor Suitability Standards in Real Estate Syndication: California’s Procrustean Bed† Approach

Jane W. Hall*

This exploration of efforts by securities regulators to limit the sale of real estate syndication interests to “suitable” investors focuses on one of the most current and troublesome—the presumptive investor suitability standard, which bars investment by persons who do not meet minimum financial profiles. The analysis is applicable by analogy to other securities, such as oil and gas program interests, in which presumptive suitability standards are also imposed. The author argues that California’s present presumptive standard is not fully consistent with the reasoning underlying its development, and she proposes a new standard that utilizes a more flexible means of determining investor suitability. She also discusses sanctions for violation of various suitability rules, including the nascent right of an “unsuitable” investor to maintain a private action for damages.

Investor suitability involves “fitting” the securities to the prospective investor, taking into account that person’s investment objectives, financial situation, and needs, as well as his or her sophistication and experience in securities transactions.† Although the concept has been

† “[Men and women] who are shy of cash, or short of liquid capital, should assess their own circumstances, and not merely invest and rest easy because they fit into the Procrustean bed of the suitability letter.” Rossbach, Client “Suitability”: Six Questions Every Tax-Shelter Investor Should Ask, 111 TRUSTS & ESTATES 442, 444 (1972).

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1. “The concept of suitability expresses a homely truth about investing—investment decisions can be made only in light of the goals and needs of the person for whom they are made.” Mundheim, Professional Responsibilities of Broker-Dealers: The Suitability Doctrine, 1965 DUKE L.J. 445, 448 [hereinafter cited as Mundheim].
termed a "juridical quest for the holy grail" by one securities practitioner, the difficulty of establishing, implementing, and enforcing standards for determining the suitability of a particular security investment for an individual investor has, in recent years, deterred few securities regulators from embarking on such a quest. Suitability standards have been implemented or proposed by a growing number of state agencies involved in securities regulation, by the industry's self-regulatory body, and by associations of state securities regulators.

The National Association of Securities Dealers (NASD) has long recognized some broker-dealer responsibility in the suitability area:

In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer on the basis of facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.


This rather limited standard has been criticized for not affording prospective investors sufficient protection:

[S]uitability rules are cast in terms of the needs of the customer based on information he furnishes to the broker. Unarticulated but implicit in such rules is also the broker's obligation to obtain current basic information regarding the security and then to make an evaluation as to the suitability of a recommendation for a particular customer in view of both the information concerning the security and the customer's needs.


3. See text accompanying notes 61-80 (California), 97-117 (other states) infra.

4. See note 1 supra. In 1973, the Board of Governors of the NASD proposed an amendment to article III, section 2 of the Rules of Fair Practice:

(a) Except as provided in paragraph (b) hereof, in recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and to his financial situation and needs.

(b) In recommending to a customer the purchase, sale or exchange of any security which is part of the initial public offering of a company in the promotional, exploratory or developmental stage, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of information furnished by the customer concerning the customer's investment objectives, financial situation and needs, and any other information known by the member. In connection with all such determinations, the member must maintain in its files the bases for and the reasons upon which it reached its determination.

NASD Notice to Members 73-17 at 13-14 (Mar. 14, 1973). Although the proposed amendment resulted from inquiry by the SEC into the "hot new issues" market, id. at 2, paragraph (b) could be applied to many real estate limited partnership offerings.

The NASD has also proposed more specific suitability standards for tax sheltered investments, including real estate programs. See text accompanying notes 85-96 infra.

Standards of varying kinds have been imposed both industry-wide and in identifiable segments of the securities field. Even those standards which have existed for many years are being given new vitality, emerging as legal rules—the violation of which may give rise to civil liability—rather than mere ethical guidelines for professional conduct in the securities business.

Much of the attention given the suitability concept recently has centered around the regulation of tax shelter investments, particularly real estate syndicates. It is not surprising that real estate programs


Every nonmember broker or dealer . . . who recommends to a customer the purchase, sale or exchange of any security shall have reasonable grounds to believe that the recommendation is not unsuitable for such customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by such broker or dealer . . . . SECO Rule 15b10-3, 17 C.F.R. § 240.15b10-3 (1974) (emphasis added).


9. Real estate syndicates, also known as real estate programs, are usually organized as limited partnerships under applicable state law and are formed to finance virtually any kind of real estate deal, from holding undeveloped land to managing apartment complexes. The sponsor of the program (or, in all likelihood, both the individual sponsor and a corporate entity controlled by the sponsor) will serve as general partner(s), being exposed to unlimited liability. The investors, as limited partners, are liable for partnership debts only to the extent of their investments. California limited partnerships are governed by California's version of the Uniform Limited Partnership Act, codified at CAL. CORP. CODE §§ 15501-31 (West 1972), as amended (West Supp. 1974).


While it is true that not all real estate syndications have a specific tax orientation,
have been in the regulatory spotlight lately,\textsuperscript{10} for there was dramatic growth in syndication activity during the late 1960's and early 1970's. The public offering of real estate syndications filed with the National Association of Securities Dealers (NASD) exceeded three billion dollars in 1971 alone.\textsuperscript{11}

Current economic conditions have had a disastrous impact on the real estate market,\textsuperscript{12} and the number of syndication offerings has decreased accordingly.\textsuperscript{13} Moreover, many existing real estate programs—especially those organized primarily for tax shelter—are said to be "in financial shambles today."\textsuperscript{14} Real estate financing, however, is now importantly dependent on the nation's public capital markets,\textsuperscript{15} and syndication is an attractive capital-raising vehicle because of the inherent possibilities for tax shelter\textsuperscript{16} and the wide variety of structuring alternatives within the basic limited partnership framework.\textsuperscript{17} Because of this attractiveness, the syndication market is likely to be revitalized as soon as real estate financing in general regains some

demands of the public of these vehicles.

\textsuperscript{10} Interests in these investment vehicles are unquestionably securities under both federal and California law. Rifkind & Borton, \textit{SEC Registration of Real Estate Interests: An Overview}, 27 \textit{Bus. LAw} 649, 649-51 (1972); for a discussion of California law, see text accompanying notes 32-36 infra.

\textsuperscript{11} \textit{SEC, Report of the Real Estate Advisory Committee to the Securities and Exchange Commission} 11 (Oct. 12, 1972) [hereinafter cited as Dickey Report]. In 1973, 67 registration statements covering more than \$700 million of interests in real estate limited partnerships were filed with the Securities and Exchange Commission. \textit{SEC, Securities Act of 1933 Release No. 5465} (Mar. 1, 1974), in 3 \textit{SEC Docket} 606, 641 n.1 (1974). Since a substantial number of real estate syndications are marketed as intrastate or nonpublic offerings exempt from federal registration, this figure represents only a fraction of the total offering volume. For example, from January 1 through August 15, 1972, 165 real estate offerings registered with the NASD Department of Corporate Finance—including intrastate and nonpublic offerings that were sold through NASD-affiliated broker-dealers—sought to raise a total of \$1.6 billion. \textit{Dickey Report, supra}, at 11-12.

\textsuperscript{12} \textit{See, e.g., January Housing Starts Increased 13\%, But Issuance of Permits Hit Record Low}, Wall Street Journal, Feb. 20, 1975, at 3, col. 2.

\textsuperscript{13} For example, during the last six months of 1974 there were 39 filings with the California Department of Corporations, seeking to raise a total of \$155.4 million. During the corresponding period of 1973 there were 62 filings totaling \$220.7 million. Interview with Michael J. Broady, Supervising Corporations Counsel, California Department of Corporations, in San Francisco, Apr. 4, 1975 [hereinafter cited as 1975 Broady interview].

\textsuperscript{14} \textit{Many Tax Shelter Schemes in Financial Shambles}, S.F. Examiner, Feb. 26, 1975, at 63, col. 1.


\textsuperscript{16} See text accompanying notes 140-41 infra.

\textsuperscript{17} See text accompanying notes 134-38 infra.
petitive strength in the capital markets. Thus even a modest decline in interest rates and a slight slowing of the inflationary spiral affecting construction costs could spark renewed enthusiasm for real estate development in general and for this form of financing in particular.

The dependence of real estate development on public capital has brought increased scrutiny by regulatory authorities charged with protecting the investing public's interests. Sensitive to the rather tattered history of public real estate financing, as well as to current syndication abuses and the publicity surrounding them, securities regulators are seeking “to place the public financing of real estate development on a basis which will command continued public confidence.”

This Comment will focus on one of the methods securities regulators have developed to achieve that goal: the presumptive investor suitability standard. Although the analysis is directed at the regulation of investment in real estate syndications, it is applicable by analogy


With disconcerting frequency tax sheltered deals in real estate, oil, gas, cattle, [and] citrus [fruits] are being sold to widows, retired people, and other persons of modest means who desperately need ordinary income and for whom such adventures are usually unsuitable. That, of course, is more than a disclosure problem. It is a selling practice problem. The SEC and the securities industry’s own organizations have been trying valiantly for decades to elevate the ethical standards of those who sell securities and to make their trade the profession that it ought to be. Without deprecating what has been done along this line, I find myself constrained to observe that marketing p.actices in the tax shelter field reveals how much remains to be done.

The point is much on my mind at the moment. Perhaps that is so because of a pending case in which tax-sheltered agricultural deals were sold (sold fraudulently and deceptively, we at the Commission think) to substantial numbers of people whose circumstances were so very modest as to render the concept of tax shelter ludicrous. Some of these people were actually at the poverty level, although they did happen to have small amounts of capital that belonged in savings banks not in risky and sophisticated packages originally tailored for persons who could afford to bear losses with equanimity.


22. The presumptive standard, which conclusively presumes that certain classes of persons do not have the economic ability to undertake a particular investment, is but one means of ensuring investor suitability; it is generally used in conjunction with other suitability rules. In essence, the presumptive standard bars investment in certain securities transactions by investors having less than a specified dollar value of annual income and net worth. For a discussion of the present California suitability standards governing real estate syndications, see text accompanying notes 61-80 infra.
to any security in which investment is controlled by the imposition of such a standard. California law will be emphasized, for it is in California that the presumptive standard has had the longest history and the greatest development. After a brief historical introduction, section I will describe the investor suitability standards presently utilized by California in the regulation of real estate syndications, and will compare the California suitability approach with that taken by other regulatory bodies. Section II will analyze the reasoning underlying the imposition of suitability standards, concluding that the presumptive standard presently used in California is not fully consistent with that reasoning. Section III will consider refinement of the presumptive standard to include a more comprehensive and reliable set of factors for measuring a prospective investor's financial suitability. After considering the legal and practical arguments for abandoning the conclusive presumption of unsuitability presently imposed, it will suggest a new standard that utilizes a more flexible means of determining investor suitability. Finally, section IV will discuss sanctions for violation of suitability rules, including the "unsuitable" investor's emerging right to maintain a private action for damages, and will explore the possibility of conflict between the California presumptive standard and the syndicator's broader responsibility for determining investor suitability under both state and federal law. This latter area is particularly important in a time of economic downturn, for courts will no doubt be faced with numerous opportunities to consider the suitability doctrine as investments go sour and litigation ensues.

I

DEVELOPMENT OF INVESTOR SUITABILITY STANDARDS

A. History of California Standards

Real estate syndication activity in California began during the land boom of the early 1960's with a group of Southern Californians who specialized in the sale of undeveloped acreage. By the end of the

23. It can be expected that a cause of action for alleged violation of investor suitability standards will be included in many of these lawsuits. See, e.g., Greitzer v. United States Nat'l Bank, 326 F. Supp. 762 (S.D. Cal. 1971) (defendant's motion to strike plaintiffs' allegation that they were entitled to damages for mental suffering granted). In Greitzer, plaintiffs alleged five different causes of action: two under the Securities Exchange Act of 1934, one under the Securities Act of 1933, one based on common law deceit, and the fifth under the NASD suitability rule.

Although there is fear that "suitability will inevitably be judged in the light of the ultimate result," O'Boyle, Suitability, in CONFERENCE, supra note 2, at 103, resulting in almost automatic imposition of liability, since a venture gone belly-up can be regarded as suitable for no one, it is clear that post facto determinations of suitability must be made in light of conditions as they existed at the time of the investment.

1960's apartment properties had emerged as the most popular investment for real estate syndicates, although they were also being formed to develop office buildings, resort hotels, medical complexes, industrial parks, and other projects which require substantial aggregations of capital. The tremendous size of the California real estate market and the attractiveness of real estate investment as a tax shelter contributed to the rapid acceleration of activity in California real estate syndication. Although it is difficult to estimate the amount invested each year in public and nonpublic real estate program offerings, it is probably safe to say that before the current recession it was a billion dollar business.

Early on characterized as "the most active and militant state in the regulation of its capital market," because of its adoption of the "fair, just and equitable" standard and because of the tough administrative attitude that soon evolved in applying the standard, California continues to be regarded as a state which places considerable importance on protecting the interests of the investor. California's first Blue Sky law contained a broad definition of a security. Its "investment contract" language gave administrators and judges the ability

25. Id. at 25-26.
26. Id. at 27.
27. The terms real estate syndication (or syndicate), real estate program, and real estate limited partnership are often used interchangeably, and they are so used herein.
28. During its 1972-73 fiscal year the California Department of Corporations issued 108 permits to real estate syndicators; the total sought to be raised by these offerings exceeded $446 million. Interview with Michael J. Broady, Supervising Corporations Counsel, California Department of Corporations, in San Francisco, Mar. 5, 1974 [hereinafter cited as Broady interview]. Moreover, the California Department of Real Estate issued 61 permits to raise a total of $20 million in calendar year 1972, and 34 permits totaling $14 million in 1973. Classroom presentation by W. Jerome Thomas, Chief Legal Officer, California Department of Real Estate, in Berkeley, Feb. 27, 1974 [hereinafter cited as Thomas classroom presentation]. In addition to these public offerings, untold numbers of syndications escape qualification by considering themselves—properly or improperly—as nonpublic offerings exempted from qualification requirements under one of the exemptions provided by the Corporate Securities Law of 1968, CAL. CORP. CODE § 25102(f) (West Supp. 1974).
33. The definition of "security" reads in part:
"Security" means any note; stock; treasury stock; membership in an incorporated or unincorporated association; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; collateral trust certificate; preorganization certificate or subscription; transferable share; investment contract; voting trust certificate; certificate of deposit for a security; certificate of interest or participation in an oil, gas or mining title or lease or in payments out of production under such a title or lease; any beneficial interest or other security issued in connection with a funded
“to sweep almost every conceivable sort of interest within the definition, . . . especially whenever fraud need[ed] to be redressed.”

Enactment of the Corporate Securities Law of 1968 did nothing to constrict California’s comprehensive regulatory posture. Limited partnership interests are unquestionably securities for purposes of bringing them within California’s securities regulation system. The “fair, just and equitable” standard forms the backbone of this system, and the state’s regulation of real estate programs is simply one attempt to give effect to that standard.

When real estate syndications began springing up in the early 1960’s, regulation fell solely to the Department of Corporations. Its chief officer, the Commissioner of Corporations, has broad administrative authority, and this authority was soon exercised in the qualification of real estate syndication interests. At first, the Department displayed extreme caution, delaying issuance of the permit required for the offer and sale of securities until the syndicator obtained a negotiating permit and identified by name all potential investors. These names were then submitted to the Department, along with data concerning occupation, income, net worth, and other indicia of business sophistication. This information enabled the Department to determine whether each proposed investor was indeed “suitable” for the particular program. The unwritten suitability rule for a program thought to involve considerable risk required an annual income and a net worth (exclusive of equity in home, home furnishings, and automobiles) of twice the amount of the proposed investment—that is, $20,000 annual income and $20,000 “net” net worth of a $10,000 investment.

employees’ pension, profit-sharing, stock bonus, or similar benefit plan; or, in general, any interest or instrument commonly known as a “security”; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing...

34. Dahlquist, Regulation and Civil Liability Under the California Corporate Securities Act, 33 CALIF. L. REV. 343, 357 (1945).
36.See note 33 supra.
38. Id. § 25600.
39. Id. § 25610.
40. For an overview of California securities law, see MARSH & VOLK, supra note 7.
42. R. CHEATHAM & E. MANWELL, ATTORNEY’S GUIDE TO CALIFORNIA REAL ESTATE SYNDICATES 83-84 (1970) [hereinafter cited as CHEATHAM & MANWELL]. Hereinafter, all references to net worth will be to the “net” net worth concept (that is, net worth exclusive of equity in home, furnishings, and automobiles) unless otherwise specified.
By the late 1960's, increasing numbers of real estate syndicates made this qualification procedure administratively unworkable. Bowing to the pressures of its increased workload, the Department of Corporations agreed to qualify interests in real estate programs on the condition that the syndicator market the securities only to investors who met a certain profile, usually expressed in terms of a minimum annual income and net worth. The presumptive standards sought to limit offer and sale of interests in real estate syndications "to suitable investors who [were] capable of assessing the risks of speculative investments and who [had] the financial capability to withstand such risks." By 1969, the standard had evolved to a point where the potential investor's financial suitability was to be measured by annual taxable income and liquid net worth. This California approach—applied to oil and gas drilling programs and to mutual funds intending to engage in certain investment practices as well as to real estate programs—is said to be the "forerunner of today's standards restricting those to whom a tax shelter may be offered."

**B. The Real Estate Syndicate Act**

Many real estate people were unhappy with this regulatory treatment. They complained that the Department of Corporations was unfamiliar with and unsympathetic to problems peculiar to real estate, and they charged that the Department's staff automatically considered real estate programs as "unfair, unjust, and inequitable." This dissatisfaction ultimately led to passage of the Real Estate Syndicate Act in

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43. Van Camp, supra note 41, at 408.
45. Id. at app. A-4-32.
46. Id. at app. A-4-31.
48. 1 Marsh & Volk, supra note 7, § 8.10.
50. Cheatham & Manwell, supra note 42, at 48-49. As one frequent critic of attempts to regulate real estate programs wrote:
   "It is essential that you keep in mind that many of the proponents of strict suitability standards for real estate programs and other tax shelter programs were motivated by a desire to restrict their marketability and thereby enhance the appeal of other investments of special interest to them, particularly mutual funds and common stocks. Consequently, advocates of stringent suitability standards were not necessarily so much oriented to serve investors' interests as they were to serve their own interests."
1970, which transferred jurisdiction over most smaller real estate syndicates from the Commissioner of Corporations to the Real Estate Commissioner. Affected were unincorporated organizations with no more than 100 beneficial owners “formed for the sole purpose of and engaged solely in” investment in real property.\(^{52}\)

Despite the circumstances that led to its passage, this legislation has not effected any substantial changes in the regulation of real estate programs.\(^{53}\) The Real Estate Commissioner promptly issued guidelines\(^{54}\) which were similar in many respects to the rules of the Commissioner of Corporations then in effect.\(^{55}\) There are no presumptive suitability standards expressed in the Department of Real Estate guidelines. The Real Estate Commissioner customarily requires, however, that a prospective investor have an adjusted gross income and net worth of at least $15,000 (or twice the amount of the proposed investment, whichever is higher) or, in the alternative, a net worth of $30,000 (or four times the proposed investment).\(^ {66}\) Thus, the investor suitability standards of the Department of Real Estate are generally lower than those required by the Department of Corporations.\(^{57}\)

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52. Id. § 10251. The “real property only” limitation poses difficult jurisdictional problems for prospective syndicators whose operations would encompass more than traditional real estate development. In an effort to draw jurisdictional boundaries, the Commissioner of Corporations and the Real Estate Commissioner issued concurrent releases exploring their dual territory. Under their guidelines, for example, a wine-grape syndicate of 100 or fewer beneficial owners would be within the jurisdiction of the Real Estate Commissioner if it owned agricultural land and derived its income “solely from the cultivation, harvesting and marketing of agricultural products produced on the land...” California Dep’t of Corporations, Release No. 32-C (June 27, 1973), in 1 BLUE SKY L. REP. 8682 (1973). If, however, the syndicate proposed to crush its grapes before selling them to a winemaker, it would be subject to qualification with the Department of Corporations since its activities would now include “conversion or processing of the products into a different form.” Id. Similarly, a syndicate qualified with the Department of Real Estate could own and operate an apartment complex or an office building, but not a hotel, a convalescent hospital, or an amusement park. Id.

53. 1 MARSH & Volk, supra note 7, at xiii.


57. This disparity has been attributed to “the greater need for investor sophistication and financial stability in connection with the larger public limited partnerships which come under the jurisdiction of the Department of Corporations.” 1 MARSH & Volk, supra note 7, § 31.06[1]. It is difficult to see, however, why an investment of $5,000 in a small syndicate is less risky than an investment of the same amount in a large program. Indeed, just the opposite argument could be made, since a larger total investment would allow greater diversification of program properties and heightened program management. (Taking the same percentage of the total investment as a management fee would yield a larger sum for program management; at some point, presumably, economies of scale would make possible more effective management for each dollar
In fact, the major consequence of the Real Estate Syndicate Act has been the creation of a rather awkward dual jurisdiction over these types of securities.58 And even this may be of little ultimate consequence, for only a small number of real estate programs utilize the Real Estate Commissioner's jurisdiction.69 Thus the Department of Corporations actually regulates the overwhelming majority of California real estate syndicates.60

spent.) Thus this explanation is not particularly satisfying. It seems more likely that the slightly lower standards of the Department of Real Estate should be attributed to a difference in attitude between the two agencies, with the Real Estate Commissioner imposing standards indicative of his greater faith in the viability of real estate investment.

58. By regulation, the Real Estate Commissioner has exempted "real estate syndicates qualified under the California Corporate Securities Law of 1968" from his jurisdiction. 10 Cal. Admin. Code § 2990.5 (1971). There are a number of securities exempted in the act itself, CAL. BUS. & PROF. CODE § 10260 (West Supp. 1974), but interests qualified with the Commissioner of Corporations are not among them. The Corporate Securities Law exempts from its qualification requirements a security whose issuance is "subject to authorization by . . . the Real Estate Commissioner." CAL. CORP. CODE § 25100(e) (West Supp. 1974). This nonparity of language creates jurisdictional problems for syndicates which could conceivably exceed the 100-investor mark, since qualification with the Real Estate Commissioner affords no protection to a syndicate which subsequently loses the characteristics of an organization that is "subject to [his] authorization." Thus, a syndicate sponsor who has any doubts about the ultimate size of the investor group may well decide to qualify with the Commissioner of Corporations just to be on the safe side. CHEATHAM & MANWELL, supra note 42, at 66-67, 71.

The second jurisdictional problem stems from the "real property only" limitation of the Real Estate Syndicate Act. See note 52 supra and accompanying text.

59. The number of permit applications filed with the Department of Real Estate has declined steadily.

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<tr>
<th>Year</th>
<th>Applications</th>
<th>Permits</th>
<th>Dollar Amount</th>
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<tbody>
<tr>
<td>1970</td>
<td>166</td>
<td>96</td>
<td>$32 million</td>
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<tr>
<td>1971</td>
<td>103</td>
<td>97</td>
<td>24 million</td>
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<tr>
<td>1972</td>
<td>79</td>
<td>61</td>
<td>20 million</td>
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<tr>
<td>1973</td>
<td>48</td>
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<td>14 million</td>
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<tr>
<td>1974</td>
<td>28</td>
<td>12</td>
<td>3.5 million</td>
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Thomas classroom presentation, supra note 28 (1970-1973 figures); telephone interview with W. Jerome Thomas, Chief Legal Officer, California Department of Real Estate, April 1, 1975 (1974 figures). Thomas attributes the decline in syndication offerings filed with the Department of Real Estate to the economic downturn as well as to what might be termed the coming-of-age of real estate syndication. When the Real Estate Syndicate Act was first passed, many real estate licensees who had not previously entered the securities market decided to give syndication a try. Those who were unsuccessful, or who found syndication less profitable than they had anticipated, are no longer filing permit applications; those who were successful are now putting together larger syndications that must be qualified with the Department of Corporations. Thomas telephone interview, supra.

60. Real estate program securities offered in nonpublic transactions are specifically exempted from the jurisdiction of the Real Estate Commissioner. CAL. BUS. & PROF. CODE § 10261 (West Supp. 1974). Although cast in terms of a transaction exemption, section 10261 must be read as a securities exemption since the exemption is "from the provisions of this chapter," i.e., the entire Real Estate Syndicate Act, rather than just the qualification requirements. Id. For a definition of a nonpublic offering, see 10 Cal. Admin. Code § 260.102.2 (1973).
C. The 1973 Rules of the Commissioner of Corporations

In mid-1973, the Commissioner of Corporations announced new rules for real estate programs in the form of limited partnerships. The 1969 rules occupied three pages of California's Administrative Code; the 1973 rules took up 28 pages—an indication of the degree to which the industry had grown in terms of size and sophistication. While the 1969 rules contained only one brief paragraph on investor suitability, the new rules devote five sections and almost two pages to the subject.

Three reasons for the imposition of suitability standards are advanced in the first section: the limited transferability, the relative lack of liquidity, and the specific tax orientation of many real estate programs. In light of these characteristics, sponsors are required to set forth in the prospectus both the investment objectives of the program and a description of the type of person who could benefit from it. Suitability standards are to be proposed by the sponsor and reviewed for fairness by the Commissioner. Such factors as high leverage, substantial prepaid interest, balloon payment financing, excessive investments in unimproved land, and uncertain cash flow may result in more restrictive suitability standards. Programs involving more than ordinary investor risk should be sold only to persons with substantial net worth. Programs with strong "soft dollar" orientation—those structured to give deductible tax losses of 50 percent or more of the limited partner's capital contribution in the year of investment—should be sold to persons in higher income tax brackets, considering both state and federal taxes.

The second section, entitled "Sales to Appropriate Persons," requires:

The sponsor and each person selling program interests on behalf of the sponsor or program shall make every reasonable effort to assure that those persons being offered or sold the program interests

62. The rules have been amended several times since their original promulgation, but the suitability sections have not been changed. The most significant additions were disclosure requirements for track records and projections. 10 Cal. Admin. Code §§ 260.140.117.3(k), 260.140.117.4 (1974).
64. 10 Cal. Admin. Code § 260.140.112.1 (1974). It could be argued that the first two reasons are really one. See text accompanying note 83 infra.
65. Id.
66. Id.
67. Id. This section is said to liberalize the guidelines by taking into account the impact of state income taxation, since under the prior unwritten rules only the federal income tax bracket could be used in determining investor suitability for tax-oriented offerings. 1 MARSH & VOLK, supra note 7, § 31.06(2)(b).
are appropriate in light of the suitability standards set forth above and [sic] are appropriate to the customers' investment objectives and financial situations.\(^{68}\)

In order to determine that the investor can reasonably benefit from the program, the sponsor must ascertain that the investor has the capacity of understanding the financial aspects of the program and that he or she has apparent understanding of: (1) the fundamental risks and possible financial hazards of the investment, (2) its illiquidity, (3) its tax consequences, and (4) the fact that the investment will be directed and managed by the sponsor.\(^{68}\)

Despite the unfortunate drafting, this

\(^{68}\) 10 Cal. Admin. Code § 260.140.112.2 (1973). This section as promulgated contains a drafting error. The first "appropriate" presumably refers to the persons being offered the program interests, while the second "appropriate" must refer to the program interests themselves. Thus, the section could be corrected to read:

The sponsor and each person selling program interests on behalf of the sponsor or program shall make every reasonable effort to assure that those persons being offered or sold the program interests are appropriate investors in light of the required suitability standards set forth above and that the program interests being offered or sold are appropriate to the customers' investment objectives and financial situations.

\(^{69}\) Id. That the investor has the capacity to understand the program may be evidenced by consideration of four factors: the nature of the investor's employment experience; the investor's educational level; the investor's access to advice from qualified sources (attorney, accountant, or tax adviser); and the investor's prior experience with similar investments. \(^{\text{Id.}}\)

The importance of the sophistication element cannot be overemphasized, especially in real estate syndication, where complexity abounds. Few courts have grappled with this aspect of the suitability doctrine, perhaps because it is even more difficult to determine many investors' understanding of a proposed investment than it is their financial suitability for the investment. In what may well be the longest investor suitability decision to date, a California court of appeal contented itself with one brief paragraph on the plaintiff's ability to understand her securities transactions:

 Plaintiff acknowledged that she understood that there was a risk, that she knew securities could go down as well as up, and that she understood that defendants were not going to make good her losses, or guarantee her a profit. This, however, is not to say that she was competent to evaluate the extent of the risk she was taking or the propriety of one of her financial condition so doing. The fact that she had inherited money, that she had prior transactions with other brokers, and that she had improvidently invested in one speculative security on her own initiative might justify a finding of knowledgeableness and lack of reliance, but they do not compel that result when taken with her other testimony.

The receipt of confirmation slips and accounts, and her ability to chart the cost and prices of her securities are facts of the same tenor. They may permit, but they do not compel, findings that plaintiff knew she was engaged in a course of trading and purchasing securities of a type that were unsuitable for one of her financial situation and needs.

Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 722, 69 Cal. Rptr. 222, 244 (1st Dist. 1968). But cf. Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 429 (N.D. Cal. 1968), aff'd as modified, 430 F.2d 1202 (9th Cir. 1970) ("plaintiff was neither as 'dumb' in matters of brokerage accounts . . . as [she] made herself appear to be on the stand, nor was she as smart, experienced, or informed as defendants' counsel would make her out to be," but her knowledge was sufficient to put her on notice, so suitability claim barred by estoppel, laches, and waiver).

Although the California rules devote an entire subsection to investor sophistication, 10 Cal. Admin. Code § 260.140.112.2(b) (1973), reproduced at note 195 infra, it may
section is, in effect, a "know your customer" rule. It encompasses the twofold rationale behind the imposition of investor suitability standards: first, that the potential investor must be sophisticated—or at least patient—enough to understand what he or she proposes to invest in, and second, that the investment must be suitable for the investor in light of his or her own investment objectives, financial condition, and needs.

The third section requires a sponsor to maintain, for at least four years, a record of information obtained to demonstrate that the investors meet the suitability standards employed in the particular offering. To obtain the information, the sponsor may use a form, signed by the participant, setting forth the prescribed suitability standards and containing a representation by the participant that he or she meets the standards. When the offering is underwritten or sold by a broker-dealer, the sponsor must obtain a commitment from the broker-dealer to maintain the same records required of the sponsor. This section seems to emphasize the sponsor's responsibility for assuring that the proposed investors meet the suitability standards imposed, but it arguably allows the sponsor to rely on the representations made by the investor in a suitability letter.

The fourth section requires a minimum initial cash investment of $2,000, and limits subsequent transfers, with certain exceptions, to no less than an amount equivalent to an initial minimum purchase. In be that the subject does not receive adequate attention. Since the analysis of this Comment is primarily directed at the presumptive suitability standard, which deals exclusively with economic suitability, the element of investor sophistication is not discussed at any great length.

70. Compare Rule 405 of the New York Stock Exchange, commonly referred to as the "know your customer" rule, which provides in part:

Every member organization is required . . . to

(1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization . . . .

(2) Supervise diligently all accounts handled by registered representatives of the organization.


74. For further discussion of whether the presumptive suitability standard allows the sponsor or selling representative to shift the burden of determining suitability to the investor, see text accompanying notes 191-203 infra.

75. 10 Cal. Admin. Code § 260.140.112.4 (1973). Transfers by gift or inheri-
a law review article published shortly after the new rules were announced, then-Commissioner Brian R. Van Camp described the minimum investment requirement as a "belt and suspenders" kind of precaution. While it may be argued, he wrote, "that such a requirement only forces the investor to lose more than he can afford, one response is that if an investor is going to spend this kind of money, perhaps he will take every precaution to investigate the program's soundness.

The final section of the new rules sets out the presumptive suitability standards. Unless the Commissioner approves a lower standard, participants are required to have a minimum annual gross income of $20,000 and a net worth of $20,000 or, in the alternative, a minimum net worth of $75,000. In either case, net worth is to be determined exclusive of home, home furnishings, and automobiles, but the fair market value of assets included in the computation may be used. In "high risk" offerings, or offerings that are "principally tax oriented," higher suitability standards may be required. For sales to fiduciary accounts, the standards are to be met by the fiduciary or by the fiduciary account or by a donor who supplies the funds to purchase the interest in the program.

76. Van Camp, supra note 41, at 409. Another reason for requiring a substantial minimum investment was suggested during a panel discussion on private offerings of real estate program securities. Stephen Weiss, an experienced securities practitioner, termed the minimum investment "[a]n automatic weeding-out process, which leads you to the wealthy, sophisticated investors . . . ." Panel discussion, Loughran Institute of Georgetown University Law Center, Sept. 21, 1973, in 2 SEC. REG. L.J. 48, 63 (1974).

77. Van Camp, supra note 41, at 409. It might also be argued that requiring a minimum investment of several thousand dollars comports with the notion that a limited partner should have a more substantial stake in the venture than an ordinary corporate shareholder. Moreover, sponsors may find the requirement desirable because of the expense involved in keeping partnership tax records.

78. 10 Cal. Admin. Code § 260.140.112.1 (1973). That section in its entirety, presently provides:

Unless the Commissioner approves a lower suitability standard, participants shall have a minimum annual gross income of $20,000 and a net worth of $20,000, or, in the alternative, a minimum net worth of $75,000. Net worth shall be determined exclusive of home, furnishings and automobiles. Under this section, the assets included in the computation of net worth may be valued at their fair market value. In high risk or principally tax oriented offerings, higher suitability standards may be required. In the case of sales to fiduciary accounts, the suitability standards shall be met by the fiduciary or by the fiduciary account or by a donor who directly or indirectly supplies the funds to purchase the interest in the program.

79. Id. In practice, however, higher standards are seldom required. See note 187 infra and accompanying text.

80. Id. For a suggested modification of this requirement, see note 239 infra and accompanying text.
D. Comparison with Other Suitability Standards

The California rules are similar in most respects to the Statement of Policy Regarding Real Estate Programs adopted by the Midwest Securities Commissioners Association on February 28, 1973.81 The Midwest guidelines are more stringent than the California rules in two respects. First, the sponsor's record-keeping obligation is not limited to four years, as it is under the California rules.82 Second, a $2,500 minimum investment in "low risk" offerings and a $5,000 minimum investment in "high risk or principally tax oriented" offerings is required;83 the California rules impose an across-the-board minimum investment of $2,000.84

The California rules and the Midwest statement of policy are the most comprehensive attempts to provide substantive rules governing offering of limited partnership interests in real estate syndications. Other regulatory bodies, however, are not far behind. In 1972, the NASD's Board of Governors released for comment detailed proposals for regulation of all "tax sheltered programs," including real estate syndications.85 Although the California rules are claimed to be "consistent in approach and requirement" with the NASD standards,86 subparagraph 5(b) of the original NASD proposal would have required a potential investor to have income taxed in the 50 percent federal tax bracket and a net worth of at least $50,000.87 In addition, the 1972 proposal required that the investor's net worth must bear a reasonable relationship (normally 10:1) to his or her aggregate tax shelter investments.88 This approach recognized that:

[T]he need for substantial net worth is a highly significant test of

81. 1 BLUE SKY L. REP. ¶ 4821 (1974).
83. 1 BLUE SKY L. REP. ¶ 4821 at 637 (1974).
85. NASD, Tax Sheltered Programs: Proposed Article III, Section 33 of Rules of Fair Practice 56-57 (May 9, 1972). These proposals were modified in 1973. See text accompanying notes 90-92 infra.
86. Van Camp, supra note 41, at 406.
87. NASD, Tax Sheltered Programs: Proposed Article III, Section 33 of Rules of Fair Practice 56 (May 9, 1972). The NASD proposals, however, would have allowed a member to determine that a prospective investor who did not meet the standards was nevertheless suitable:
In any instance in which a determination of suitability is made without the provisions of paragraph (b) hereof being entirely satisfied:
(1) the burden of proving justification for the determination shall be upon the person making it, and
(2) the person who makes such a determination shall document in writing the basis therefor with particular reference to its departure from the standards specified in subparagraph (b) and retain such documentation in the files of the member.
88. Id. at 21, 56.
suitability which is not adequately covered by the California . . . standards. A $5,000 minimum investment only insures that the investor has $5,000, not that he can afford to lose it (even if he is in the 50% tax bracket). Likewise, even the customary $50,000 minimum net worth test does not prevent an investor whose total net worth is $50,000 from investing $25,000 in a tax shelter which would be a highly speculative risk of half of his financial resources.89

It also recognized that the investor’s total commitment to tax shelter investments is relevant to determining suitability for a particular investment.

After a round of comments from securities regulators, practitioners, and “certain national trade organizations,” the NASD announced modifications of its suitability proposals in mid-1973.90 The earlier specific standards were replaced by requirements that the prospective investor in a real estate program have “a fair market net worth sufficient to sustain the risk inherent in the program”91 and “after giving effect to all of his tax sheltered investments, [be] reasonably anticipated to be in a tax bracket appropriate to enable him to obtain the tax benefit described in the prospectus . . . .”92

In 1974, however, the SEC’s Division of Market Regulation dashed cold water on the NASD proposals. It notified the NASD by letter that the Commission deemed it inappropriate, “at this time, that the Association should attempt to provide a regulatory structure which impacts . . . directly on issuers, sponsors and others which are not members of the [NASD].”93 With respect to the proposed investor suitability standards, the letter continued:

It may be possible for the Association to develop general guidelines as to suitability based on the rules included in the proposal . . . . With such general guidelines members will indeed have better tools with which to fulfill current obligations to ensure that suitable investments are recommended to customers.94

Recognizing that general guidelines—instead of the planned prohibi-

89. Mosburg, supra note 49, at 231.
91. Id. § 5(b)(3).
92. Id. § 5(b)(2).
94. SEC letter, supra note 93. The “current obligations” of NASD members are set forth in article 3, section 2, of the NASD Rules of Fair Practice, reproduced at note 1 supra.
tion of participation by NASD members in offerings not meeting the proposed standards—could complicate the NASD's job of supervising compliance, the letter hinted at increased SEC involvement in regulation of tax sheltered programs, including real estate syndications. The matter has been in limbo ever since.

95. The SEC letter concluded:

Because of existing and potential abuses in connection with tax shelter programs, the Commission has directed its staff to continue to collect information with respect to abuses involving tax shelter programs and to formulate various proposals, including new rules or guidelines applicable to all packagers and promoters of tax shelter programs, enlarged enforcement programs, and suggestions for additional legislation, for the consideration of the Commission so that it will be in a position to determine how best to provide proper regulation. The Association has already been most helpful in the collection of information and the Commission hopes to continue to have the benefit of its assistance.

[The NASD's] work and that of various state officials and other interested persons who are concerned with the problems of tax shelter programs has been extremely valuable to the Commission. The Commission hopes that the suggestions in this letter will provide a means for the Association to implement the fruits of that work immediately and effectively so that we can make rapid progress toward improving protection of investors who buy tax shelter programs.

Id.

An SEC staff member stated in December, 1974, that the staff was drafting for submission to the Commission proposed legislation giving the Commission substantive regulatory power (beyond the authority to require full disclosure and prevent fraud) over "externalized management programs," including real estate syndications. Address by Allen Barstow, SEC Annual Conference on Securities Regulation, Dallas, Tex., Dec. 3, 1974, reported in Wertheimer, Special Problems of Unregistered Real Estate Securities, Dec. 1974, at 15 (paper prepared for presentation at the Second Annual University of California Securities Regulation Institute, San Diego, Cal., Jan. 8, 1975) (copy on file with the California Law Review) [hereinafter cited as Wertheimer].

If one wished to speculate on the form such legislation might take, the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80b-21 (1970), provides one model, and the SEC's proposed "Oil and Gas Investment Act of 1972," S. 3884, 92d Cong., 2d Sess. (1972), another. For the text of the bill and the comments of the SEC staff, see 118 CONG. REC. 26967-84 (1972). It would have regulated intrastate transactions as well as private offerings. Mosburg, supra note 49, at 225. See also Comment, Regulation of Real Estate Syndications: An Overview, 49 WASH. L. REV. 137, 179-90 (1973) (concluding that federal substantive regulation is needed, especially for non-specified property programs).

This Comment's primary focus is on state investor suitability rules, but its discussion of the California rules and its proposal for new suitability guidelines could be used by analogy in any efforts to provide for substantive regulation at the federal level.

96. Earlier, the SEC's Real Estate Advisory Committee had recommended that "[e]ach prospectus of real estate limited partnerships should disclose that unless the potential investor has a minimum income and is in a specified minimum federal income tax bracket, participation in the program is probably not economically viable for him." Dickey Report, supra note 11, at 68 (emphasis added); recommendations in summary form in [1973 Transfer Binder] CCH Fed. Sec. L. REP. ¶ 79,265 (1973).

Before announcing its specific recommendations, the Committee expressed its general conclusions, urging establishment of a permanent real estate advisory committee and suggesting "that the Commission encourage state regulators and securities associations, in the spirit of cooperation and unanimity, to abate implementation of their own proposals and join in the formation of the permanent advisory committee." Id. at 14, In
Other states are presently imposing slightly different presumptive suitability standards and minimum investment rules. Illinois, for example, requires a $2,500 minimum investment in real estate limited partnership programs for its residents. For a program structured to provide income, Illinois investors must have adjusted gross income, as defined in the Internal Revenue Code of 1954, subject to federal income tax at a rate of 36 percent or more, plus a net worth of at least $100,000. For tax sheltered programs, a net worth of $200,000 and income subject to federal income taxation at a rate of at least 50 percent is required.

Ohio, whose securities commissioner, like Illinois's, belongs to the Midwest Securities Commissioners Association, has prescribed another variant on the Midwest guidelines. For all non-specified property programs, investors must make a minimum initial cash purchase of...

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98. Id.

99. Id.

100. In these programs, also known as "blind pools," the sponsor sets forth in the offering document the criteria which will be used in acquiring properties once the investors' monies are in hand, but no binding arrangements to acquire particular properties are made before the offering begins. Blind pools are generally regarded as involving a higher degree of risk than specified programs, although a large non-specified property program can acquire a number of properties, thereby reducing risk by diversification. California also has rules applicable only to blind pools, 10 Cal. Admin. Code § 260.140.-115.1.-115.7 (1973), but no special suitability requirements.

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For "income-producing and non-developmental" non-specified property programs, investors must have $30,000 annual gross income and $30,000 net worth. For "high risk, developmental or principally tax motivated" non-specified property programs, investors must have a $50,000 net worth and income in at least the 50 percent federal income tax bracket.

Pennsylvania has promulgated special guidelines for non-specified property programs. For such programs that are structured to provide deductible tax losses of 50 percent or more of the investor's capital contribution in the year of investment, Pennsylvania residents must meet the highest minimum suitability standards presently being imposed: a net worth of at least $200,000, taxable income during the last tax year, some portion of which was subject to a federal income tax rate of 50 percent or more, and estimated earnings during the current tax year which will be similarly taxed. In the alternative, Pennsylvania residents may qualify if they had an annual gross income of at least $100,000 during the last tax year and an estimated income in the six-figure range for the current tax year. Where the non-specified property program is structured to provide participants with current income of at least six percent of capital contribution, investors must have a minimum net worth of $100,000 or an annual gross income of $25,000. For programs that do not fit either category, the sponsor must propose suitability standards for review by the commissioner.

As a further precaution, Pennsylvania requires that a participant's commitment to all non-specified property programs must bear a "reasonable relationship" to net worth or annual income. This requirement will be deemed violated, unless the commissioner otherwise permits, if an investor is allowed to purchase program interests in an

102. Id. Alternatively an investor whose net worth is $75,000 can also qualify for such programs. Id.
103. Id. Again, there is an alternative standard of $100,000 minimum net worth with no minimum tax bracket. Id.
106. Id.
107. Id. Again, Pennsylvania adds its unique requirement that the investor's estimated income for the current tax year must meet the same minimum standard of $25,000. Id.
108. Id.
109. Id.
Texas has taken yet another approach to investor suitability. In mid-1974, its Securities Board announced adoption of standards based on the Midwest guidelines. Texas regulators, however, promulgated their versions of only two of the five suitability sections found in the Midwest rules: the first section, requiring that sponsors establish suitability standards, and the fourth section, requiring a minimum initial investment. The minimum investment is higher than that required by either California or the Midwest guidelines.

In most offerings the minimum initial cash purchase shall be $5,000 per Participant, except (i) that in offerings of Programs whose principal plan of business is the acquisition and holding of property the cash flow of which is legally restricted to 6% or less of equity, the minimum initial cash purchase by each Participant shall be $10,000, and (ii) that in offerings of Programs under circumstances fully justified to the Commissioner, a minimum initial cash purchase by each Participant may be $2,500.

Some states, notably New Jersey and New York, have 1960's-vintage legislation regulating real estate syndication, but no investor suitability rules, while other states impose suitability standards of varying severity but apparently publish no formal written guidelines.
Although it is perhaps too early to say for certain, the trend seems to be toward increasing use of investor suitability standards, including pre-

factors and the relative lack of liquidity of securities of this proposed type of program as compared with other security investments that a minimum of $1,000 purchase (two $500 Units) is to be required. In addition, the investor must be of sufficient financial means to apprise himself of and assume the risks inherent in the purchase of Limited Partnership Units, including lack of liquidity of investment, and such investment is not unsuitable for him based upon his investment objectives, financial situation and needs. Moreover a substantial number of state securities commissioners have established investor suitability standards of a given minimum net worth dependent upon annual gross income (as defined in Section 62 of the Internal Revenue Code) for the marketing within their respective jurisdictions of securities of real estate programs. Some have also established minimum dollar levels for purchases in their states. In the case of the present offering the states of Illinois, Iowa, Kentucky, Maine, Michigan, Minnesota, North Dakota, South Carolina, Tennessee, Virginia, Wisconsin, and Wyoming have established five ($2,500) units of Limited Partnership interest as the minimum permitted purchase and the states of Arkansas, Florida, Kansas, Louisiana, Missouri, New Hampshire, New Mexico, North Carolina and South Dakota have established ten ($5,000) Units of Limited Partnership interest as the minimum permitted purchase. The State of California has established four ($2,000) Units of Limited Partnership interest as the minimum permitted purchase. No transfers will be permitted in such states of less than the minimum permitted purchase, nor may an investor transfer, fractionalize or subdivide Units so as to retain less than such minimum number of Units. The issuance of limited partnership interest described herein resulting from any offer and/or sale in the State of California will be subject to the following legend condition restricting transfer: It is unlawful to consummate a sale or transfer of a Unit, or any interest therein, or to receive any consideration therefor, without the prior written consent of the Commissioner of Corporations of the State of California, except as permitted in the Commissioner's Rules. In addition, the states of Arkansas, California, Illinois, Iowa, Kentucky, Maine, Michigan, Minnesota, Missouri, South Dakota, Tennessee, Virginia, Wisconsin, and Wyoming have imposed the requirement that no interest be sold to the respective residents of their state unless the investor represents in the Subscription Agreement (i) that he has net worth (exclusive of home, furnishings and automobiles) of at least $20,000 and an annual gross income of at least $20,000, or is purchasing in a fiduciary capacity for a person or entity having such net worth and such annual gross income; or (ii) he has a net worth (exclusive of home, furnishings and automobiles) of at least $75,000, or is purchasing in a fiduciary capacity for a person or entity having such net worth. In addition, the state of South Carolina has imposed the requirement that no interest be sold to the respective residents of its state unless the investor represents in the Subscription Agreement that (i) he has an adjusted gross income, as defined in the Internal Revenue Code of 1954, as amended, subject to Federal Income Tax at a rate of 36% or more; or (ii) he has a net worth of $100,000 (excluding home, furniture and automobile). Other states may impose similar standards. Sales of Units will be made in compliance with the applicable state requirements. Because of various risk factors and the relative lack of liquidity of securities of this proposed type of program, as compared with other securities investments, the selling broker-dealers will make reasonable inquiry to endeavor to ascertain that the investor is of sufficient financial means to apprise himself of and assume the risks inherent in the purchase of the Limited Partnership Units. Prospectus for MultiVest Real Estate Fund, Ltd., Series VII, Jan. 15, 1974, at 2, reprinted in 2 REAL ESTATE SECURITIES 662 (D. Augustine ed. 1974).

Perhaps to avoid this problem, some syndicators choose to restrict their sales to investors who meet suitability standards high enough to satisfy the rules of most if not all states in which the securities are offered. See Prospectus for Balcor Realty Investors Ltd.-74, Oct. 7, 1974 ($50,000 net worth and taxable income in 39 percent bracket or $100,000 net worth) (copy on file with the California Law Review).
sumptive standards, in real estate syndication,\textsuperscript{118} oil and gas drilling programs,\textsuperscript{119} and other related investment vehicles.\textsuperscript{120}

II

APPLICATION OF THE PRESUMPTIVE STANDARD

As can be inferred from the foregoing look at suitability standards established for real estate programs by different regulatory bodies, the variation among standards is probably limited only by the number of entities involved in their promulgation. It is nevertheless possible to discern a basic philosophy behind all of these standards—a philosophy which may justify the imposition of special suitability standards in real estate syndication because of factors unique to these investment vehicles. This section will first discuss the general rationale for all investor suitability standards. It will then explore the special considerations involved in utilizing them to regulate the sale of real estate programs. Against that background, the latter part of this section will examine the presumptive suitability standard presently imposed in California. It will demonstrate that application of that standard produces results which are inconsistent with the raison d'être for all suitability standards: to distinguish “suitable” from “unsuitable” investors.

A. The Philosophy Underlying Suitability Standards

There is a twofold rationale for requiring investor suitability standards in any securities transaction. First, an individual should understand the nature and risks of any investment he or she proposes to make. Deciding whether this understanding is present for any given investment necessarily involves an assessment of the individual's capacity to make investment decisions generally. Employment experience, education, prior investment experience, and access to expert advice have been used as indices for assessing this capacity.\textsuperscript{112} The more complicated the investment, the more sophistication—or at least time and patience—required to achieve the degree of understanding necessary,\textsuperscript{122} and the greater the danger that the investment decision will
be made not by the prospective investor but by the person touting the investment.\(^\text{123}\)

Second, the proposed investment should be suitable for the individual investor, in light of his or her own investment objectives, financial condition, and needs. A retired person should most likely seek maximum safe cash flow rather than long-term capital appreciation, while a younger person should probably regard capital growth and hedging against inflation as major investment goals. This suitability concept is more difficult to use in formulating a regulatory model, for it requires a viable legal definition of suitability. Courts which have had occasion to analyze suitability have almost invariably considered only one factor: the risk of loss involved in a particular investment.\(^\text{124}\) This one-factor analysis has been criticized as failing to take account of economic risk theory, which recognizes a number of variables.\(^\text{125}\) A patently unsuitable investment, however, is relatively easy for the law to recognize, as the cases involving the suitability concept illustrate.\(^\text{126}\) The more outrageous the investment appears, considering the individual's needs, financial circumstances, and the degree to which he or she relied on the salesperson's recommendation in making the investment, the more likely the court is to impose sanctions on the salesperson or the sponsor.

It could be argued, however, that these two premises are really one: \textit{The investor who fully understands what he or she is doing will make only suitable investments.} This statement may not be entirely respectable in terms of economic theory,\(^\text{127}\) but from a legal standpoint


124. See cases discussed in text accompanying notes 296-342, 380-92 infra.


126. The "boiler room" cases, which typically involved a broker using a long distance telephone line and high-pressure sales pitch to sell highly speculative securities to unknown persons, are illustrative. See, e.g., Gerald M. Greenberg, 40 S.E.C. 133 (1960); Best Securities, Inc., 39 S.E.C. 931 (1960). See also Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 69 Cal. Rptr. 222 (1st Dist. 1968); Philips & Co., 37 S.E.C. 66 (1956).

127. It seems, however, to be implicit in Cohen's analysis:

It is not proposed that the law absolutely prohibit a broker from selling a security which would raise portfolio risk above the risk threshold. If an
it may be justifiable for a number of reasons. First, the principle has sound legal analogies.\textsuperscript{128} Second, it obviates the need for a court to grapple with the suitability question except in cases involving investors for whom the judiciary feels special concern.\textsuperscript{129} Precisely this line of analysis has been adopted by the Securities and Exchange Commission in Rule 146 regarding private offerings.\textsuperscript{130} As initially proposed, the rule required that the issuer seeking exemption have reasonable grounds to believe that each offeree could bear the economic risk of the investment. Barraged by criticism, the SEC first considered deleting the controversial requirement, but it decided to compromise:

The approach originally proposed would not be consistent with the statutory exemption, its legislative history, and judicial decisions. Accordingly, we attempted to balance alternatives. If an offeree, by himself, has the ability to evaluate a private placement, if he can analyze a real estate program, there would be no additional condition that he be able to bear the economic risk of the investment. On the other hand, if the offeree utilizes a representative to satisfy the nature of offeree test, if he uses and relies on a tax advisor as his representative, for instance, then the offeree would have to be the type of person who could bear the economic risk of investment.\textsuperscript{131}
B. Special Factors in Real Estate Syndication

A number of reasons have been advanced for the development of suitability standards for investments in real estate limited partnership syndications. Typically emphasized are:

- the tax shelter aspects of the investment, including the possibility of tax liability, perhaps even beyond loss of the investment itself, resulting from depreciation recapture in the event of sale or other disposition of the partnership interest or the underlying investment property;
- the increased risk from an investment which is ordinarily highly leveraged;
- the inherent lack of liquidity of such an investment, resulting from the limited transferability of partnership interests (required to assure partnership taxation), the lack of a resale market for such interests, and the possible dire tax consequences upon transfer;
- the limited investor democracy rights of such an investment.\(^\text{132}\)

One practitioner has written that the California approach to investor suitability recognizes three “facts of life” concerning investment in oil and gas drilling programs and real estate syndications:

1. The investment is tax oriented: it will frequently prove unprofitable unless the investor is in a tax bracket where the tax benefits can be utilized to full advantage;

2. The investment is illiquid and risky: only an investor who has a substantial net worth can afford to take the risk of loss and of inability to liquidate in an emergency;

3. The risk and the tax orientation are interrelated: the investor's loss will be cushioned by the tax considerations if the investment proves unsuccessful.\(^\text{133}\)

It is apparent that tax orientation, liquidity, and risk will vary from one syndication to another—depending, inter alia, on the structure of the deal, the type and quality of property or properties to be purchased,

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\(^{133}\) Mosburg, *supra* note 49, at 230-31. The SEC's Real Estate Advisory Committee added the following risk factors to its discussion of limited partnership securities: possible changes in the federal tax laws or regulations or interpretations thereunder; the investor's inability to stay in a certain tax bracket; development or construction cost overruns; operation losses caused by delayed rent up or subsequent vacancy factors; financial capabilities of users (particularly in government subsidized housing projects); specialized management problems; rise in operating expenses; limited partners' inability to participate in management decisions; partnership status for tax purposes ceases under certain events; transferability limitations; and tax consequences in the event of foreclosure or other disposition.

*Dickey Report*, *supra* note 11, at 11.
the size and diversity of the investment portfolio, and the expertise and philosophy of the sponsor. As a starting point in exploring these variations, it may be convenient to divide real estate programs into two categories.\textsuperscript{134} The first category comprises syndications which could not be sold if it were not for their tax shelter advantages, such as investments in limited partnerships owning government-assisted low- and moderate-income housing projects.\textsuperscript{135} Since there is little or no current cash flow and small hope of economic recovery on disposition, this type of investment is appropriate only for persons in high tax brackets who can utilize the large deductions to shelter other income from taxation.\textsuperscript{136} The second category comprises syndications in which tax considerations are only one factor—albeit often an important one—in the investment decision. These programs may, in fact, shelter a portion of the investor's income, but they have investment merit independent of the possibility of tax shelter.

Within this latter category, the possible variations of real estate limited partnerships are virtually limitless. Investment objectives can include cash flow, tax shelter, capital appreciation, and inflation hedge—either singly or in combinations. Risk posture can also vary, depending upon such factors as degree of leverage and the type of property chosen by the partnership. For example, possible construction cost overruns and rent-up difficulties will add to the risk of buying properties in the development or predevelopment stage. Moreover, the partnership may invest in a single property or it may hold multiple properties. The properties may be specified at the time of the offering, or the syndicate may be formed to invest in non-specified properties that meet the criteria set forth in the offering document.\textsuperscript{137} In single-property syndicates the investor may have a better opportunity to select an investment that closely matches his or her specific objectives, since with only one property involved it is easier for the sponsor to structure the investment to emphasize cash flow, tax shelter, or some other goal. On the other hand, multiple-property syndications offer diversification of risk, reducing the chance of loss, as well as opportunities for economies of scale. The partnership may hold only one type of property (for example, luxury "adult only" apartment buildings) in a number of states or locations within a state, or it may purchase sev-

\textsuperscript{134} The Dickey Report also utilized this approach. \textit{Dickey Report}, \textit{supra} note 11, at 8.

\textsuperscript{135} For a brief description of these programs, see Calkins & Updegraft, \textit{Tax Shelters}, 26 \textit{Tax Law.} 493, 508-10 (1973).

\textsuperscript{136} \textit{See id.} at 494, 509. The Calkins and Updegraft article is an excellent primer on tax sheltering.

\textsuperscript{137} \textit{See note 100 supra.}
eral different types of property—ranging from hotels, apartments, mobile home parks, and resort developments to office buildings, industrial parks, shopping centers, and medical complexes.138

The foregoing few paragraphs have briefly illustrated the almost endless variety of real estate limited partnership structures and orientations. These variations suggest that it may be inappropriate for securities regulators to treat all real estate limited partnerships alike. These entities, however, all share certain inherent characteristics that may justify special regulatory treatment. Almost all of these “problem” characteristics stem from tensions created by the complexities and inconsistencies of our federal income tax laws.139 On the one hand, the tax law “giveth” by recognizing a form of business organization that allows partners with limited liability to recognize partnership losses on their individual returns.140 Furthermore, it has sought to encourage certain investments, such as residential real estate, by giving them more attractive tax treatment than is accorded other investments.141 On the other hand, the tax law “taketh away,” making valiant if not altogether logical efforts to halt abuses and stem the tide of lost tax revenues.142 The real estate limited partnership thus faces special problems not experienced by typical corporate investment vehicles, and many securities regulators have determined to give separate treatment to real estate syndications.143

141. Compare id. §§ 167(j)(2), 167(j)(5), 167(k) with id. § 167(j)(1).
142. See Rev. Rul. 74-320, 1974 INT. REV. BULL. No. 27, at 29 (IRS attack on limited partnerships organized under California law); Rev. Rul. 74-40, 1974-1 CUM. BULL. 159 (tax consequences to limited partner on sale or exchange of partnership interest); Rev. Proc. 74-17, 1974-1 CUM. BULL. 438 (conditions for advance ruling on tax status as partnership); Rev. Proc. 72-13, 1972-1 CUM. BULL. 735 (same). See also Corman, The Use and Misuse of Tax Shelters: The Congress and Tax Reform, 49 NOTRE DAME LAW. 509 (1974); McDaniel, Tax Reform and the Revenue Act of 1971: Lesions, Laguipness and Lessons, 14 B.C. IND. & COM. L. REV. 813 (1973).
143. The propriety of grouping together for regulatory purposes all investment vehicles with common tax characteristics could itself be argued, but the practice is so firmly accepted by regulators that the argument would undoubtedly be unsuccessful.
Since this approach has been firmly adopted in California, it must next be asked if the Commissioner's imposition of investor suitability standards, including the presumptive standard, is appropriate regulatory treatment, and then if the standards presently imposed are consistent with the reasoning that led to their development.

C. Rationale for the Presumptive Standard

California's presumptive suitability standard sets up an absolute bar to investment in real estate limited partnerships by persons who do not meet the minimum standards of annual income and net worth, regardless of their level of understanding. In this way it supposedly applies the general rationale underlying all suitability standards to the more specialized context of real estate syndication. The presumptive standard does not deny the validity of assuming that a sophisticated investor will make only suitable investments; rather, it raises a conclusive presumption that an investor who does not meet minimum financial standards could not possibly be sophisticated enough to understand a complicated real estate offering.\(^{144}\) This analysis requires aligning sophistication and ability to bear economic risk on a single scale, an uneasy alignment because of the imperfect correspondence between the two qualities.\(^ {145}\) Doctors, for example, are popularly regarded as wealthy but notoriously naive about their investments; the same notoriety extends to widows who have inherited large sums of money from their deceased husbands.\(^ {146}\)

Even granting the general practice, however, a failure to distinguish between real estate syndications with divergent characteristics, such as programs with a "tax shelter only" orientation and those with additional economic advantages, seems indefensible. Although the present California standard leaves some room for such distinctions, see 10 Cal. Admin. Code § 260.140.112.1 (1974), they are in fact rarely made. See text accompanying notes 186-88 infra. This problem is discussed in connection with the revised suitability standard proposed in this Comment. See text accompanying notes 245-47 infra.

144. One securities regulator said that he would prefer a suitability standard which required $20,000 annual income of the principal wage earner, because he felt that a family whose head brought in $20,000 was more likely to have the hoped-for investor sophistication than a family comprising two persons whose combined incomes totaled $20,000. Broady interview, supra note 28.

145. The investor suitability rules now in effect recognize this imperfect correspondence, but only after the minimum income and net worth standards have been met. The "Sales to Appropriate Persons" section of the rules, 10 Cal. Admin. Code § 260.140-112.2 (1974), which requires the sponsor to ascertain that the prospective investor understands certain aspects of the program, would presumably preclude a sale to an economically "suitable" person who lacked the capability of understanding the nature of the proposed investment and did not have access to expert advice. See notes 57-59 supra and accompanying text.

146. As a court wrote of one such woman, who had turned her portfolio worth more than $200,000 over to the defendants: "To adequately describe plaintiff's lack of sophistication in financial matters would be a herculean task." Stevens v. Abbott, Proctor & Paine, 288 F. Supp. 836 (E.D. Va. 1968) (liability for excessive trading).
The presumptive standard, however, can also be viewed as an attempt to give content to the "fair, just, and equitable" standard against which all California securities offerings must be judged. An extremely speculative offering, of highly dubious or nonexistent economic merit, would be considered unsuitable for even the most wealthy and sophisticated investor, and it would thus be deemed "unfair, unjust, and inequitable" and denied qualification in California. On the other hand, a conservative offering involving little risk of loss would be considered "fair, just, and equitable"—that is, in a sense, suitable—for any potential investor, and such an offering would receive open qualification in California, authorizing its offer and sale to members of the general public. Falling between these two poles are securities that would have to be regarded as suitable for some but not all investors.

For such securities, the Commissioner has adopted two analogous regulatory alternatives. The "limited offering qualification," authorizing the offer and sale of securities only to persons designated by name or class, is normally required

147. Cal. Corp. Code § 25140 (West Supp. 1974). From this standpoint, presumptive suitability standards are analytically more appropriate in a substantive regulatory system, such as California's, than they are in a regulatory scheme that relies on full disclosure.

148. It is perhaps worth noting, however, that California investors were not denied the opportunity to participate in the two biggest securities frauds of recent vintage: the Equity Funding scandal and the Home-Stake oil-drilling Ponzi scheme. The former was exempted from the California qualification requirements both because it was an insurance security subject to authorization by the Insurance Commissioner, Cal. Corp. Code § 25100(d) (West Supp. 1974), and because it was listed on a national securities exchange, id. § 25100(o). The latter was apparently improperly relying on the exemption for nonpublic limited partnership interests, id. § 25003(f).

This is not to say that substantive securities regulation is ineffectual. See Jennings, The Role of the States in Corporate Regulation and Investor Protection, 23 Law & Contemp. Prob. 193 (1958), especially Professor Jennings' description of the Tucker automobile case, id. at 211 & n.110.

149. This legal analysis of economic risk focuses almost exclusively on risk of loss, ignoring other factors such as portfolio diversification and projected return. For criticism of the legal approach, see authorities cited in note 125 supra.


The Commissioner of Corporations has emphasized that investor suitability is not to be forgotten when sale of securities is authorized pursuant to an open qualification. Of course, even though distribution of a particular security is authorized by an open qualification, the suitability of the securities to the needs of a particular purchaser still is a matter of concern to the broker-dealer, agent, or investment adviser, who renders professional assistance to the purchaser.


152. One common class is management-level employees of the issuer's business.
if the business in which the issuer is engaged is not anticipated to produce profits within a reasonable period of time, or if the business operations depend upon the development of a product or system which will not be completed prior to the commencement of the offering, or if preliminary objectives[,] upon which the profit-making business of the business depends, have not been achieved.\textsuperscript{153}

The second alternative, of course, is the presumptive suitability standard. So far utilized primarily in the regulation of limited partnership investment vehicles such as real estate syndications and oil and gas drilling programs,\textsuperscript{154} as well as certain mutual funds,\textsuperscript{155} it serves the same investor-protection purpose as the limited offering qualification. The latter, however, is used when the particular business venture itself is unusually speculative,\textsuperscript{156} while presumptive suitability standards have been developed in areas where the entire class of business ventures has inherent characteristics\textsuperscript{157} that can be viewed as making investment suitable for only a limited group of persons.\textsuperscript{158}

\textbf{D. \textit{The Presumptive Standard at Work}}

It is now necessary to view the operation of the presumptive standard, the means chosen in California to eliminate the "unsuitable" class of investors from participation in real estate programs. Will eliminating those potential investors whose financial condition does not meet the minimum income and net worth profile assure that only economically suitable persons will be able to invest?\textsuperscript{159} Or, to put the question more narrowly, will the presumptive standard ensure that only economically \textit{unsuitable} investors will be eliminated from consideration?

As has been seen, the presumptive standard arbitrarily draws a line between persons who meet the requisite financial profile and those who do not. The standard—presumably for the sake of adminis-

\textsuperscript{153} 10 Cal. Admin. Code § 260.140.05 (1973).
\textsuperscript{154} Id. § 260.140.123 (1974).
\textsuperscript{155} Id. § 260.140.85(b) (1971).
\textsuperscript{156} See text accompanying note 153 supra.
\textsuperscript{157} See text accompanying notes 132-33, 139-43 supra.
\textsuperscript{158} There is some recognition by securities regulators that risk will vary within the class: "In some high-risk syndicate offerings, high investor standards may be the feature of the offering that will cause the Department to issue a permit that would otherwise not have been issued . . . ." Thomas, \textit{A Regulator Looks at "Fair, Just and Equitable,"} in \textit{REAL ESTATE VENTURE ANALYSIS} 29, 35 (S. Roulac ed. 1972). While such recognition may exist in the Department of Corporations, it seldom takes the form of higher suitability standards. See text accompanying notes 186-88 infra.
\textsuperscript{159} This, of course, is too broad a question, although it follows naturally from the name "presumptive \textit{suitability} standard." The purpose of the presumptive standard is \textit{not} to select "suitable" investors; that function is assigned to the "Sales to Appropriate Persons" section, 10 Cal. Admin. Code § 260.140.112.2 (1974), discussed in text accompanying notes 57-59 supra. Rather, the presumptive standard is designed only to eliminate investors who are presumed "unsuitable" for investment in real estate programs.
trative ease—looks only at two figures, gross annual income and "net" net worth, which may or may not be the most significant indicia of economic suitability for any particular investor. It entirely ignores many other factors that might be relevant to the suitability determination. The result is a crude but conclusive presumption of unsuitability for those who do not meet the standard—as well as an equally crude and often irrebuttable presumption of suitability for those investors who do. In the process two undesirable outcomes are inevitable: some truly suitable investors will be prevented from investing, and some truly unsuitable investors will meet the standard and be allowed to purchase real estate program securities. Perhaps the best way to reveal the weaknesses of the presumptive standard is to examine a group of hypothetical investors, some meeting and others failing the presumptive test as presently imposed.

Consider first the case of Arthur, 28 years old and already a confirmed bachelor. Only a few years out of business school, Arthur is already making well above the $20,000 minimum income requirement, and his earning potential for the future appears bright. His net worth, however, has not yet reached the $20,000 mark. Because of his doubts about the stock market and his desire to establish himself in the lifestyle he fancies, Arthur has concentrated his investment dollars in two areas. He is purchasing as his residence an expensive condominium unit and furnishing it with antiques and oriental rugs, which he considers a sound investment, and he has indulged himself in an extravagant automobile, which he justifies because much of the cost is deductible as a business expense. Arthur is now seeking a long-term investment which will give him additional tax shelter as well as possible capital appreciation.

Barbara, a 53-year-old widow with grown children, inherited a modest portfolio of stocks and bonds from her late husband. Its present market value is approximately $60,000. Although she attended college and now has a responsible job, her annual income, including

160. One regulator explained the two-factor test this way:

It is not unreasonable to assume that persons with high income and high net worth can afford the loss that is a distinct possibility in a highly speculative venture. Moreover, the same persons are better able to afford—and therefore more likely to seek out—indeed independent legal and financial advice about the syndication.

Thomas, supra note 158, at 35.

161. It is a thesis of this Comment that the presumptive standard inevitably tends to perform both the job of eliminating "unsuitable" investors and the job of selecting "suitable" investors. See text accompanying notes 191-203 infra.

162. "Net" net worth, that is. See text accompanying note 42 supra.

163. The rules would appear to allow the investor to compute net worth using either fair market value or cost basis. 10 Cal. Admin. Code § 260.140.112.5 (1973).
the yield from her investment portfolio, is slightly less than $20,000. She is interested in a comparatively conservative real estate program oriented not toward tax shelter but toward capital appreciation upon termination of the limited partnership—an event contemplated to occur after Barbara's planned retirement at age 60. She has no need for additional income or liquidity now, and she views her proposed real estate investment as an effective hedge against the inflation she fears will take place between now and her retirement.

Carolyn and David are in their 30's and have three children. This year David will earn $25,000 as an aeronautical engineer, but in recent years he has experienced several periods of unemployment during which the family's income dropped dramatically. In addition to their heavily mortgaged suburban home and two automobiles, they have a modest bank account, a few shares of stock, and a valuable diamond necklace that Carolyn inherited from her grandmother. Although it is now worth more than $25,000, Carolyn considers it a family heirloom which she would never sell. Carolyn and David recently attended an investment seminar presented by a local real estate firm. They were very impressed with the sales pitch made at the seminar and came away convinced that one of the firm's limited partnership offerings was the ideal investment for them.

Edward, a 42-year-old sales representative, was recently divorced for the second time. His earnings record has been erratic, depending in part on personal problems and in part on the market for whatever product he happens to be selling, but this year he expects to make almost $30,000. A considerable chunk of his income, however, goes for alimony and child support, and he has recently agreed to pay his daughter's expenses at a private Eastern college. Marital property settlements and periods of reduced income in the past have kept him from building his net worth. Last year, however, on the advice of a stockbroker friend, Edward invested his entire year-end bonus in speculative mining stocks and, after an unprecedented market advance of these securities, his portfolio now has a value of $35,000. His stockbroker friend has recently recommended investment in a real estate syndicate organized to develop shopping centers.

Frances is vice president of a family-held manufacturing business. Her husband, George, is sales manager of the firm. They are in their

164. In 1971, the average woman earned only 59.5 percent of what her male counterpart earned. COUNCIL OF ECONOMIC ADVISORS, ECONOMIC REPORT OF THE PRESIDENT 104 (1973).

165. "[P]rograms are sold, not bought, and ... the success of the offering from a marketing standpoint is more greatly affected by the effectiveness of the sales effort than by the excellency of the program ... ." Mosburg, supra note 49, at 236 (emphasis in original).
40's and have an institutionalized teen-age child who was born with multiple birth defects. Frances and several other members of her family own all the manufacturing corporation's stock. Although her shares have a book value of $50,000, their market value is unknown, for the stock has never been traded. Frances and George have a combined income of $35,000. They are increasingly concerned about the continued marketability of the corporation's products, but their minority shareholding position does not allow them to change the old-fashioned product line. They view real estate investment as a perfect complement to their stake in the family business.

Of these hypothetical investors, only Arthur and Barbara do not meet the minimum presumptive standard of investor suitability. Carolyn and David, Edward, and Frances and George would all be considered "suitable" investors as far as the presumptive standard is concerned. These thumbnail sketches, however, illustrate some of the factors the presumptive standard does not consider. Perhaps the most serious shortcoming is that the presumptive standard focuses on resources rather than on needs by relying upon the prospective investor's gross income rather than income less living expenses. A person or couple responsible for a large family—or, as in the case of Frances and George, a family member with special needs—will have to spend more money to meet day-to-day expenses than a single person with no family commitments. Thus a 53-year-old widow like Barbara, with a $19,000 income, may well have more investment dollars after paying her bills than a young couple like Carolyn and David. Although their income is $6,000 higher, Carolyn and David have three children, large monthly payments on their home and auto loans, plus a seemingly endless list of major expenses ranging from children's clothes and dental bills to property taxes and summer vacations. Because the presumptive standard relies on gross annual income—a figure which gives little indication of an individual's ability to invest after everyday expenses are met—it ignores these obvious differences in investment capability.

Moreover, by examining only the gross income for the current taxable year, the presumptive standard makes no evaluation of the likelihood that a prospective investor will continue to have income above the minimum level. In the case of a tenured professor, an income beneficiary of a trust, or a corporate executive with a long-term employment contract, there may be every reason to believe that the current

166. This is not to say that Carolyn and David, Edward, or Frances and George should not be eliminated as prospective investors pursuant to the "Sales to Appropriate Persons" section, 10 Cal. Admin. Code § 260.140.112.2 (1974). Indeed, in all three situations, it is doubtful that investments in real estate programs "are appropriate to the customers' investment objectives and financial situations" as required by part (a) of that section. *Id.*
INVESTOR SUITABILITY

year's income accurately reflects the individual's continued earning capability. In other instances, however, a single year's income may be decidedly atypical. Edward, for example, is a salesman enjoying an excellent year. Will his earnings remain high? David is employed in an industry that has been buffeted by changing economic conditions. Will he suffer further periods of unemployment? Barbara is 53 years old. Will her income drop drastically upon her retirement?\(^{167}\)

The net worth requirement suffers from similar drawbacks because it fails to take cognizance of the speculative market value or the lack of liquidity of the assets held. While Barbara's investments are in high-quality stocks and bonds with adequate diversification, Edward's total portfolio consists of high-risk mining stocks with a current market value of many times his original investment. Will metal fever continue to rage? Frances and George own a minority shareholding position in a closely-held corporation manufacturing an outdated product line. If they needed cash for an emergency, would they be able to find a buyer for their stock? Carolyn, on the other hand, could probably sell her diamond necklace on short notice, but her emotional attachment to the heirloom piece might make it illiquid for a different reason.\(^{168}\)

It thus appears that the presumptive standard is not always an accurate tool for separating the economically unsuitable from the economically suitable prospective investors. Because of factors that the presumptive standard does not consider, one might well conclude that a real estate program investment would be suitable for Arthur and for Barbara, the two investors who do not meet the minimum standard.\(^{169}\)

By the same token, one might also conclude that such an investment would be unsuitable for Carolyn and David, for Edward, and for Frances and George, all of whom meet the minimum suitability profile.\(^{170}\)

It can be argued, of course, that the presumptive standard was never intended to be the mainstay of investor suitability regulation; that it was intended to perform only a preliminary screening function to weed out the persons for whom investment in a real estate program would presumably be unsuitable. While this is probably true, it ig-

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167. If the prospective investor were, say, 62 years old, this would be an even greater concern, since he or she would presumably be retired before the anticipated sale of the partnership property, typically scheduled for six or seven years after initial investment.

168. It could be argued that a valuable piece of property held purely for personal emotional or esthetic satisfaction should not be considered at all in computing net worth.

169. This group of hypothetical investors has admittedly been "rigged" to demonstrate the shortcomings of the presumptive standard as clearly and briefly as possible. As individual investors, however, they have financial conditions, investment objectives, needs, and human frailties that are far from atypical.

170. See note 166 supra.
nores two problems upon which the next sections will focus: the concern that any presumptive standard—no matter how finely drafted—will occasionally eliminate suitable investors, and the inevitable tendency of a presumptive standard to dominate the process of determining investor suitability, to the detriment of both suitable and unsuitable investors.

III

TOWARD A MORE MEANINGFUL AND FLEXIBLE STANDARD

The presumptive standard as presently imposed in California can sometimes fail to separate those investors who are no doubt "unsuitable" from those who may well be "suitable" for investment in real estate syndications. This, no doubt, is to be expected of any relatively new administrative procedure. A presumptive standard inevitably involves line drawing, and lines are almost inevitably crude—especially the first time they are drawn. The question then arises: How can the standard be changed to distinguish more accurately the two classes of prospective investors? This section will first consider several ways in which the presumptive standard could be modified to take into account more refined—and thus more reliable—indicia of investor suitability. It will then discuss the problem of using the presumptive standard as the primary indication that an investor is suitable. To solve this problem, a necessary correction to the present rules is suggested. Finally, after an exploration of the legal and practical arguments against the irrebuttable presumption of unsuitability raised by the present standard, this section concludes by proposing a more meaningful and flexible suitability standard.

A. Refining the Present Standard

Examination of a group of hypothetical investors has indicated that the presumptive standard fails to consider a number of factors relevant to making a determination of suitability. Perhaps these omissions can be corrected, resulting in a standard which will draw a more precise line between suitability and unsuitability. This part thus explores some means of refining the present standard. The suggestions themselves are no doubt susceptible of further refinement, and they are not in-

171. An important interest served by the presumptive standard is administrability, both for securities regulators and for those selling real estate programs. If the numbers do not add up, the potential investor is excluded, and there is no need for further inquiry. It would be theoretically possible to devise an elaborate suitability formula to reflect many variables not presently considered in determining presumptive suitability, but such a formula might not be administrable. Therefore, this inquiry will concentrate on some relatively simple means of determining suitability.
tended in and of themselves as proposals for amending the California rules. Rather, they are an attempt to demonstrate that the presumptive standard now imposed does not draw as accurate a line as it might and to suggest ways of improving it.

Consider first the income requirement of the presumptive standard. By focusing on gross income, the standard does not reflect family size or other factors that affect an individual's ability to invest. Thus a person with five children and an income of just over $20,000 would be considered suitable, while a person with no family obligations and an income of just under $20,000 would be considered unsuitable. Is there a practicable method of measuring economic ability to invest more accurately?

One possibility would be to measure taxable income rather than gross income. This figure, which is readily available from the prior year's tax return, reflects all deductions allowed by the Internal Revenue Code. Thus, it has already been adjusted to reflect family size and many ordinary expenditures that affect an individual's ability to invest. Requiring, for example, that a prospective investor have a taxable income of at least $15,000 (in lieu of the present $20,000 gross income) would eliminate some potential investors, like Carolyn and David, whose gross incomes are above the $20,000 mark but who are already burdened with mortgage payments and other deductible expenses of raising a family. At the same time, it would allow persons like Barbara, whose deductible expenditures are low, to qualify even though their gross incomes are below the $20,000 minimum.

The tax law, however, goes one step further in recognizing the differences in ability to pay tax—and hence, by analogy, to invest, especially in an investment vehicle with inherent possibilities for tax shelter—between individuals with family obligations and individuals with no such obligations. The progressive rates are applied at different income levels to married persons filing joint returns, to heads of households, and to unmarried persons. For example, a single person will pay tax at a marginal rate of 36 percent on taxable income over

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172. Earlier versions of the California suitability rules did look to taxable income. See text accompanying note 45 supra.
174. Id. §§ 151(b) ($750 exemption for taxpayer), 151(e) ($750 exemption for each dependent).
175. E.g., id. §§ 162 (deduction for trade or business expenses), 163 (deduction for interest paid or accrued), 170 (deduction for charitable contributions), 212 (deduction for expenses incurred in production of income), 213 (deduction for medical/dental expenses), 215 (deduction for alimony payments).
176. Id. § 1(a).
177. Id. § 1(b).
178. Id. § 1(c).
$18,000, while a married couple will not pay tax at the 36 percent rate until their taxable income tops $24,000.\textsuperscript{179} Thus, the presumptive standard could be expressed, not in terms of gross income of $20,000 or taxable income of $15,000, but in terms of taxable income in at least the 30 percent marginal bracket.\textsuperscript{180} Under present tax rates, this would require that a single person, excluding those qualifying as heads of households, have a taxable income of at least $14,000 to be considered suitable for investment in a real estate program, while a married couple would be required to have taxable income of at least $20,000. Under this presumptive standard, Carolyn and David (perhaps the least suitable of the hypothetical investors) would probably be eliminated, while both Arthur (perhaps the most suitable) and Barbara would apparently qualify.

Another shortcoming of the income requirement presently used is that it makes no effort to evaluate the likelihood that a suitable level of income will be maintained during the term of the investment. It may well be impossible for the presumptive standard alone to perform such an evaluation, since no administrable standard\textsuperscript{181} could take account of age, occupation, health, stability, and other indices of earning potential. One suggestion, however, is that the presumptive standard look not to a single year’s income but to a figure representing the average of perhaps three years’ income.\textsuperscript{182} Although this requirement might disqualify some younger persons whose earning potential was high but not yet well established, it would also tend to eliminate persons whose earning records were erratic.

As an alternative to the averaging technique, the presumptive standard could depart from the strictly objective approach presently used. For example, an income standard could be drafted along the following lines:

The sponsor and each person selling program interests on behalf of the sponsor or program shall make every reasonable effort to ensure

(a) that the prospective investor has an annual taxable income (as defined in section 63 of the Internal Revenue Code of 1954) some portion of which is subject to federal income taxation at a rate of at least 30 percent and

\textsuperscript{179} Id. § 1. The head of household will pay tax at the 36 percent rate on income over $22,000. \textit{Id.}

\textsuperscript{180} It has been argued that any presumptive standard should consider not only the federal income tax bracket but also the impact of state and local taxes. However, since most state and local taxes are deductible from gross income, \textit{Int. Rev. Code of 1954, § 164}, their effect has already been factored into the federal income tax bracket.

\textsuperscript{181} See note 171 \textit{supra}.

\textsuperscript{182} For Pennsylvania’s unique approach to this problem, see text accompanying notes 105-06 \textit{supra}. 
(b) that this level of income can reasonably be expected to continue for the anticipated duration of the program, based on a consideration of the prospective investor's occupation, length of employment, and age.

Consider next the net worth requirement of the presumptive standard. As has been seen through examining a group of hypothetical investors, the requirement of $20,000 net worth can fail to separate suitable from unsuitable investors because it does not adequately consider the diversity, quality, and liquidity of the investor's assets. The exclusion of home, home furnishings, and automobiles from the net worth computation is evidently intended to remove what might be considered the most illiquid of assets from consideration in determining suitability, but there is no further evaluative attempt. It may well be impossible to construct a purely objective net worth requirement that will solve the problems inherent in the present standard. Refining characteristics, however, could be built into a net worth requirement expressed along the following lines:

The sponsor and each person selling program interests on behalf of the sponsor or program shall make every reasonable effort to assure

(a) that the prospective investor has a net worth (exclusive of home, home furnishing, and automobiles) of at least $20,000 and of sufficient diversity, quality, and liquidity that investment in a real estate program is not inappropriate; and

(b) that the prospective investor's commitment to this real estate program and similar investments bears a reasonable relationship to total net worth.\textsuperscript{183}

The alternative $75,000 net worth requirement would be similarly drafted.\textsuperscript{184}

A further problem with the present standard is that it does not adequately distinguish between different types of real estate syndications involving varying degrees of risk and tax shelter orientation.\textsuperscript{185} Although the first section provides that "[a]s a general rule programs structured to give deductible tax losses of 50% or more of the capital contribution of the participant in the year of investment should be sold

\textsuperscript{183} This standard entails a subjective determination on the part of the program sponsor or selling representative that the prospective investor's net worth meets certain standards. It might be argued that such a determination should be governed by existing standards for judging the appropriateness of any investment decision. It could also be argued, however, that additional guidelines are warranted for real estate programs. Pennsylvania has taken this latter approach. See text accompanying notes 109-10 \textit{supra}.

\textsuperscript{184} However, "[w]here . . . tax considerations form a critical part of the economic sense of the investment . . . [t]he tax bracket should remain a standard of suitability, irrespective of net worth." Mosburg, \textit{supra} note 49, at 230 n.77.

\textsuperscript{185} For a brief discussion of the variety of syndications, see text accompanying notes 134-38 \textit{supra}.
only to persons in higher tax brackets,"186 higher presumptive standards are in fact seldom imposed.187 Nor are higher standards typically required for programs "involv[ing] more than ordinary investor risk,"188 as the rules suggest. To combat this problem, the presumptive standard could be reworked—perhaps along the lines chosen by Illinois189 or Ohio190—to build in a firm requirement of higher suitability standards for real estate programs that involve an unusual degree of risk or that are principally designed to afford tax shelter to high-bracket investors.

But while these suggestions could improve the presumptive standard, they do not confront directly the standard's most basic flaw: that a conclusive presumption, based for reasons of administrative necessity on only a few factors, inevitably produces results affecting both investors who meet the presumptive standard and those who fall below its minimum requirements.

B. A Necessary Correction to Ensure Investor Suitability

Refining the presumptive standard to include a more reliable set of factors with which to eliminate the presumably unsuitable investors is only a first step in the larger task of constructing a more useful set of investor suitability standards for California real estate programs. The second step is to ensure that the presumptive standard, however refined or modified, is not used by sponsors and selling representatives as conclusive proof of the suitability of investors who meet the minimum standards of income and net worth.

Many sponsors of real estate programs, when talking "off the record," admit that the existence of the presumptive suitability standard makes it easier for them to determine that a prospective investor is "suitable" to be included as a limited partner in one of their syndications.191 This reading of the presumptive standard—"not presump-

187. 1975 Broady interview, supra note 13. For an indication of the diversity of offerings that have been permitted to qualify in California with the minimum presumptive standards, see Prospectus for American Property Investors III, Sept. 26, 1973; Prospectus for Century Properties Preferred Fund IX, Sept. 5, 1974; Prospectus for Continental Real Estate Partners, Ltd.-74A, Mar. 11, 1974; Prospectus for GHL Realty Fund II, Oct. 25, 1974; Prospectus for McNeil Real Estate Fund V, Ltd., Feb. 21, 1975. Higher standards were required in only a few instances. E.g., Prospectus for Century Properties Equity Fund IX, Sept. 5, 1974 (strong tax orientation); Prospectus for Wine Lands 24, May 29, 1974.
189. See text accompanying notes 98-99 supra.
190. See text accompanying notes 102-03 supra.
191. Naturally, ease of compliance is a desideratum of securities regulation. But sponsors and their representatives should not use the presumptive standard to avoid their responsibility, under both state and federal law, for determining investor suitability. This
tively unsuitable, *ergo* suitable"—should be regarded as manifestly im-
proper, but it understandably follows from the unfortunate way in which the California rules are drafted.\footnote{192}

In order to understand this problem, it is necessary to examine the wording of the present rules to see how poorly they spell out the obligations of sponsors and selling representatives with respect to as-
certaining the economic suitability of prospective investors who meet the minimum requirements of the presumptive standard but may never-
theless be unsuitable for investment in a particular real estate program. The "Sales to Appropriate Persons" section of the rules\footnote{193} has two parts. The meaning of part (a) is muddied by poor drafting,\footnote{194} but the section as a whole should be read as expressing two quite separate elements of investor suitability: (1) the ability to understand the nature of the proposed investment, and (2) the ability to bear the eco-
nomic risks of the proposed investment. The rules provide ample clar-
ification for the first element in part (b) of the "Sales to Appropriate Persons" section.\footnote{195}

possible conflict between the presumptive standard and the broader responsibility for de-
termining investor suitability will be discussed further in section IV infra.

\footnote{192} The Midwest guidelines use identical language. Midwest Securities Commis-
sioners Ass'n, Statement of Policy Regarding Real Estate Programs § III.B.1 (Feb. 28,

\footnote{193} 10 Cal. Admin. Code § 260.140.112.1 (1973), initially discussed in text ac-
companying notes 68-70 supra.

\footnote{194} See note 68 supra and accompanying text.

\footnote{195} That section provides:

The sponsor and/or his representatives shall ascertain that the investor
can reasonably benefit from the program, and the following shall be evidence thereof:

(1) The investor has the capacity of understanding the fundamental as-
pects of the program, which capacity may be evidenced by the following:

(i) The nature of employment experience;

(ii) Educational level achieved;

(iii) Access to advice from qualified sources, such as an attorney,
accountant or tax adviser;

(iv) Prior experience with investments of a similar nature.

(2) The sponsor and/or his representatives shall ascertain that the in-
vestor has apparent understanding:

(i) of the fundamental risks and possible financial hazards of the
investment;

(ii) of the lack of liquidity of this investment;

(iii) that the investment will be directed and managed by the spon-
sor; and

(iv) of the tax consequences of the investment.

10 Cal. Admin. Code § 260.140.112.2(b) (1973). The initial four-factor list gives
sponsors and their representatives a guide to determining investor sophistication; the sec-
ond list tells sponsors and their representatives four critical aspects about investment in
real estate programs that they must be certain the prospective investor understands. If
the sequence of the rule is followed, it provides a "belt and suspenders" assurance that
investors understand what they are buying, since it must first be determined that the
investor is sophisticated and only then that he or she understands the crucial risk factors
It is in dealing with the second element of investor suitability—the ability to bear economic risk—that the California rules fail to provide proper investor protection. Part (a) of the “Sales to Appropriate Persons” section gives the only content to this element:

The sponsor and each person selling program interests on behalf of the sponsor or program shall make every reasonable effort to assure that those persons being offered or sold the program interests are appropriate in light of the suitability standards set forth above and are appropriate to the customers' investment objectives and financial situations.9

Note that, as presently worded, the only concrete guide to the economic substance element of suitability is the reference to "the suitability standards set forth above." In most offerings, these standards will be the presumptive standards of $20,000 annual income and $200,000 net worth or $75,000 net worth, since only rarely are more or less stringent standards proposed or required. Without further clarification, then, the rules seem to permit sponsors and selling representatives to use the presumptive standard as proof of suitability as well as of unsuitability: if the investor is not presumptively unsuitable, then he or she must be suitable for investment in a real estate program.

This interpretation, however, must be rejected as contrary to the investor-protection goals behind the California rules, especially since correcting the drafting weakness—by inserting the words "that the program interests being offered or sold" just before the phrase "are appropriate to the customer's investment objectives and financial situations"—provides sponsors and selling representatives with two guides to a prospective investor's economic suitability. First, they would be required to determine that the prospective investor is not eliminated by the presumptive standard, and second, they would have to "make every reasonable effort to assure . . . [that the program interests being offered or sold] are appropriate to the customers' investment objectives and financial situations." This second requirement contains the classic language of investor suitability.

of real estate programs. In dealing with the investor sophistication element of suitability, therefore, the California rules attempt to ensure that unsophisticated persons who do not have access to advice from qualified sources will not be persuaded to purchase an investment they are incapable of understanding.

196. "Economic substance" will be used in this discussion as a shorthand term for the second aspect of investor suitability. Admittedly a cumbersome term, it was chosen because it has a more neutral connotation than "wealth" or other such one-word expressions of the ability-to-bear-economic-risk concept.

198. Id.
199. See note 187 supra.
200. See note 68 supra.
201. See notes 1, 4, and 6 supra.
Like the sophistication guides, the two economic substance guides should be used together and in the logical, two-step sequence just indicated. Sponsors and their representatives must put those investors who are not eliminated by the presumptive standard to a second test of economic substance, thereby filling in the logical hiatus of the “not presumptively unsuitable, ergo suitable” non sequitur.

As has just been discussed, the investor-protection goals of securities regulation in California require that the “Sales to Appropriate Persons” section be modified to clarify the responsibility of the sponsor and selling representative for determining the suitability of investors who meet the minimum profile of the presumptive standard. The next three parts will explore the obverse of the suitability coin: that investor protection will also be achieved by allowing more flexibility for investors who do not meet the presumptive standard but who should be regarded as suitable because of circumstances that the presumptive standard does not measure. First, additional arguments for abandoning the present presumptive standard must be explored, then this Comment’s proposal for new standard can be considered.

C. Abandoning the Irrebuttable Presumption of Unsuitability

Beyond the arguments emphasizing the inadequacy of the present standard and the difficulty of constructing an administrable standard that adequately distinguishes “suitable” from “unsuitable” investors, there is something philosophically troubling about a rule which absolutely bars certain investments by persons whose wealth does not meet designated criteria. Investor protection is a very strong interest, especially in California, but it is at least arguable that investor protection, even in California, does not require imposition of the present ir-

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202. See note 195 supra.

203. The drafting is woefully deficient, but at least the original language is in the conjunctive. See the emphasized “and” in text accompanying note 197 supra. The California suitability rules for oil and gas programs make it plain that the determination of a prospective investor’s economic suitability is a two-step process. The “Sales to Appropriate Persons” section of the oil and gas rules reads in pertinent part:

In addition to the [presumptive suitability standards] it will be the responsibility of the sponsor and each person selling units to make every reasonable effort to see that such securities are an appropriate investment for the participants.

10 Cal. Admin. Code § 260.140.123.3(a) (1974). Moreover, the oil and gas rules clearly state that “[i]t will be the responsibility of the sponsor and the persons selling units to see that units are sold only to participants meeting the applicable suitability standards.” Id. § 260.140.123.1.

204. For a criticism of “merit” securities regulation, see, e.g., J. MOFSKY, BLUE SKY RESTRICTIONS ON NEW BUSINESS PROMOTIONS (1971).

205. See text accompanying notes 29-36 supra.
rebuttable presumption of unsuitability. This argument can rise to constitutional level, or it can be made on a purely practical basis.

1. Constitutional Arguments Against an Irrebuttable Standard

Although there is a long series of cases upholding the constitutionality of most state efforts to regulate the issue and sale of securities, several recent United States Supreme Court decisions indicate that the presumptive suitability standard might be vulnerable to constitutional attack because it creates an irrebuttable presumption of unsuitability for investment in real estate programs.

The two decisions providing perhaps the strongest support for this position are *Vlandis v. Kline* and *United States Department of Agriculture v. Murry*. In *Vlandis*, the Court invalidated as violative of due process a Connecticut statutory scheme which conclusively presumed that certain categories of students were out-of-state residents, for the purpose of determining tuition, during the entire period of their attendance at the state university. As Justice Stewart wrote for the five-justice majority:

[I]t is forbidden by the Due Process Clause to deny an individual the resident rates on the basis of a permanent and irrebuttable presumption of nonresidence, when that presumption is not necessarily or universally true in fact, and when the State has reasonable alternative means of making the crucial determination.

Despite the traditional importance of the two interests arguably impaired by the Connecticut statute—education and the right to travel freely between states—the majority focused only on the irrebuttable, permanent nature of the presumption and the relative ease with which individualized determinations of residency could be made. Thus *Vlandis* could be read as support for a constitutional challenge to California's presumptive suitability standard.

In *United States Department of Agriculture v. Murry*, the Court held unconstitutional a provision of the federal Food Stamp Act that made a household ineligible to receive food stamps for approximately

206. See, e.g., cases collected in 1 Blue Sky L. Rep. ¶¶ 1075, 1111 (1973). Indeed, the most recent reported decision finding a provision of a state securities law unconstitutional is more than 20 years old. See cases collected id. ¶ 1121 (1973).
207. 412 U.S. 441 (1973).
209. 412 U.S. at 452.
two years if it contained a member over the age of 18 who was claimed as a dependent, for federal income tax purposes, by a taxpayer not a member of an eligible household.\textsuperscript{212} Despite the less permanent nature of the presumption, the Court held that the provision violated due process, citing \textit{Vlandis} and \textit{Stanley v. Illinois}\textsuperscript{213} for support. Again, the importance of the interest at stake in \textit{Murry}—access to reduced food bills for families well below the poverty threshold—was not mentioned by the majority as a basis for its opinion. The case can therefore be read as additional support for the constitutional argument. In fact, since it dealt with a presumption lasting only a limited length of time, \textit{Murry} is even more closely analogous to California's presumptive suitability standard, which would only bar investment in a real estate program at a time when the investor did not have the requisite annual income and net worth.\textsuperscript{214}

It might well be, however, that the Court would not extend irrebuttable presumption analysis to a case in which the private interest is primarily economic.\textsuperscript{215} Instead, the court could use classic equal protection doctrine to uphold the presumptive standard. \textit{Dandridge v. Williams},\textsuperscript{216} in which the Court refused to invalidate a Maryland Aid to Families With Dependent Children (AFDC) provision that discriminated against large families by setting a $250-per-month ceiling on AFDC grants, regardless of family size, contains an example of the deference the Court has traditionally accorded legislation regulating economic interests:

\begin{itemize}
\item \textsuperscript{212} 413 U.S. 508 (1973). The terse opinion for the five-justice majority was written by Justice Douglas, who only two weeks earlier had joined Justice Rehnquist's dissent to the irrebuttable presumption analysis in \textit{Vlandis}, 412 U.S. at 463.
\item \textsuperscript{213} 405 U.S. 645 (1972) (irrebuttable presumption that unmarried father, in contrast to married or divorced father, was unfit parent violated equal protection).
\item \textsuperscript{214} It should be mentioned, however, that the presumptive standard would probably create a permanent bar to investment in any particular program, since offering periods are generally quite short and restrictions on transferability stringent.
\item \textsuperscript{215} For example, in Cleveland Bd. of Educ. v. LaFleur, 414 U.S. 632 (1974), the Court held that a school district's mandatory maternity leave policy violated due process by creating an irrebuttable presumption that a teacher in her fifth month of pregnancy was incapable of continuing her duties. The opinion stressed the fact that overly restrictive maternity leave regulation could in effect "penalize the pregnant teacher for deciding to bear a child." \textit{Id.} at 640. Since "freedom of personal choice in matters of marriage and family life" had long been protected by the fourteenth amendment, \textit{id.} at 639, and since the board's mandatory maternity leave rules could "constitute a heavy burden on the exercise of these protected freedoms," \textit{id.} at 640, due process required "that such rules must not needlessly, arbitrarily, or capriciously impinge upon this vital area of a teacher's constitutional liberty." \textit{Id.} This exposition of the importance of the teachers' interest in \textit{LaFleur} contrasts sharply with the truncated reasoning of the majority in both \textit{Vlandis} and \textit{Murry}; it may well indicate that an economic interest alone, even when expressed in terms of the freedom to invest in that most cherished of property interests, American real estate, would not trigger irrebuttable presumption analysis.
\item \textsuperscript{216} 397 U.S. 471 (1970).
\end{itemize}
In the area of economics and social welfare, a State does not violate the Equal Protection Clause merely because the classifications made by its laws are imperfect. If the classification has some "reasonable basis," it does not offend the Constitution simply because the classification "is not made with mathematical nicety or because in practice it results in some inequality."  

Three of the four dissenting justices in *Murry* found it impossible to square the Court's decision in that case with its earlier *Dandridge* opinion, since the social welfare goals were basically the same in each case.  

Perhaps what distinguished the two cases, however, was not the private interests involved but the means the government had chosen to preserve the financial integrity of its welfare program. The legislative history of the Food Stamp Act indicated that the provision under attack in *Murry* was intended to ensure that college students from middle- and high-income families would not invade the food stamp program. Yet the section's effect was to deny food stamps to a much larger and more deserving group. On the other hand, the limitations of AFDC allowances at issue in *Dandridge* applied to precisely the families the legislature had intended to single out: those with unusually large numbers of dependent children, who could be expected to have "the greater ability of large families—because of the inherent economies of scale—to accommodate their needs to diminished per capita payments." From this perspective, the presumptive standard more closely resembles the AFDC ceiling upheld in *Dandridge* than it does the food stamp eligibility limitation at issue in *Murry*; the means used to separate "unsuitable" from "suitable" investors seem to have been more rationally chosen than the means of eliminating undeserving households from those eligible for food stamps.  

A Second Circuit case involving federal securities law—although

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218. 413 U.S. at 522-24 (Rehnquist, J., dissenting).
219. Among the named plaintiffs in *Murry* were divorced women with teenage children whose households had been denied food stamps because their former husbands, although presently contributing little or nothing to their children's support, had claimed the children as dependents on the prior year's tax return, and young working-class persons, married and single, whose households had been denied stamps because their parents, although presently giving them no financial assistance, had similarly claimed them as dependents. Id. at 510-11.
220. 397 U.S. at 479-80.
221. Utilizing this "means-focused" approach to equal protection or due process, it could be argued that a standard such as Pennsylvania's, which uses an extremely high annual income and net worth requirement only for nonspecified property programs, see text accompanying notes 104-10 supra, would be even more vulnerable to constitutional attack, since the difference between blind pools and specified property programs may not be significant enough to warrant such stringent suitability rules only for the former.
decided well before the Supreme Court's relatively recent reversion\textsuperscript{222} to irrebuttable presumption analysis—gives another indication of the approach a court might adopt in a suit challenging the presumptive standard on constitutional grounds. \textit{Gratz v. Claughton}\textsuperscript{223} was an action brought by shareholders pursuant to section 16(b) of the Securities Exchange Act of 1934\textsuperscript{224} to recover short-swing profits made by a person who at the time of the challenged transactions owned more than 10 percent of their corporation. The defendant attacked the constitutionality of section 16(b)'s conclusive presumption that 10-percent shareholders were controlling persons who should not be allowed to profit from their assumed access to inside information. Judge Learned Hand quickly disposed of this argument. After taking judicial notice that access to inside knowledge of a corporation's affairs "often does not require anything approaching a majority of the shares,"\textsuperscript{225} the court upheld the constitutionality of section 16(b)'s requirement that 10-percent shareholders disgorge their short-swing profits.\textsuperscript{226}

Thus, despite language in \textit{Vlandis} and \textit{Murry} that has apparent applicability even to purely economic classifications, it seems unlikely that a court would disturb the presumptive standard on constitutional grounds. The state's interest in investor protection is important, and the presumptive standard—although it indisputably involves a conclusive presumption that certain persons are "unsuitable" investors for real estate programs—could be described as having a "reasonable basis" sufficient to uphold its constitutionality.\textsuperscript{227}

\textsuperscript{222} For a brief review of the Supreme Court's earlier use of irrebuttable presumption analysis, see Note, \textit{Irrebuttable Presumptions: An Illusory Analysis}, 27 STAN. L. REV. 449 n.3 (1975).
\textsuperscript{223} 187 F.2d 46 (2d Cir.), cert. denied, 341 U.S. 920 (1951).
\textsuperscript{225} As Judge Hand wrote:
\begin{quote}
It is of course true that the ownership of ten per cent of the shares does not always put the owner among those who do control; but neither Congress, nor any other legislature, is obliged to limit the means which it chooses so exactly to its ends that the correspondence is exact. If only those persons were liable, who could be proved to have a bargaining advantage, the execution of the statute would be so encumbered as to defeat its whole purpose. We do not mean that the interest, of which a statute deprives an individual, may never be so vital that he must not be given a trial of his personal guilt; but that is not so when all that is at stake is a director's, officer's or "beneficial owner's" privilege to add to, or subtract from, his holdings for a period of six months. In such situations it is well settled that a statute may provide any means which can reasonably be thought necessary to deal with the evil, even though they may cover instances where it is not present.
\end{quote}
\textit{Id.}
\textsuperscript{226} There are some indications that the Court is evolving an intermediate standard of equal protection review that would require a closer relationship between the classification and its purpose. See Gunther, \textit{Foreword: In Search of Evolving Doctrine on a
2. Practical Arguments for a Rebuttable Standard

That the presumptive standard is probably constitutional, however, does not end the inquiry. On the contrary, there are a number of practical considerations which ultimately compel the conclusions that the irrebuttable presumption of unsuitability presently employed is inconsistent with the rationale underlying investor suitability and that it should be replaced with a more flexible test.

It has already been shown that the presumptive standard does not always eliminate only the "unsuitable" investors. Although the standard is susceptible of further refinement, even the most finely tuned standard will not draw a perfect line. There are simply too many variables in the real estate investment process—from the widely divergent characteristics of the investment vehicles themselves to the many factors that must be considered in determining each particular security's economic suitability for each individual investor—for a presumptive standard to be much more than crude. Thus, it could first be argued that the present presumptive standard should be abandoned because it is incapable of doing the screening job it was designed to perform.

Moreover, the standard is not only imperfect; it may well be redundant. The "Sales to Appropriate Persons" section of the California real estate syndication rules should be interpreted as making the sponsor and selling representative responsible for determining that the proposed investment is "appropriate to the customers' investment objectives and financial situation." If an investor with an income and net worth of less than $20,000 would always be eliminated under this "know your customer" rule, then the presumptive standard is surplussage. If a few investors in this category would not be eliminated

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228. See text accompanying notes 162-67 supra.
229. See text accompanying notes 172-90 supra.
231. Id.
232. It has been argued by the real estate industry that all special suitability standards for real estate programs (including but not limited to the presumptive standard) are redundant because the intent behind such rules is served by existing mechanisms, such as the NASD suitability rule. National Ass'n of Real Estate Boards, Statement on the Regulation of Real Estate Securities, Aug. 22, 1972 (presented to the Real Estate Advisory Committee of the SEC), in Real Estate Securities and Syndication: A Workbook app. A-1, 20 (S. Roulac ed. 1973). This argument proves too much. First, although many real estate programs are marketed through NASD broker-dealers, not all persons selling such securities in California are subject to NASD regulation. The NASD
under the basic rule—because of factors peculiar to their own circumstances or the nature of the particular real estate program—then the presumptive standard is unnecessary in most instances and inappropriate in the remainder.\textsuperscript{233}

Following this line of reasoning, it seems that the proper role for a presumptive standard would be to provide \textit{persuasive evidence} but not conclusive proof of a prospective investor's unsuitability. Modified in this way, the standard would allow the sponsor and selling representative to determine, after a careful consideration of the individual investor's particular circumstances, that he or she was suitable even though the presumptive standard had not been met. Permitting this discretion is premised, of course, on the belief that the policies underlying securities regulation in California would be better effectuated by placing the responsibility for determining suitability squarely on the sponsor and the salesperson. The "Sales to Appropriate Persons" suitability rule should be read as placing responsibility there for the many suitability determinations involving persons who are not presumptively unsuitable but who should be eliminated as potential investors in a particular program because of other factors.\textsuperscript{234} Why should it be different for a few potential investors who would survive a rigorous suitabil-

\footnotesize{estimates that its members distribute about three-quarters of all registered tax shelter programs and that in approximately half of these the sponsor is also an NASD affiliate. SEC Securities Exchange Act Release No. 10260 (July 2, 1973), in 2 SEC DOCKET 82, 85 (1973). However, "the greater part of the offerings of tax shelter programs, by dollar volume, appears to be sold in transactions characterized by the participants as not involving a public offering . . . ." SEC letter, \textit{supra} note 93. This is specifically recognized in a suitability rule promulgated by the Commissioner of Corporations and applicable only to broker-dealers and their agents who are not registered under the 1934 Act. 10 Cal. Admin. Code § 260.218.2 (1973). Second, the program sponsor, whom the California rules give joint and several responsibility with the selling representative for determining investor suitability, would apparently not always be considered a broker (whether or not the sponsor utilizes sales personnel beyond its own key officers or directors) and thus subject to regulation either by the NASD, \textit{see} note 1 \textit{supra}, or the SEC pursuant to SECO Rule 15b10-3, \textit{see} note 6 \textit{supra}. \textit{See generally} Augustine & Fass, \textit{Broker-Dealer Licensing in the Field of Real Estate Syndication}, 29 Bus. L\textit{aw.} 369 (1974) [hereinafter cited as Augustine & Fass]. For further discussion of broker-dealer licensing, \textit{see text accompanying notes 256-70 infra.}

233. There is a further practical argument for eliminating the present irrebuttable standard: that it is misused in some efforts to market real estate securities. Experts believe that in "softening up" potential investors some program sponsors and their sales staffs use the presumptive standard either to imply an exclusivity about the investment or to imply that because persons are not presumptively unsuitable they are "ideal" prospects for real estate investment. Interview with Stephen E. Roulac, real estate consultant and lecturer, School of Business Administration, University of California, Berkeley, in Berkeley, Jan. 27, 1975. Either use of the presumptive standard is patently improper and would justify modification in the absence of more compelling reasons for retention.

234. If this is not so, then the presumptive standard has become pre-eminent, serving to identify presumptively suitable investors rather than to eliminate presumptively unsuitable investors. \textit{See text accompanying notes 191-203 supra.} This danger will be further explored in \textit{text accompanying notes 398-407 infra.}
Returning to the hypothetical investors discussed earlier, specifically Barbara and Arthur, may be useful in showing how such a standard would work. Slightly varying the original facts, suppose that a sizable portion of Barbara's portfolio comprises municipal bonds, the income from which is nontaxable. A sponsor, upon careful examination of her investment needs and financial situation—especially in light of her artificially low taxable income, retirement objectives, and lack of family obligations—might decide that Barbara was indeed a suitable investor for a real estate program oriented toward modest capital appreciation rather than tax shelter.

Similarly, an exception might be warranted for Arthur, although on a slightly different basis. Suppose that, following his business school education, Arthur had joined a real estate development firm and had become quite familiar with real estate syndications similar to the sponsor's program. In light of Arthur's full understanding of—and willingness to assume—the risks involved in the proposed investment, it would seem that he too should not be denied the opportunity to participate.

In each of these examples, a strong argument can be made for departing from the presumptive standard as presently imposed. In Barbara's case, her investment objectives and needs—combined with her financial condition, including a solid net worth and an annual income just below the minimum required by the presumptive standard—could lead a responsible sponsor and selling representative to determine that investment in a particular real estate program was suitable for her. In Arthur's case, his special sophistication—again combined with a financial profile only slightly below that required by the presumptive standard—militates in favor of allowing him to invest.

D. A Suggested New Standard

In order to effect the various changes that have been suggested in this Comment, two sections of the present California rules must be substantially rewritten. While some of the specific rewording has already been spelled out in piecemeal fashion, it is now necessary to synthesize these ideas into a concrete proposal for revising the investor

235. The standard answer is that the presumptive suitability standard provides a workable administrative determination of unsuitability before the fact of investment— as opposed to a judicial determination of unsuitability after the fact. Broady interview, supra note 28. This response, however, fails to explain why a before-the-fact determination is necessary for an investor making $19,999 but not for one making $20,000. See text accompanying notes 242-52 infra.
suitability rules and to show how the revised sections would read in their entirety.

1. Revising the "Sales to Appropriate Persons" Section

The "Sales to Appropriate Persons" section, which should be regarded as the basic guide for determining investor suitability, would be rewritten as follows:

260.140.112.2. Sales to Appropriate Persons. (a) The sponsor and each person selling program interests on behalf of the sponsor or program shall make every reasonable effort to ensure:

(1) that those persons being offered or sold the program interests are appropriate investors in light of the suitability standards set forth above, and

(2) that the program interests being offered or sold are appropriate to the prospective investor's investment objectives, financial situation, and needs.

The presumptive suitability guidelines of section 260.140.112.5 shall be persuasive evidence of (a)(1) above, but a prospective investor who does not meet the minimum requirements of the presumptive guidelines need not be excluded if, after a strong showing by the investor of his or her particular financial circumstances, the sponsor and the selling representative are convinced to a high degree of certainty that an exception is warranted. It should be emphasized that the responsibility for determining investor suitability rests with the sponsor and the selling representative and that exceptions should be made and documented with extreme care in light of this responsibility.

As evidence of (a)(2) above, the sponsor and the selling representative shall make every reasonable effort to ensure:

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237. The reference is to the "Standards to Be Imposed" section, which reads:

Given the limited transferability, the relative lack of liquidity, and the specific tax orientation of many real estate programs, the sponsor and its selling representatives should be cautious concerning the persons to whom such securities are marketed. Suitability standards for investors will, therefore, be imposed which are reasonable in view of the foregoing and of the type of program to be offered. Sponsors will be required to set forth in the prospectus the investment objectives of the program, a description of the type of person who could benefit from the program and the suitability standards to be applied in marketing it. The suitability standards proposed by the sponsor will be reviewed for fairness by the Commissioner in processing an application. In determining how restrictive the standards must be, special attention will be given to the existence of such factors as high leverage, substantial prepaid interest, balloon payment financing, excessive investments in unimproved land, and uncertain or no cash flow from program property. As a general rule, programs structured to give deductible tax losses of 50% or more of the capital contribution of the participant in the year of investment should be sold only to persons in higher income tax brackets considering both state and federal income taxes. Programs which involve more than ordinary investor risk should emphasize suitability standards involving substantial net worth of the investor.

Id. § 260.140.112.1 (1974).
(i) that the prospective investor's net worth is of sufficient
diversity, quality, and liquidity that investment in a real estate
program is not inappropriate;

(ii) that the prospective investor's total net worth bears
a reasonable relationship to the proposed commitment to this
real estate program and similar investments (a relationship of
10:1 will generally be deemed reasonable); and

(iii) when the prospective investor's annual income is a
factor in determining suitability, that the income can reasonably
be expected to continue at a sufficiently high level for the antici-
pated duration of the program, based on a consideration of the
person's occupation, length of employment, and age.

(b) The sponsor and each person selling program interests on
behalf of the sponsor and program shall make every reasonable effort
to ascertain:

(1) that the prospective investor has the capacity of under-
standing the fundamental aspects of the program; and

(2) that the prospective investor has apparent understanding:

(i) of the fundamental risks and possible financial hazards
of the investment;

(ii) of the lack of liquidity of the investment;

(iii) that the investment will be directed and managed by
the sponsor; and

(iv) of the tax consequences of the investment.

(c) The following factors may be considered as evidence of
(b)(1) above:

(i) the nature of the prospective investor's employment
experience;

(ii) the prospective investor's educational level;

(iii) the prospective investor's access to advice from quali-
fied sources, such as an attorney, accountant, or tax advisor;

(iv) the prospective investor's prior experience with in-
vestments of a similar nature.

(d) In extremely unusual circumstances, exceptions from the
presumptive suitability guidelines of section 260.140.112.5 may be
made primarily on the basis of the investor's sophistication, as evi-
denced by factors (i), (ii), and (iv) in (c) above. Such an excep-
tion shall be made only after the sponsor and selling representative
have made the determination, required by (a)(2) above, that the
program interests being offered or sold are appropriate to the cus-
tomer's investment objectives, financial situation, and needs.

For example, an exception under section 260.140.112.2(d) might be
made for a business school graduate, working actively in real estate develop-
ment, who has prior experience in evaluating real estate program investment
—but not if that person had family commitments which, in the sponsor's
and selling representative's views, dictated a different investment program.
2. Revising the Presumptive Suitability Standard

The presumptive standard of the present California rules would also be revised. It would read:

260.140.112.5. Presumptive Suitability Guidelines. (a) Unless the Commissioner approves lower guidelines, or unless an exception is made under section 260.140.112.2, investors shall have an annual taxable income (as defined in section 63 of the Internal Revenue Code of 1954), some portion of which is subject to federal income taxation at a rate of at least 36 percent, and a net worth (exclusive of home, furnishings, and automobiles) of at least $20,000 or, in the alternative, a minimum net worth (exclusive of home, furnishings, and automobiles) of $75,000. The assets included in the computation of net worth may be valued at cost or fair market value unless the higher valuation would be inappropriate in light of the investor-protection goals of the presumptive guidelines.

(b) In principally tax oriented offerings, investors shall have an annual taxable income, some portion of which is subject to federal income taxation at a rate of at least 50 percent, and a net worth (exclusive of home, furnishings, and automobiles) of at least $20,000.

(c) In offerings involving more than ordinary risk, investors shall have an annual taxable income, some portion of which is subject to federal income taxation at a rate of at least 36 percent, and a net worth (exclusive of home, furnishings, and automobiles) of at least $50,000 or, in the alternative, a minimum net worth (exclusive of home, furnishings, and automobiles) of at least $100,000.

(d) In the case of sales to fiduciary accounts, the guidelines may be met by the fiduciary, by the fiduciary account, or by a donor who directly or indirectly supplies the funds to purchase the interest in the program.

In addition to these changes, the last two sentences of the first section of the present California rules must be changed to reflect the new presumptive standards for tax oriented and high-risk offerings:

As a general rule, principally tax oriented offerings, including programs structured to give deductible tax losses of 50 percent or more of the capital contribution of the participant in the year of investment, should be sold only to persons meeting the presumptive suitability

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238. Id. § 260.140.112.5 (1973).
239. “May” has been substituted for the “shall” used in the similar sentence of the present version, id., because it should also be possible, in appropriate instances, for the cestui que trust to meet the suitability guidelines, e.g., when an independently wealthy person is also the beneficiary of a relatively modest trust formed to engage in more speculative investments.
standards of section 260.140.112.5(b). Programs which involve more than ordinary investor risk should emphasize suitability standards requiring participants to have substantial net worth and should normally be sold only to persons meeting the presumptive suitability standards of section 260.140.112.5(c).

**E. In Support of the Proposed Standard**

These proposed modifications, it will be seen, take into account the shortcomings of the present presumptive standard discussed earlier.\(^2\)\(^4\)\(^1\) Moreover, by allowing an investor who does not meet the presumptive guidelines to participate in exceptional circumstances, the proposed suitability rules provide a degree of flexibility not accorded by the present rules. In addition, the proposed rules emphasize the responsibility of the sponsor and the selling representative for determining investor suitability in all cases.

Some of the responses to this proposal can be anticipated and discussed at this point. First, it will undoubtedly be argued that the presumptive standard in its present irrebuttable form is necessary as a means of protecting unsuitable investors before the investment is made. Putting responsibility on the sponsor is fine, this argument goes, but would not the investor-protection goals of substantive securities regulation be better served by a rule which prevents unsuitable investors from sinking their money into a venture they do not understand and cannot afford rather than one which may or may not give them a worthwhile cause of action against the sponsor?

There are several answers to this argument. First, some prospective investors who do not meet the presumptive standard are not necessarily unsuitable.\(^2\)\(^4\)\(^2\)\(^4\)\(^3\) As to them, the argument suggests the great danger of substantive regulation: unnecessary paternalism. As to the bulk of prospective investors whose income and net worth figures fall below the minimum guidelines, they should be protected by the proposed rules just as surely as they are protected by the present presumptive standard.\(^2\)\(^4\)\(^3\) Moreover, the proposed rules would extend protec-

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241. See text accompanying notes 172-90 supra.  
242. See text accompanying note 167 supra.  
243. A sponsor or selling representative who is willing to abuse the strong (but rebuttable) presumption of unsuitability seems just as likely to ignore the irrebuttable standard, the consequences of the latter being no more severe than the former. This conclusion is disputed, however, by some securities regulators, who believe that sponsors and selling representatives will honor a firm presumptive standard but would fail to fulfill their responsibility for making only warranted exceptions if a rebuttable standard were adopted. 1975 Broady interview, infra note 13. One response is that sponsors and selling representatives should be regarded as responsible for making final suitability determinations for investors who meet the minimum profile of the present presumptive standard. It is difficult to see why they can be trusted to make this determination for
tion to a larger group of investors. The presumptive standard in California is set deliberately low so as to eliminate as few arguably suitable investors as possible; a standard set as high as Pennsylvania’s\(^{244}\) is far more likely to provoke charges of paternalism. Many experts, however, believe that investment in the typical real estate program makes economic sense only for persons whose financial resources are considerably greater than the minimum standards.\(^{245}\) This is especially true in real estate programs that are principally tax oriented and in those that involve an unusually high degree of risk; for such programs, therefore, the proposed rules would require imposition of more stringent presumptive guidelines. By making the presumption of unsuitability rebuttable upon a showing by a prospective investor that his or her peculiar financial circumstances warrant an exception to allow investment in a particular real estate program, the guidelines can be set at a level more indicative of suitability than of patent unsuitability.\(^{246}\) Thus the desired protection can be extended to additional persons for whom investment in most real estate programs is probably inappropriate without eliminating the possibly suitable investors within that higher economic substance bracket.\(^{247}\)

It will also be argued that ease of administration and compliance requires retention of the present presumptive standard. Unquestionably a conclusive presumption is simpler to apply than a rebuttable one, but administrative ease is not the only value served by investor suitability standards.\(^{248}\) A presumptive standard which is easy to apply but which produces unjust results in practice is likely to undermine confidence of both sponsors and investors in the fundamental fairness of substan-

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244. See text accompanying notes 104-10 supra.
246. Raising the presumptive guideline to a more realistic indicium of suitability will also mitigate the danger that the presumptive standard will be used by unscrupulous selling representatives as a positive marketing device. See note 233 supra.
247. The proposed guidelines, set forth in text accompanying notes 236-40 supra, suggest that a single person should have an annual taxable income of at least $18,000 and that a married couple should have an annual taxable income of at least $24,000—considerably higher figures than the presently required $20,000 annual gross income. The net worth guidelines could be similarly increased, for offerings involving more than typical risk of loss, without the danger of unnecessarily eliminating investors whose individual circumstances would justify a lower suitability threshold.
248. Indeed, the cases involving irrefutable presumptions in other contexts have given little weight to the interest in ease of administration. E.g., Stanley v. Illinois, 405 U.S. 645, 656 (1972) ("the Constitution recognizes higher values than speed and efficiency"), quoted in Cleveland Bd. of Educ. v. LaFleur, 414 U.S. 632, 646 (1974); Vlandis v. Kline, 412 U.S. 441, 450 (1973). The constitutional argument against the presumptive standard appears in text accompanying notes 207-27 supra.
tive securities regulation. Moreover, applying the proposed rebuttable presumption should not add greatly to the workload of sponsors and selling representatives, since they should already be making equally difficult suitability determinations for prospective investors whose income and net worth exceed the minimum standards.

In summary, then, the more flexible standard proposed in this Comment offers enhanced protection to a larger number of prospective investors without adding substantially to the compliance responsibilities of sponsors and selling representatives and without arbitrarily foreclosing investment opportunities for those persons who can meet the other tests of suitability. The presumptive suitability standard has great superficial appeal as a securities regulation device; the modifications suggested in this section, however, will make the investor suitability rules for California real estate programs consonant with the "fair, just, and equitable" standard of investor protection by which the regulations themselves as well as the securities and transactions regulated should ultimately be judged.

IV
SANCTIONS FOR VIOLATION OF SUITABILITY RULES

There remains one context in which the presumptive standard must be examined: the sanctions imposed on sponsor and selling representative for violation of suitability rules, including possible civil liability to investors who have been permitted to invest despite their unsuitability. This Comment will not undertake an exhaustive analysis of the various forms of sanction. It does attempt to set them out clearly, in the context of suitability for investment in real estate programs, because of their importance to practitioners in the field as well as to regulators seeking to evolve effective investor suitability rules.


250. Investors who did not meet the proposed presumptive guidelines could be eliminated as unsuitable unless they were able to make the required showing of suitability.

251. See text accompanying notes 230-35 supra.

252. Its proliferation in recent years, even into regulatory schemes premised on full disclosure, see text accompanying notes 85-96 supra, is testimony to the appeal of the presumptive standard.

253. Although there are some abbreviated discussions of sanctions in the area of real estate syndication, see, e.g., 3 Real Estate Securities 7-124 (D. Augustine ed. 1974), there has been no truly comprehensive analysis of the subject—perhaps because the current renaissance of real estate syndication is too recent for there to have been enough enforcement activity to generate such coverage.
Although California will be used when reference to state law is appropriate, this section is largely concerned with federal law. Thus its conclusions should be generally applicable to sales of real estate programs, wherever made, that violate suitability rules.

Nothing in this section should be read as implying that every investor in a real estate program which fails to live up to expectations should be able to cry "suitability violation." There are obviously many persons for whom a typical real estate program would be a suitable investment because of their sophistication, ability to bear economic risk, and investment objectives, including the need for tax shelter. Nor should this section be interpreted as advocating the imposition of liability upon a sponsor or selling representative who has made every reasonable effort to ensure that a particular investor is suitable, and who honestly and reasonably believes that a proper determination of suitability has been made. There are many "gray" areas in the suitability concept, and liability should only be imposed cautiously, on a case-by-case basis, after carefully considering the legitimate interests of sponsor, selling representative, other limited partners, and the real estate industry.

The first two parts of this section will describe the basic sanctioning framework; the third part will critically examine California's suitability rules, particularly the presumptive standard, in that framework. The crucial focus of this section is on the counterproductive effect the present presumptive standard could have, in terms of investor protection, on determinations that sanctions should be imposed upon those who sell real estate program securities to unsuitable investors. After discussing this problem, the section will conclude by briefly exploring the ramifications on the sanctioning process of the modified standard proposed earlier in this Comment.

A. The Range of Public Sanctions

Sponsors and selling representatives who are found to have sold real estate program interests to unsuitable investors may face disciplinary action under both California and federal law. Although the bulk of the development in this area has taken place at the federal level, state law will be considered first.

1. California Law

The Commissioner of Corporations is given the power to bring an action in superior court to enjoin any acts or practices that violate rules, such as those governing real estate programs, promulgated under the Corporate Securities Law of 1968, or to enforce compliance with the
There are also criminal penalties for willful violations and for fraud. In addition, broker-dealers and agents—whom California law requires be licensed to engage in securities transactions—are subject to disciplinary proceedings, including censure, suspension, or revocation of certification as a broker-dealer or agent, for willful violations of federal or state securities law, including the rules governing real estate programs.

Although broker-dealer is broadly defined under California law, issuers are specifically excluded from the definition. It has generally been thought that sponsors who serve as general partners of real estate programs organized in limited partnership form would qualify as issuers and be exempted from obtaining a broker-dealer license to sell the securities of their limited partnerships, although the sponsor's agents would have to be licensed under the less rigorous agent licensing requirements. Under federal law, however, it is now "widely agreed" that "professional syndicators"—persons who are in-

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254. CAL. CORP. CODE § 25530(a) (West Supp. 1974). The Commissioner is also empowered to include a claim for "restitution or damages . . . on behalf of the persons injured by the [alleged violation]." Id. § 25530(b).

255. Id. §§ 25540-41. Real estate syndicators are occasionally brought to task under these sections. In late 1974, for example, a Southern California syndicator pleaded no contest in superior court to two counts of making false statements in the sale of securities and one count of engaging in the unlawful sale of securities. See Jerome Goldberg Pleads No Contest to 3 Counts Over Real Estate Deals, Wall Street Journal, Dec. 10, 1974, at 17, col. 2.


257. Id. §§ 25212, 25213.

258. Broker-dealer is defined by California's Corporate Securities Law of 1968 as "any person engaged in the business of effecting transactions in securities in this state for the account of others or for his own account." Id. § 25004.

259. Id. Also excluded by rule are licensed real estate brokers and salespersons whose only securities transactions are governed by the Real Estate Syndicate Act of 1970. 10 Cal. Admin. Code §§ 260.204.1, 260.204.3 (1972). For a discussion of that law, see text accompanying notes 51-62 supra. It seems clear that only licensed real estate brokers selling securities which are subject to authorization by the Real Estate Commissioner are exempted from the broker-dealer and agent licensing requirements of the Corporate Securities Law of 1968. See note 60 supra. Thus, even though the privately-placed real estate program need not be qualified with the Commissioner of Corporations, CAL. CORP. CODE § 25102(f) (West Supp. 1974), the selling representative should possess a broker-dealer's or agent's license unless the issuer exemption is available.

260. See Augustine & Fass, supra note 232, at 376-77. It should be noted, however, that the conclusion reached by the authors results from interpreting as applicable to real estate programs a statutory definition of issuer, as "the person or persons in active control of the exploration or development of the property," which by its terms applies only to oil, gas, or mining securities. See CAL. CORP. CODE § 25010 (West Supp. 1974).

volved in several limited partnerships as general partner—will be regarded as brokers and not issuers.\textsuperscript{262} It is difficult to see why a different result should obtain under California law, and thus professional syndicators should be required to qualify as broker-dealers before they involve themselves in the marketing process.

2. \textit{Federal Law}

All brokers and dealers who use the mails or any other means or instrumentality of interstate commerce to effect transactions in real estate program securities are required to register with the SEC by the Securities Exchange Act of 1934 (the 1934 Act).\textsuperscript{263} While issuers are not considered as either brokers or dealers under the 1934 Act,\textsuperscript{264} it was pointed out earlier\textsuperscript{265} that sponsors engaged in marketing several syndications will generally be regarded as brokers and required to register.\textsuperscript{266} Many real estate programs, of course, are sold by NASD

\begin{footnotesize}
\begin{enumerate}
\item[262.] Wertheimer, supra note 95, at 7; see note 266 infra.
\item[263.] 15 U.S.C. \S 78o(a)(1) (1971). The sole exemption from registration is for "one whose business is exclusively intrastate," \textit{id.}, and the exemption is extremely narrow. One out-of-state offer has been held to destroy the exemption. Mutual Real Estate Investors, Inc., SEC Securities Exchange Act Release No. 7105 (July 30, 1963). Once the exemption is destroyed, it can never be regained. Augustine & Fass, supra note 232, at 373. As one experienced practitioner has written: "[R]eliance upon the exclusively intrastate exemption, considering the sanctions for unjustified reliance [including suits for rescission or damages under section 29 of the 1934 Act, 15 U.S.C. \S 78cc (1971) and criminal penalties under section 32, \textit{id.} \S 78ff], is fraught with risk, and since the exemption does not relieve a broker or dealer of the obligation to comply with the net capital rules, the game is not really worth the candle." Wertheimer, supra note 95, at 8.
\item[265.] See text accompanying note 262 supra.
\item[266.] See, e.g., SEC Div. of Trading & Markets No-Action Letter, Boetel & Co. (Aug. 30, 1971), in [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,343. But cf. SEC Div. of Trading & Markets No-Action Letter, DeMatties Development Corp. (Sept. 2, 1971), in id. ¶ 78,415 (carefully qualified as staff's opinion that no registration of sponsor required when publicly-offered securities would be registered under Securities Act of 1933 and distributed by registered broker-dealers and only securities "privately placed with knowledgeable investors" would be distributed by the sponsor, who would be an active general partner of each limited partnership).
\end{enumerate}
\end{footnotesize}
member broker-dealers and their registered representatives, but many other offerings, particularly smaller ones, are distributed by the issuer's own sales force. These persons may also be required to register as brokers under the 1934 Act. The test for registration vel non is whether the selling representative is a "servant" of the issuer, and hence exempted from the registration requirement, or whether the selling representative is an "independent contractor" subject to registration requirements.

Brokers and dealers are subject to censure, suspension, or revocation of their registration by the SEC if the Commission finds that they, or persons associated with them, have willfully violated any federal securities law or a rule or regulation thereunder. A number of SEC disciplinary actions indicate that sales to clearly unsuitable investors will constitute violations of rule 10b-5 and thus subject broker-dealers to discipline by the SEC.

Two relatively recent SEC actions involving investor suitability in

of a comprehensive policies and procedures manual and supervisory structure into which may be plugged procedures protective of 1933 Act exemptions, (2) it affords the opportunity to develop integrated standard forms and guides for all documentation of transactions (including the limited partnership agreement) which fulfill 1933 and 1934 Act requirements, and (3) it jolts personnel into the realization that they are in the securities business and into an awareness of the potential risks and liabilities for nonfeasance or misfeasance in that business.

Wertheimer, supra note 95, at 9 (emphasis in original).

267. See note 232 supra.

268. See 2 L. Loss, SECURITIES REGULATION 1298 (2d ed. 1961). The SEC has used three factors in deciding whether the selling representative is a “servant” of the issuer: (1) the selling representative is compensated by salary rather than commission; (2) the employer assumes responsibility for withholding federal income tax and social security tax; (3) the selling representative is employed both before and after the offering. In addition, SEC staff responses have suggested that selling representatives should have no significant background in the securities business and be primarily engaged in other activities than selling securities. SEC Div. of Trading & Markets No-Action Letter, The Woodmoor Corp. (Feb. 3, 1972), in [1971-1972 Transfer Binder] CCH SEC. L. REP. f 78,653.


limited partnership securities are especially pertinent to this Comment. *SEC v. A.J. Groesbeck Financial Advisors, Inc.* involved a California-based financial planning firm which, according to the SEC, was actually a "solicitation and sales conduit" for Groesbeck's real estate syndications.\(^{271}\) In the complaint's second cause of action, premised on violations of section 10(b) and rule 10b-5, the SEC alleged that although Groesbeck's clients "were generally physicians, dentists, corporate executives and other high income individuals,"\(^{272}\) some investors "were persons of low to medium income. In those instances, [defendants] have misrepresented the suitability of the investment for purposes other than tax shelter, and the risks involved."\(^{273}\) This litigation ended in a consent decree by which the corporate and individual defendants were permanently enjoined from, *inter alia*, "[t]he sale of securities without regard to their suitability to particular investors."\(^{274}\) Private suits against the same defendants are still pending.\(^{275}\)

Several years earlier, the SEC obtained another important consent judgment, this one from a major syndicator of orange grove properties. In *SEC v. American Agronomics Corp.*,\(^{276}\) the corporate and individual defendants were permanently enjoined from violating section 17(a) of the Securities Act of 1933,\(^{277}\) section 10(b) of the 1934 Act, and rule 10b-5. The most interesting feature of this decree, however, was the defendants' undertaking to make rescission offers to all persons "whose purchases of grove securities may have been unsuitable for [them] at the time of their purchases considering such factors as (i) annual gross income, (ii) net worth, (iii) income tax bracket, (iv) size of the investment in grove securities, (v) other investments, and (vi) any other relevant circumstances."\(^{278}\)

This post facto determination of investor suitability was accomplished by a survey conducted by independent certified public account-

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271. Civil No. 73-2678 (C.D. Cal., Jan. 21, 1974).
273. Plaintiff SEC's Complaint, supra note 272, at ¶ 27a.
274. Id. at ¶ 27a.
ants with the assistance of the SEC's Special Counsel. A comprehensive suitability questionnaire was mailed to each investor, and more than $2.5 million was ultimately returned to the investors who were deemed unsuitable. Among them was a retired pieceworker from Pennsylvania, who was 64 years old and making $60 per week at the time of her initial investment—an investment that obligated her to make $200 monthly payments for orange grove maintenance fees.

In addition to possible injunctive and disciplinary proceedings by the SEC, the sponsor and the selling representative, if affiliated with the NASD, can be disciplined by that body for violation of its suitability rule. As one commentator has observed, however, the NASD "rarely invokes the suitability rule alone; it usually raises the rule in a case where the broker-dealer is also disciplined for violations of the more mechanical net capital or bookkeeping rules, or where the broker-dealer's conduct has been so willful or grossly violative of the ethical rules as to amount to fraud in the legal sense." But in SEC review of NASD disciplinary proceedings in the "boiler-shop" cases, the Commission made it clear that once broker-dealers undertake to

280. Id.
281. Because the questionnaire could serve as a model for a conscientious syndicator's suitability inquiry, it is reproduced in pertinent part as an appendix to this Comment.
283. It should be noted, however, that even a sponsor who is clearly an issuer and thus exempted from the registration requirement of section 15(a) is not immune from SEC discipline. Section 15(b)(7) of the 1934 Act empowers the Commission to "censure any person, or bar or suspend for a period not exceeding twelve months any person from being associated with a broker or dealer" upon a finding that the sanction is in the public interest and that the person has, inter alia, violated any provision of the 1934 Act or any rule or regulation thereunder. 15 U.S.C. § 78o(b)(7) (1971) (emphasis added). By implication, then, a sponsor of a single intrastate real estate program, even though exempted as an issuer from the broker-dealer registration requirement, could be disciplined under section 15(b)(7) for making palpably unsuitable recommendations.
284. NASD discipline of its members is required by section 15A(b)(9) of the 1934 Act, 15 U.S.C. § 78o-3(b)(9) (1971); the Commission is authorized to review NASD disciplinary proceedings by sections 15A(g) and (h), id. §§ 78o-3(g)-(h). See 2 L. Loss, supra note 268, at 1371-80. NASD sanctions include censure, fine, suspension, expulsion, and revocation, but not the power to make the aggrieved investor whole. NASD Rules of Fair Practice art. V, § 11, CCH NASD MANUAL ¶ 2301 (1971).
287. NASD disciplinary actions are "subject to review by the Commission, on its own motion, or upon application by any person aggrieved thereby . . . ." 15 U.S.C. § 78p(g) (1971). Review procedures are set forth in section 15A(h) of the 1934 Act, id. § 78p(h).
recommend a particular security, they cannot shift the responsibility for determining suitability to the customer:

Whether or not customers Z and E considered a purchase of the stock . . . a suitable investment is not the test for determining the propriety of applicants' conduct . . . . The test is whether [the broker-dealer] fulfilled the obligation he assumed when he undertook to counsel the customers, of making only such recommendations as would be consistent with the customer's financial situation and needs. The record shows that [the broker-dealer] knew all the facts necessary to enable him to realize that reasonable grounds for his recommendations did not exist.288

If the sponsor and selling representative are not NASD members, they can be disciplined by the SEC289 for violations of the SECO rules, including rule 15b10-3,290 promulgated under section 15(b)(10) of the 1934 Act.291

B. Private Actions by Unsuitable Investors

In addition to sanctions imposed by state and federal securities regulators and by the NASD, there is growing judicial acceptance that an injured investor has the right to bring a private action against the sponsor and selling representative for recommending and allowing the investor to buy a security that is unsuitable, considering his or her par-


The NASD has wavered on the duty of the selling representative to take affirmative steps to learn about a prospective investor's financial background and needs. For example, it failed to discipline a well-known Wall Street brokerage firm which made sales of USAMCO, a highly speculative vending machine stock, to customers for whom such investment was patently unsuitable, leaving it to the SEC to impose sanctions. Shearson, Hammill & Co., SEC Securities Exchange Act Release No. 7743 (Nov. 12, 1965), in [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,306. (For criticism of the NASD's weak stand in this case, see SPECIAL STUDY, supra note 123, at 311-12.)


290. 17 C.F.R. § 240.15b10-3 (1974), reproduced at note 6 supra.

ticular financial situation, investment objectives, and needs. Three theories have been proposed by commentators—and adopted at least in part by the courts—to support such a private right of action: liability for violation of SECO or NASD suitability rules per se,292 liability under rule 10b-5 for suitability violations tantamount to fraud, and liability at common law for fraudulent or deceitful violations of the suitability doctrine. In addition, there may be a private right of action under state securities law, and it can also be argued that negligent suitability violations should give rise to liability.

I. Liability for Violation of SECO or NASD Suitability Rules Per Se

Although early advocates of the suitability doctrine293 perceived it as an ethical standard, violations of which would not—absent fraud—give rise to civil liability,294 commentators soon urged that compliance with suitability rules should be an express legal responsibility of broker-dealers.295

The case that sparked much of this discussion was Colonial Realty Corp. v. Bache & Co.,296 decided by the Second Circuit in 1966. In that case, plaintiffs sought recovery for losses suffered on margin calls, alleging that defendant's negligence in handling its account constituted

292. The same arguments have also been made for violation of stock exchange suitability rules. See Lowenfels, Implied Liabilities Based upon Stock Exchange Rules, 66 COLUM. L. REV. 12 (1966); cf. Wolfson & Russo, The Stock Exchange Member: Liability for Violation of Stock Exchange Rules, 58 CALIF. L. REV. 1120, 1129-32 (1970). Since stock exchanges are never involved in real estate limited partnership securities, however, their rules will not be discussed in this section, except insofar as the cases involving the "know your customer" rule may be used by analogy to support liability for NASD rule violations.

293. E.g., Mundheim, supra note 1.

294. Id. at 459-60, 463-72. Even the Supreme Court, however, has not hesitated to use an ethical standard to construct a legal duty in a proper case. See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963), which is also an extremely important case because of the Court's expansive view of the broad, remedial purposes of federal securities legislation.


Another approach to civil liability for violation of NASD or stock exchange rules is set forth in the second tentative draft of the American Law Institute's proposed Federal Securities Code. It would not rule out private liability; rather, it attempts to set up a procedure that would allow the SEC to guide the courts in their determinations of which association or exchange rules should support a private action. ALI FED. SECURITIES CODE § 1416 (Tent. Draft No. 2, 1973).

a failure to conduct its business in a manner "consistent with just and equitable principles of trade" as required by the NASD's general business conduct rule.\(^\text{297}\) The district court held unequivocally that plaintiffs had failed to state a federal claim;\(^\text{298}\) in affirming that judgment on its particular facts, Judge Friendly's opinion virtually reversed the district court's blanket denial of a private action. After summarizing the arguments for both sides, he wrote:

What emerges is that whether the courts are to imply federal civil liability for violation of exchange or dealer association rules by a member cannot be determined on the simplistic all-or-nothing basis urged by the two parties; rather, the court must look to the nature of the particular rule and its place in the regulatory scheme, with the party urging the implication of a federal liability carrying a considerably heavier burden of persuasion than when the violation is of the statute or an SEC regulation. The case for implication would be strongest when the rule imposes an explicit duty unknown to the common law.\(^\text{299}\)

Thus, although the court held that plaintiffs failed to state a claim by alleging a violation of the "catch-all"\(^\text{300}\) general business conduct provision of the NASD rules, it left room for courts to imply a private right of action in proper cases.

Since Colonial Realty, a number of courts have sought to give substance to Judge Friendly's test for implication.\(^\text{301}\) In Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,\(^\text{302}\) a 1969 decision that involved an alleged violation of the New York Stock Exchange's "know your customer" rule,\(^\text{303}\) the Seventh Circuit discussed Colonial

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\(^{298}\) See 358 F.2d at 180.

\(^{299}\) Id. at 182.

\(^{300}\) Id.

\(^{301}\) A California federal district court had the first opportunity to decide whether the suitability rule would support a civil action for damages, but it ruled in defendants' favor on grounds of estoppel, laches, and waiver and thus did not have to reach the suitability issue. Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N.D. Cal. 1968), modified on other grounds, 430 F.2d 1202 (9th Cir. 1970). The court, indicated, however, that it would have difficulty holding a broker-dealer civilly liable for violating the NASD suitability rule alone because "[c]onceivably, a broker might honestly think that his 'ground' for believing his recommendation 'suitable' is 'reasonable,' only to find himself overruled in a lawsuit and found guilty of fraud notwithstanding his good faith." 283 F. Supp. at 431 (dictum), citing Colonial Realty with apparent approval. But after a discussion heavy with suitability language, see id. at 433-35, the court held defendants liable under rule 10b-5 for excessive trading of plaintiff's commodity account and awarded her $439,520 in damages. Id. at 444. On appeal, damages were reduced to $296,520. 430 F.2d at 1212.

\(^{302}\) 410 F.2d 135 (7th Cir.), cert. denied, 396 U.S. 838 (1969).

Realty and, without expressly rejecting Judge Friendly's formulation, stated that "[t]he touchstone for determining whether or not the violation of a particular rule is actionable should properly depend upon its design 'for the direct protection of investors.'"\textsuperscript{804} The court concluded:

[O]ne of the functions of Rule 405 is to protect the public, so . . . permitting a private action for its violation is entirely consistent with the purposes of the statute.

We do not decide that an alleged violation of Rule 405 is \textit{per se} actionable. . . .

Although mere errors of judgment by defendant might not support a federal cause of action, the facts alleged here are tantamount to fraud on the [plaintiff], thus giving rise to a private civil damage action.\textsuperscript{805}

After \textit{Buttrey}, district courts in Illinois have denied a private right of action for violations of stock exchange rules in cases where actual fraud was not alleged.\textsuperscript{806} But in 1973 a New York district court found in \textit{Starkman v. Seroussi} that rule 405—unlike the general business conduct rule at issue in \textit{Colonial Realty}—"is precise and has among its purposes protection of the customer qua customer."\textsuperscript{807} Thus the alleged violation, failing to exercise due diligence in accepting orders for plaintiff's margin account, stated a federal claim for implied liability under sections 6 and 19 of the 1934 Act.\textsuperscript{808}

\textsuperscript{304} 410 F.2d at 142, quoting Lowenfels, \textit{Implied Liabilities Based upon Stock Exchange Rules}, 66 COLUM. L. REV. 12, 29 (1966). It should be noted, however, that Lowenfels termed the \textit{Colonial Realty} result "contrary to the central purpose of the statutory plan—the complete and effective protection of the investing public." \textit{Id.} at 23.

In another article published the same year, Lowenfels similarly advocated a private right of action for violations of NASD Rules of Fair Practice since they are "concerned primarily with protecting the interests of the investing public." Lowenfels, \textit{Private Enforcement in the Over-the-Counter Securities Market: Implied Liabilities Based on NASD Rules}, 51 CORNELL L.Q. 633, 651 (1966). He concluded:

The development of the law in this area of implied liabilities and remedies pursuant to the federal securities acts has undergone tremendous growth and expansion in recent years. Many courts have recognized that such growth is vital if the securities acts are to accomplish their avowed purpose of fully protecting the investing public. . . . To sustain private actions pursuant to NASD Rules of Fair Practice would be consistent with [the purpose of the NASD] as well as with the fundamental policies underlying the federal securities laws.

\textit{Id.} at 654-55.

\textsuperscript{305} 410 F.2d at 142-43. \textit{But cf.} Landy v. FDIC, 486 F.2d 139, 166 (3d Cir. 1973) (dictum) ("no indication that the SEC or the NYSE consider rule 405 part of the federal scheme to prevent fraudulent practices and protect investors").


\textsuperscript{308} \textit{Cf.} Reinhardt v. Rauscher Pierce Sec. Corp., 83 N.M. 194, 490 P.2d 240 (Ct. App. 1971) (negligent failure to sell customer's stock pursuant to oral "stop-loss" order
Several cases involving the NASD suitability rule have seemingly followed the Buttrey approach and denied a private right of action when violations short of fraud were alleged.\cite{800} Starkman v. Seroussi,\cite{310} however, might be read as analogous precedent for finding that alleged violations of NASD or SECO suitability rules—although falling short of fraud—would give rise to a private right of action under the Colonial Realty test.\cite{321}

could subject defendant to liability for plaintiff's loss, evidently under state law, although NASD rules discussed; summary judgment for defendant reversed).


\footnote{310. 377 F. Supp. 518 (S.D.N.Y. 1974).}

\footnote{311. Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 182 (2d Cir.), cert. denied, 385 U.S. 817 (1966), set out in text accompanying note 299 supra. Another analogous holding is SEC v. First Securities Co., 463 F.2d 981 (7th Cir.), cert. denied, 409 U.S. 880 (1972), which involved alleged violations of the NASD rule imposing on broker-dealers a duty to supervise their employees. See NASD Rules of Fair Practice art. III, § 27, CCH NASD MANUAL ¶ 2177 (1974). In First Securities, 15 claims by individuals totaling $972,500 were asserted against the assets of a brokerage firm in equitable receivership. The individuals had invested in a fraudulent escrow fund established by Nay, the president and principal shareholder of First Securities. He had kept his scheme a secret for 15 years by doing most of the "escrow" business in his own handwriting and by imposing a rule that no one else in the firm was to open his mail. The court found that the defendant brokerage firm "wilfully allowed Nay's enforcement of a rule . . . antithetical to the prevention of frauds of the type which occurred." 463 F.2d at 988. It concluded:

> We have no doubt that the enforcement of Nay's rule . . . is sufficient without more to constitute a violation of Rule 27. Such violations provide a basis for private damage actions where the rule violated serves to protect the public. . . . First Securities is properly liable for Nay's fraud because of its violation of Rule 27 of the N.A.S.D.

Id. at 988 (citations omitted). Thus, although Nay's conduct was admittedly fraudulent, the defendant brokerage firm's acts were at most "wilful," but this was sufficient to support the investors' claims against the firm. It is not difficult to imagine suitability violations which could cross that threshold.

It should also be noted that private rights of action have been implied under provisions of the 1934 Act having little to do with fraud. See Comment, Securities Exchange Act of 1934—Civil Remedies Based upon Illegal Extensions of Credit in Violation of Regulation T, 61 Mich. L. Rev. 940 (1963) and cases cited therein. It is true that the regulatory and self-regulatory structure established for stock exchanges and their members by the 1934 Act differs from the largely self-regulatory treatment given broker-dealers. Compare, e.g., sections 6 and 19 of the 1934 Act, 15 U.S.C. §§ 78f, 78s (1970), with sections 15 and 15A, id. §§ 78o, 78o-3. The SEC, however, now has explicit statutory authority to regulate broker-dealers who are not NASD members, id. § 78o(b)(8)-(10), power that may have as profound an effect on SECO broker-dealers as its power to force changes in stock exchange rules and regulations, id. § 78s(b), may have on stock exchange member firms. Thus it seems anomalous either to allow a private action for violation of stock exchange rules but not broker-dealer suitability rules, or to allow

Another Seventh Circuit case clearly illustrates the nexus between suitability rules and the antifraud provisions of the federal securities acts, and shows the judicial tendency to subsume the former under the commodious umbrella of the latter. In Avern Trust v. Clarke, such an action for violation of SECO suitability rules but not for NASD suitability rules, despite nuances of statutory construction that might initially suggest making either distinction. See Shipman, supra note 295, at 963-89.

In part, judicial development of the suitability doctrine under the antifraud provisions can be traced back to Judge Clark's landmark opinion in Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944), upholding revocation of a broker-dealer's registration for its failure to disclose to customers—"almost entirely single women or widows who knew little or nothing about securities or the devices of Wall Street," id. at 435—the large markup it was taking on securities transactions. Formulating what was later called the "shingle theory," Judge Clark stated:

The key to the success of all of petitioner's dealings was the confidence in itself which it managed to instill in the customers. Once that confidence was established, the failure to reveal the mark-up pocketed by the firm was both an omission to state a material fact and a fraudulent device.

We need not stop to decide, however, how far common-law fraud was shown. For the business of selling investment securities has been considered one peculiarly in need of regulation for the protection of the investor. "The business of trading in securities is one in which opportunities for dishonesty are of constant recurrence and ever present. It engages acute, active minds, trained to quick apprehension, decision and action." We need not decide whether the fraud practiced by the defendant is ordinary and hence actionable as a common-law fraud or whether it is a fraud in excess of the requirements of common-law fraud and hence actionable as a violation of the Act.

The essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do.

The applicability of this doctrine to disciplinary proceedings is "unquestioned," but its availability in a private action is less certain. Jacobs, The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers, 57 Cornell L. Rev. 869, 880 (1972). There is language in one Second Circuit case that a broker's implied representation of an adequate basis for his opinions "may not be as rigidly enforced in a civil action where an investor seeks damages for losses allegedly caused by reliance upon . . . unfounded representations." Hanly v. SEC, 415 F.2d 589, 596-97 (2d Cir. 1969) (dictum). However, in Newkirk v. Hayden, Stone & Co., Civil No. 2932-SD-C (S.D. Cal., Sept. 30, 1965), in [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,621, at 95,321, a California federal district court stated—after discussing the extent to which the naïve plaintiff had relied on his broker's recommendations—that "if a violation of the Act can subject a violator to loss of his license it should justify an action for damages."

As one commentator has pointed out, the shingle theory "is a fiction; the representation is implied and then liability is imposed" when the duty created by the shingle theory is found to have been breached. Jacobs, supra, at 880. "A more direct method would be to hold that a broker violates 10b-5 if he engages in proscribed acts, without going through the gymnastics required by the shingle theory." Id.

For shingle-theory disciplinary cases involving suitability, see, e.g., Best Securities, Inc., 39 S.E.C. 931, 933-34 (1960) (mass sales by telephone, without suitability determi-
the court of appeals, citing Buttrey,314 concluded that the district court's dismissal of a cause of action based on an alleged violation of the NASD suitability rule was improper, since the claimed conduct was fraudulent, but went on to hold that the dismissal had not prejudiced plaintiffs' case315 since the same theory was incorporated under their claim for violation of the antifraud provision of section 15 of the 1934 Act.316 Thus Avern Trust confirmed what earlier decisions317 had implied: a suitability violation tantamount to fraud would be actionable under the antifraud provisions.

Bearing in mind that development of civil liability under the antifraud provisions of federal securities law for violation of the suitability doctrine is still in its infancy,318 it is necessary to discuss its applicability to real estate syndication. There are several considerations which suggest that allowing a private action for suitability violations in this area would be particularly appropriate. Fraud has been implied from non-disclosure in situations where the special relationship between the two parties raises a duty to disclose,319 and there are many aspects of real estate syndication from which such a special relationship can be constructed. For one thing, real estate programs are often extremely complex—so complex that the average investor will probably be unable to evaluate the desirability of investment without expert guidance. To the extent that an investor does not obtain independent advice,320 he or she may well rely on the apparent expertise of the person selling the program. When that person is affiliated with the program's sponsor, who in its capacity as general partner will occupy a fiduciary relationship with the limited partners as to matters concerning management of the program,321 it is understandable that an investor unschooled in

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313. 415 F.2d 1238 (7th Cir. 1969).
315. Plaintiffs lost their suit, in which they sought compensatory damages of $152,500 and punitive damages of $295,000, after a jury trial. 415 F.2d at 1239.
316. Id. at 1242.
317. See notes 301-06, 309 supra and accompanying text.
318. See text accompanying notes 347-48 infra.
320. As will be remembered, the California suitability rules allow the sponsor and selling representative to use the prospective investor's access to advice from qualified sources as evidence of the investor's capacity of understanding the program. 10 Cal. Admin. Code § 260.140.112.2(b)(1)(iii) (1973). It may well be asked, however, assuming that the investor does seek such counsel, how well equipped the average attorney or tax accountant is to advise on investment in real estate programs, especially when asked to opine on the merits of one particular program vis à vis another.
recognizing conflicts of interest will repose in the selling representative an especially high degree of trust and confidence. This might also be true if the selling representative were associated with a major brokerage firm and held himself or herself out as a specialist in real estate investment.

Moreover, there are some obvious instances in the syndication field when sale of a particular program to an individual investor would be so grossly inappropriate as to be fraudulent. For example, rule 10b-5 should be invoked when a sponsor or selling representative upon whom the investor is justifiably relying induces a person in a relatively low tax bracket to purchase program interests that would be suitable only for someone greatly in need of tax shelter.

A hypothetical case may be useful to show how the two interrelated theories outlined in the last half-dozen paragraphs should be applied in the context of real estate syndication. Assume that Carolyn and David, spurred on by the sponsor's enthusiastic sales presentation, decide to follow up on their interest in real estate investment. After a visit from the sponsor's selling representative, who "evaluates" all relevant information about their financial conditions and needs and pronounces them ideally suited for investment in the sponsor's current syndication offering, Carolyn and David spend an evening studying the prospectus, then decide to invest.

322. The biggest conflict of all, of course, is that between the sponsor's and selling representative's "professionalism" and their desire to market their program. See Mundheim, supra note 1, at 446-47. For a description of other conflicts of interest between sponsor and investor, see 10 Cal. Admin. Code §§ 260.140.114.1-114.3 (1973).

323. Reliance of a relatively unsophisticated person upon one with much greater sophistication may be a key element of a 10b-5 action. Compare Phillips v. Reynolds & Co., 294 F. Supp. 1249, 1251, 1255-56 (E.D. Pa.), motions for new trial and to amend findings dismissed, 297 F. Supp. 736 (E.D. Pa. 1969) (plaintiff, a graduate of the Wharton School and an experienced speculator, did not rely on an assumption of current profitability of unseasoned company when broker omitted disclosure of its $9 million deficit), with Affiliated Ute Citizens v. United States, 406 U.S. 128, 152-53 (1972), rev'g in pertinent part Reyos v. United States, 431 F.2d 1337 (10th Cir. 1970) (Indians selling shares of stock in development company entitled to rely on bank and its employees, who were entirely familiar with market for stock, were so considered by the Indian sellers, and had represented to the Indians that "the bank would be acting for the individual stockholders;" 10b-5 claim stated even in absence of material misrepresentations).


325. See text preceding note 165 supra.


327. Assume the selling representative examines recent tax returns and inquires as to their net worth as the presumptive standard requires.

328. After their study of the offering document, Carolyn and David do not understand various aspects of the program. They ask the selling representative about these
Two years later the syndication begins to go sour. The SEC announces that it is investigating. Carolyn and David, unaware until they read in the newspaper of the SEC's interest that their program is in serious financial straits, consult an attorney with a strong tax, real estate, and securities law background. They then discover that the program into which they put the bulk of their investment dollars was a highly speculative venture designed primarily to afford tax shelter to persons in high tax brackets. A sophisticated reader of offering documents could have discerned this from the prospectus, but Carolyn and David did not.footnote

First, assume that the program was sold in interstate commerce by NASD broker-dealers, including the sponsor. Assume further that Carolyn and David bring suit in federal district court against the sponsor and selling representative. Their complaint states several causes of action: one premised on liability for violation of the NASD suitability rule,footnote one premised on liability under rule 10b-5 for suitability violations tantamount to fraud, one premised on liability for violation of section 12(2) of the 1933 Act,footnote and also a cause of action for common law fraud based on the court's pendent jurisdiction.

What should be the result? Under Judge Friendly's Colonial Realtyfootnote test, the strongest case for implied liability for violation of an NASD rule is "when the rule imposes an explicit duty unknown to the common law."footnote The NASD suitability rule clearly imposes such a duty—that, in recommending a security transaction, the member "shall have reasonable grounds for believing that his recommendation is suitable . . ."footnote—although the scope of the duty lacks definition. It is

and are further assured that the program makes economic sense for them. Cf. Anderson v. Knox, 297 F.2d 702 (9th Cir. 1961), cert. denied, 370 U.S. 915 (1962).

329. It may well be that the prospectus or the sales presentation contained other material misstatements or omissions, further exposing the sponsor and selling representative to liability under the securities laws.

330. If the sponsor were a SECO broker-dealer instead of an NASD member, the complaint would allege violation of the SECO suitability standard, rule 15b10-3, 17 C.F.R. § 240.15b10-3 (1974), set out at note 6 supra. If the sponsor and selling representative were not required to register as broker-dealers, see text accompanying notes 263-68 supra, this cause of action would be eliminated since they would not be governed by either NASD or SECO rules. The rules might have some utility, however, as evidence of what standards a responsible seller of securities would follow. See Mercury Investment Co. v. A.G. Edwards & Sons, 295 F. Supp. 1160, 1163 (S.D. Tex. 1969) (dictum); Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 69 Cal. Rptr. 222 (1st Dist. 1968).


333. Id. at 182.

perhaps this vagueness of the suitability doctrine that led a California federal district court in Hecht v. Harris, Upham & Co.\textsuperscript{886} to declare in dictum that it would have difficulty holding a broker-dealer civilly liable for violating the NASD suitability rule because "[c]onceivably, a broker might honestly think that his ‘ground’ for believing his recommendation ‘suitable’ is ‘reasonable,’ only to find himself overruled in a law suit . . . ."\textsuperscript{886}

This dictum should be rejected. In the first place, it confuses the broker-dealer’s honest belief, a subjective test, with the proper objective test—whether a reasonable broker-dealer would have made a similar recommendation under the same circumstances. That the pure-hearted but empty-headed broker-dealer believed in the suitability of a recommendation is unlikely to produce a test consonant with the investor-protection goals of the suitability doctrine, and it is plainly not the test prescribed by the NASD. Even if this improper view of the test were to be followed, however, it is inapplicable to the facts of Carolyn and David’s case, in which the sponsor and selling representative, with full knowledge that their program’s primary value was as a tax shelter, nevertheless recommended it to persons whose need for tax shelter was minimal.

Moreover, federal courts that have squarely confronted the suitability problem have not taken the approach suggested by the Hecht dictum. Whether they denied a private action for suitability violations falling short of fraud\textsuperscript{887} or allowed a private action founded on broker-dealer negligence,\textsuperscript{888} it is clear that other courts have correctly interpreted suitability rules as requiring that the recommendation of a security be tested by an objective “reasonable broker-dealer” standard. The recommendation made to Carolyn and David should not pass that test.

In Wells v. Blythe & Co.,\textsuperscript{889} another California federal district court held that allegations of negligence alone were insufficient grounds for federal jurisdiction over a cause of action based on violation of the NASD suitability rule. Since Wells involved a claim that the broker-dealer negligently failed to recommend that plaintiff sell a security, it should not be read as precedent for a cause of action based on an unreasonable recommendation actually made to a customer.\textsuperscript{840}

\textsuperscript{335.} 283 F. Supp. 417 (N.D. Cal. 1968), modified on other grounds, 430 F.2d 1202 (9th Cir. 1970).
\textsuperscript{336.} 283 F. Supp. at 431 (dictum).
\textsuperscript{337.} See cases cited at note 309 supra.
\textsuperscript{339.} 351 F. Supp. 999 (N.D. Cal. 1972).
\textsuperscript{340.} In fact, it could be persuasively argued that failure to recommend sale of a security is outside the purview of the NASD suitability rule, which only speaks to recommendations actually made.
The court in *Wells* did indicate, however, that it approved of the Seventh Circuit's approach in allowing a private action for a suitability violation tantamount to fraud.

Thus a California federal court might well decide that a suitability violation per se would not give rise to private liability. Carolyn and David's claim, however, goes far beyond an inadvertent or negligent violation of suitability rules. The sponsor and selling representative recommended to Carolyn and David as suitable for their particular circumstances a real estate program which was in fact suitable only for persons to whom immediate tax shelter offered such potent benefits that they would be willing (and, of course, able) to risk the ultimate loss of their entire investment. That Carolyn and David were not such investors was patently obvious. Their need for tax shelter was minimal; their net worth was not great enough that they could willingly take the risks involved when the benefits to them were so slender. In such a case, the recommendation of the sponsor and selling representative should be regarded as a fraudulent misstatement under rule 10b-5.

Whatever the *scienter* requirement of rule 10b-5, it should be satisfied by the sponsor's and selling representative's callous disregard of Carolyn and David's lack of suitability for their program. Moreover, drawing on the *Affiliated Ute* case, it should be held that Carolyn and David justifiably relied on the improper recommendation. Since their investment in the program was triggered by the recommendation, the causation element of a 10b-5 action is also satisfied. In short, the sponsor and selling representative should be liable to Carolyn and David for the damages caused them by the recommendation of unsuitable securities. Since Carolyn and David still have their program inter-

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341. 351 F. Supp. at 1001.


343. Such a holding would be consistent with the results generally reached elsewhere. See cases discussed in text accompanying notes 296-311 *supra*.

344. Compare *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442, 445 (2d Cir. 1971) (no 10b-5 cause of action "in the absence of allegation of facts amounting to *scienter*, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud"), with *White v. Abrams*, 495 F.2d 724, 734-36 (9th Cir. 1974) (adopting flexible duty standard; where defendant derives great benefit from confidential relationship with plaintiff and knows plaintiff is relying upon defendant for information to which the latter has ready access, rule 10b-5 imposes a duty of extreme care with liability for breach). Commentators have argued that rule 10b-5 should be interpreted as permitting a private action for negligence in securities transactions, but few courts have so held. See note 353 *infra*.

ests, the proper measure of damages is rescission.  

The elements of Carolyn and David's hypothetical suit are among those that make real estate syndication an especially attractive target for private liability under rule 10b-5 when suitability rules are callously breached. As Professor Bromberg has written in his authoritative work on rule 10b-5, the requirement that a broker-dealer's recommendation be suitable is still "embryonic." But, he hastened to add, "it takes no great prophet to foresee a closer connection between suitability and the fraud rules." In the area of real estate syndication, the connection should be easily perceived.

3. Liability for Negligent Suitability Violations: An Unexplored Middle Ground

Imposing civil liability for a fraudulent suitability violation, such as that involved in the hypothetical case of Carolyn and David just discussed, is fully supported by existing judicial precedent; imposing civil liability for a negligent violation raises far more difficult questions which have yet to be answered definitively. Strong arguments favoring liability for violation of suitability rules per se have been advanced by commentators—arguments that a fortiori would support imposition of liability to an injured investor for a negligent violation of those rules—but the courts have almost uniformly denied liability for a nonfraudulent suitability violation.

In part, this judicial reluctance may be attributable to the fact that there is no comprehensive legal definition of suitability. It is, of course, only through confronting the borderline cases, involving possibly negligent but not fraudulent recommendations, that courts will be able to articulate a viable suitability formulation. Thus the problem may well lie in the judicial reluctance to break new ground itself, rather than in any inherent difficulty of the investor suitability terrain.

There is, however, an argument based on section 12(2) of the Securities Act of 1933 (the 1933 Act) which suggests that implied liability for negligent suitability violations, especially in the area of real estate syndication, may not be such unfamiliar territory. Although

346. For a discussion of the measure of damages in 10b-5 actions, see 3 BROMBERG, SECURITIES LAW: FRAUD 225-29 (1967).
347. 1 id. § 5.4, at 99 (1973).
348. Id. at 99-100.
349. See articles cited at note 295 supra.
350. See text accompanying notes 302-17 supra.
351. See text accompanying notes 124-26 supra.
353. Commentators have also argued that rule 10b-5 itself should permit a private action for negligent misrepresentations. Epstein, The Scienter Requirement in Actions
section 12(2) is customarily considered among the antifraud provisions of the 1933 and 1934 Acts, by its terms it sets a negligence standard:


In fact, however, only a handful of cases have indicated that a 10b-5 private action will lie for negligent conduct. In Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961), the Ninth Circuit rejected defendant's contention that plaintiff must allege and prove "genuine fraud, as distinct from 'a mere misstatement or omission,'" id. at 274, but the import of the statement was uncertain since fraud was in fact alleged. In the Ninth Circuit's most recent 10b-5 decision, however, the court explained that the Ellis language was not intended to create either an absolute liability or a negligence standard for all cases. White v. Abrams, 495 F.2d 724, 734 (9th Cir. 1974). Instead, Judge Wallace announced a flexible duty analysis which would look to the extent of the duty that rule 10b-5 imposes on a particular defendant in a particular factual setting.

In making this determination the court should focus on the goals of the securities fraud legislation by considering a number of factors that have been found to be significant in securities transactions.

. . . [W]e feel the [trial] court should, in instructing on a defendant's duty under rule 10b-5, require the jury to consider the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question.

While giving examples in the nature of generalization is fraught with dangers, we do so by way of guidance. Where the defendant derives great benefit from a relationship of extreme trust and confidence with the plaintiff, the defendant knowing that plaintiff completely relies upon him for information to which he has ready access, but to which plaintiff has no access, the law imposes a duty upon the defendant to use extreme care in assuring that all material information is accurate and disclosed. If the defendant has breached this duty he is liable under rule 10b-5, provided the other elements of materiality, causation and damages are established. On the other hand, where the defendant's relationship with the plaintiff is so casual that a reasonably prudent person would not rely upon it in making investment decisions, the defendant's only duty is not to misrepresent intentionally material facts. Under this standard the duty to investigate and disclose material facts will necessarily vary according to the fact situation.

Id. at 735-36 (heading and footnotes omitted).

Other courts have followed the Ninth Circuit's lead in appearing to dispense with the scienter requirement. E.g., Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965). In an Eighth Circuit case, City Nat'l Bank v. Vanderboom, 422 F.2d 221, 229-30 (8th Cir.), cert. denied, 399 U.S. 905 (1970), there is an explicit statement, although it probably should be regarded as dictum, that negligent conduct is sufficient for a 10b-5 action. The Second Circuit, however, which is generally regarded as having the most influence on the development of securities law, has staunchly refused to eliminate scienter. E.g., Cohen v. Franchard Corp., 478 F.2d 115, 122-24 (2d Cir.), cert. denied, 414 U.S. 857 (1973) (rejecting plaintiffs' claim that real estate syndicate promoters were liable under
Any person who . . . offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such securities from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.\footnote{854}

Section 12(2)'s plain requirement of privity between plaintiff and defendant, as well as its generally shorter statute of limitations\footnote{855} and stiffer venue provisions,\footnote{866} have made 10b-5 actions more attractive to investors injured as a result of typical transactions in the securities markets. Thus the development of section 12(2) has been truncated\footnote{857} in favor of rule 10b-5.


\footnote{855}{354. 15 U.S.C. § 77l(2) (1971) (emphasis added). The section has, however, occasionally been read as preserving "some form of the traditional \textit{scienter} requirement." Barnes v. Ososfky, 373 F.2d 269, 272 (2d Cir. 1967).

\footnote{856}{Section 13 of the 1933 Act provides:

No action shall be maintained to enforce any liability created under . . . section 12(2) unless brought within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence . . . . In no event shall any such action be brought to enforce a liability created under . . . section 12(2) more than three years after the sale.

15 U.S.C. § 77m (1971). Rule 10b-5 actions, on the other hand, are generally governed by the state statute of limitations applicable to the type of action most closely resembling a 10b-5 claim, since the 1934 Act has no statute of limitations for section 10(b). This may well result in a longer statute of limitations, especially since under the federal tolling doctrine the statute is often held not to begin running until the plaintiff discovers the fraud. \textit{E.g.}, Janigan v. Taylor, 344 F.2d 781, 784 (1st Cir.), \textit{cert. denied}, 382 U.S. 879 (1965) ("where fraud is involved the cause of action is, so-to-speak, automatically concealed, and does not arise until discovery"). \textit{See} Ruder & Cross, \textit{Limitations on Civil Liability Under Rule 10b-5}, 1972 DUKE L.J. 1125, 1142-50.

\footnote{856}{Compare section 22(a) of the 1933 Act, 15 U.S.C. § 77v(a) (1971), with section 27 of the 1934 Act, \textit{id.} § 78aa.

\footnote{857}{For example, in Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 787 (2d Cir. 1951), Judge Frank overlooked section 12(2) entirely when he stated that in the absence of a 10b-5 action plaintiffs "would have no redress whatever under the statute."}
In many real estate program sales, however, the privity requirement of section 12(2) would be satisfied, since the investor often deals directly with the sponsor or at least indirectly through a selling representative connected with the sponsor. (This was true in Carolyn and David's hypothetical case—and their discovery of the suitability violation two years after the sale would give them ample time to file an action before the three-year statute of limitations had run.) It can therefore be argued that even a negligent failure to discern an investor's unsuitability for a particular syndication should subject the seller to civil liability under section 12(2), either for an oral communication including an untrue statement of a material fact (if the sponsor or selling representative represented to the investor that the program was suitable) or an oral communication omitting to state a material fact (if the sponsor or selling representative made no mention of suitability).

Under the flexible duty analysis recently articulated by the Ninth Circuit in *White v. Abrams*, liability for many negligent suitability violations could also be imposed under rule 10b-5. Particularly when an investor purchases a real estate program interest from the sponsor or a representative of the sponsor, under circumstances in which it is clear that the prospective investor is relying upon the sponsor's superior knowledge and representations of suitability, it would seem that the approach laid out in *White* would set a duty of extreme care for which 10b-5 liability should be imposed upon proof of a negligent breach.

Judicial enforcement, including imposition of civil liability upon those who injure investors, is a necessary element of effective securities regulation. The broad reading of rule 10b-5 to offer investors more protection than that afforded by the common law fraud doctrine reveals the significance many courts attribute to private liability in providing meaningful protection for the investing public. Section 12(2) should be interpreted in the same manner. When the duties imposed on persons selling securities are clearly articulated and specifically designed to protect investors, as they increasingly are in the area of investor suitability standards, courts should consider imposing civil liability for their careless but nonfraudulent violation—either through an expansion of liability, express as well as implied, for violations of the securities laws or by application of common law negligence principles.

Naturally, courts should proceed cautiously, establishing the boundary separating suitable from unsuitable recommendations on a case-by-case basis. That these determinations must typically be made after the fact of investment failure should not prevent courts from un-

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358. 495 F.2d 724, 734-36 (9th Cir. 1974), reprinted in pertinent part at note 353 *supra*.

359. See note 353 *supra*. 
dertaking this line-drawing process—for there would seem to be nothing in an unsuccessful business venture requiring a different analytical approach from that already used, necessarily post facto, to award damages for injuries caused by an incautious driver, a careless physician, or a defective product. That suitability violations cause primarily economic rather than physical or psychological injury may be important in measuring the liability to be imposed, but it should not deter courts from deciding whether there should be liability. The related goals of investor protection and investor confidence underlying the entire process of securities regulation—the latter goal particularly important in a time of pronounced economic uncertainty—would seem to be importantly promoted by judicial development of the suitability doctrine, including imposition of civil liability for negligent violations of investor suitability rules. Improving suitability guidelines promulgated by securities regulators should simplify and encourage the judicial task.

4. Liability for Suitability Violations Under California’s Securities Laws

California’s Corporate Securities Law of 1968 provides for private actions under limited circumstances. Based on section 12(2) of the 1933 Act and one prong of rule 10b-5, section 25401 makes it unlawful, inter alia, to sell a security “by means of any written or oral communication which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statement made . . . not misleading.” Section 25501 authorizes private suits for rescission or damages for violations of section 25401, unless the defendant proves that the plaintiff knew the facts or “that the defendant exercised reasonable care and did not know (or if he had exercised reasonable care would not have known) of the untruth or omission.” It would seem that representing a real estate program

360. Indeed, the relative certainty with which the economic injury can be measured and the relative ease with which damage awards can be limited to actual out-of-pocket loss militate in favor of imposing liability.
361. Other primarily economic torts are beginning to receive judicial recognition. See W. PROSSER, LAW OF TORTS 927-69 (4th ed. 1971).
362. “Except as explicitly provided in this chapter, no civil liability in favor of any private party shall arise against any person by implication from . . . violation of any provision of this law or any rule or order hereunder.” CAL. CORP. CODE § 25510 (West Supp. 1974).
363. Id. § 25401.
364. Id. § 25501. The measure of damages is specified:
   Upon rescission, a purchaser may recover the consideration paid for the security, plus interest at the legal rate, less the amount of any income received on the security, upon tender of the security. . . . Damages recoverable under this section by a purchaser shall be an amount equal to the difference between (a) the price at which the security was bought plus interest at the legal rate
security as suitable—or failing to disclose its unsuitability—when the seller knows or should know that it is, in fact, patently unsuitable for a particular investor should subject the seller to liability pursuant to section 25501. Moreover, section 25504 provides for joint and several liability of persons who control a person liable under section 25501. This section could subject the sponsor and its principal officers to civil liability when its employees market syndication securities without regard to their suitability. In fact, however, these sections have almost never been used, no doubt because of the attractiveness of federal securities remedies such as rule 10b-5 and their broad availability to injured investors.

from the date of purchase and (b) the value of the security at the time it was disposed of by the plaintiff plus the amount of any income received on the security by the plaintiff. . . . Any tender specified in this section may be made at any time before entry of judgment.

Id.

365. But cf. 1 MARSH & VOLK, supra note 7, §§ 14.02-03, where the two principal architects of California's Corporate Securities Law of 1968 give their interpretation of its provisions for civil liability. To Marsh and Volk, the decision in Twomey v. Mitchum, Jones & Templeton, Inc., 262 Cal. App. 2d 690, 69 Cal. Rptr. 222 (1st Dist. 1968), discussed in text accompanying notes 380-92 infra, "raised some disturbing questions" on the effectiveness of their attempt to limit private actions to claims based on strict common law fraud, traditional equitable principles, or violation of the specific provisions of the Corporate Securities Law of 1968 that expressly give rise to civil liability.

1 MARSH & VOLK, supra note 7, § 14.02[2].

366. That section provides:

Every person who directly or indirectly controls a person liable under Section 25501 or 25503, every partner in a firm so liable, every principal executive officer or director of a corporation so liable, every person occupying a similar status or performing similar functions, every employee of a person so liable who materially aids in the act or transaction constituting the violation, and every broker-dealer or agent who materially aids in the act or transaction constituting the violation, are also liable jointly and severally with and to the same extent as such person, unless the other person who is so liable had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability is alleged to exist.

Id. § 25504.

367. The jurisdictional minimum for a 10b-5 claim is that the seller use, in connection with any phase of the offer or sale, "any means or instrumentality of interstate commerce or of the mails. . . ." Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1971). Most courts have read this requirement expansively. E.g., Myzel v. Fields, 386 F.2d 718, 727-28 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968) (use of telephone only on intrastate basis in solicitation of purchase of plaintiffs' stock was sufficient to give jurisdiction over 10b-5 action, although mails were also used). A few courts, however, have refused to find jurisdiction when the ties to interstate commerce were extremely tenuous. Dupuy v. Dupuy, 375 F. Supp. 730, 736 (E.D. La. 1974) (intrastate telephone calls between two brothers, who lived in same apartment complex, regarding sale of plaintiff's stock, was not the use of an instrumentality of interstate commerce); Burke v. Triple A Machine Shop, Inc., 438 F.2d 978, 979 (9th Cir. 1971) (per curiam) (two local telephone calls to defendant corporations' counsel, in connection with alleged purchase of plaintiff's stock by impermissible means, did not constitute use of instrumentality of interstate commerce).
5. Common Law Liability for Suitability Violations

As a "powerful analogy for treating an unsuitable recommendation as fraudulent [under 10b-5],"\(^{368}\) Professor Bromberg pointed to the case of *Anderson v. Knox*.\(^{369}\) That case is also a powerful analogy for according recovery at common law to an unsuitable investor in a real estate program. This part will explore the existence of a common law remedy for suitability violations, emphasizing California precedent for such a cause of action.

In *Anderson v. Knox*, a life insurance agent sold bank-financed life insurance policies of $100,000 to Knox and his wife. At the time of the sale Knox was a field superintendent of a Maui sugar plantation making $8,100 per year; Mrs. Knox was a housewife. The Ninth Circuit affirmed the trial court's holding that Anderson's expressed opinion of the plan's suitability for the Knoxes was made fraudulently and with intent to deceive,\(^{370}\) and it upheld the trial court's award of $13,309 compensatory damages, $10,000 punitive damages under Hawaii decisions allowing such damages for the willful, oppressive, or wanton commission of a tort,\(^{371}\) plus $2,500 damages for mental suffering.\(^{372}\)

There are a number of factors used by the court in *Anderson v. Knox* that could also support a recovery at common law—and, by analogy, under the securities laws—in the real estate syndication context. Like many tax sheltered real estate programs, the insurance program sold to the Knoxes was suitable only for persons in high tax brackets.\(^{373}\) Also like many real estate programs, the plan sold the Knoxes was extremely complicated. Even Anderson's associate, himself an insurance agent, testified that he could not understand the schedules Anderson prepared.\(^{374}\) And like the manner in which at least some real estate programs are sold,\(^{375}\) Anderson represented himself as particularly well

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368. 1 A. Bromberg, Securities Law: Fraud § 5.4, at 100 n.35.
370. 297 F.2d at 727.
371. Id. at 728.
372. Id. at 729-31.
373. Id. at 704-05. The court found that Knox was in the 26 percent tax bracket (id. at 705), with little prospect (id. at 718-19) of ever reaching the 50 percent bracket one expert named as the lowest bracket for which a bank-financed insurance plan could be justified. Id. at 715.
374. Id. at 709.
qualified to devise a suitable insurance plan for the Knox family—a representation on which, the court found as a matter of law, Knox was fully entitled to rely. In its discussion, the court indicated that, given the program’s complexity and the customers’ relative lack of sophistication, Anderson was responsible for determining whether or not the investment was suitable and could not shift this responsibility to the prospective buyer.

In California, the existence of a common law remedy for suitability violations in securities transactions has been judicially recognized. Twomey v. Mitchum, Jones & Templeton, Inc. affirmed a damages award against a brokerage firm and its local manager, Nankin, to a widow who had entrusted more than $50,000 to Nankin, telling him that the funds were ‘‘nonreplaceable’ and that ‘he was to take them and to see that I would have a good income from them.’’ For more than three years defendants managed her account in what the trial court found to be a careless and negligent manner, engaging in a course of excessive trading and purchasing securities for her which they knew were highly speculative with little prospect of income, despite their awareness that she was a widow who needed steady income.

After an extensive discussion of the state court’s subject matter jurisdiction—presumably in response to defendants’ argument that if plaintiff had stated a claim at all, it fell within the exclusive jurisdiction of the federal courts—the court of appeal concluded that Cali-

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376. 297 F.2d at 707-11.
377. Id. at 711, quoting W. Prosser, Law of Torts 552 (2d ed. 1955), who in turn quoted the famous statement of the Vermont Supreme Court that “[n]o rogue should enjoy his ill-gotten plunder for the simple reason that his victim is by chance a fool.” Chamberlin v. Fuller, 59 Vt. 247, 256, 9 A. 832, 836 (1887).
378. 297 F.2d at 707-11.
379. Id. at 711.
381. Id. at 713, 69 Cal. Rptr. at 239.
382. Id. at 696, 69 Cal. Rptr. at 228.
383. The trial court also found that defendants sold plaintiff securities in which they acted as principal without disclosing that fact. Id. at 696, 69 Cal. Rptr. at 228. Plaintiff, however, did not expressly seek recovery of defendants’ profits on those transactions, and the court of appeal treated this finding as “a portion of the web of circumstances” tending to show defendants’ “indifference to the fiduciary duty owed to a client whose funds they controlled.” Id. at 715, 69 Cal. Rptr. at 240.
384. Id. at 697, 69 Cal. Rptr. at 228.
385. Id. at 697-707, 69 Cal. Rptr. at 228-35.
386. Section 27 of the 1934 Act grants the federal courts “exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability created by this chapter or the rules and regulations thereunder.” 15 U.S.C. § 78aa (1970).
fornia state courts could decide cases such as *Twomey*.\(^{887}\) It then proceeded in two steps to affirm the award below. First, it stated:

The trial court was warranted in finding that the defendants acted improperly, fraudulently, in breach of the fiduciary relationship, and negligently, in the performance of their fiduciary duties in handling plaintiff's investment account. Plaintiff's evidence establishes that defendants took over for her account the management and control of the funds and securities entrusted to them. Under these circumstances they owed her a duty to ascertain her financial situation and needs. They neglected to do so, and engaged in a course of trading which was excessive in frequency and unsuitable in quality for one in the situation of plaintiff.\(^{888}\)

Second, it specifically adopted the suitability guidelines suggested by Professor Mundheim\(^{389}\) "as a standard of conduct for a broker-dealer who undertakes to control the customer's account."\(^{890}\) The court quickly turned the proposed ethical standard\(^{391}\) into a rule of law, noting in the process that "[i]t would be inconsistent to suggest that a person should be defrocked as a member of his calling, and yet not be liable for the injury which resulted from his acts or omissions."\(^{392}\)

*Twomey* involved several elements—in particular, the broker's discretion over *Twomey*'s account and the excessive trading—that would not be involved in a claim based on the unsuitability of a real estate program, but the case should nevertheless have precedential value for such an action.\(^{893}\) First, the same type of conflict of interest

\(^{887}\) "[T]here is hesitancy to engulf all common law fraud actions in the sea of federal jurisdiction and to deprive the state courts of jurisdiction over such actions." 262 Cal. App. 2d at 707, 69 Cal. Rptr. at 234.

\(^{888}\) Id. at 720, 69 Cal. Rptr. at 243.

\(^{889}\) Mundheim, *supra* note 1, at 472-76. Professor Mundheim dealt at some length with the case of the "'greedy old lady' who has lost money speculating in the market [and who] comes into court posing as the 'sweet tusting widow,'" apparently an anathema to the securities industry. *Id.* at 464. He concluded that the broker-dealer should be given the responsibility of informing such a person that speculative stocks were inappropriate (although if she insisted on speculating, with full knowledge of the risks, the broker-dealer could sell them to her) and should never solicit her purchase of a speculative security. *Id.* at 475-76.

\(^{390}\) 262 Cal. App. 2d at 720, 69 Cal. Rptr. at 243.

\(^{391}\) See text accompanying notes 294-95 *supra*.

\(^{392}\) 262 Cal. App. 2d at 721-22, 69 Cal. Rptr. at 244.

\(^{393}\) *Twomey* has been cited with apparent approval by the California Supreme Court for its holding that the statute of limitations did not begin running until the fraud was discovered. *Neel v. Magana, Olney, Levy, Cathcart & Gelfand*, 6 Cal. 3d 176, 186, 491 P.2d 421, 427, 98 Cal. Rptr. 837, 843 (1971).

Although the court in *Twomey* invited California plaintiffs to try the warm waters of state-court jurisdiction, *see* note 387 *supra*, the response has been virtually nonexistent, perhaps because injured investors prefer the ease of venue and nationwide service of process afforded by federal securities law. Moreover, the waters may not be as warm as the *Twomey* decision implied. *See* note 365 *supra*. The Corporate Securities Law of 1968 contains a provision attempting to limit implied liability under state securities
that prevented the brokerage firm from making a full and objective determination of the investor's financial situation and needs in *Twomey* is present when a sponsor markets a real estate program in which it will be the general partner. Moreover, the discretion Elinor Twomey gave her broker should not be regarded as essentially different from the decision by a relatively unsophisticated person, unschooled in the complexities of real estate investment, to invest in a syndication after being assured by the sponsor and selling representative (who have, after all, represented themselves as experts and cultivated the prospective investor's trust and confidence) that such an investment is tailor-made for his or her special needs. And the real estate limited partnership offers the sponsor a continuing opportunity for profit in its role as general partner, just as the discretionary account offers the broker a chance for an ongoing stream of trading commissions.

Return for a moment to the hypothetical case of Carolyn and David, but now assume that the sale was made to them in a valid intrastate offering exempted from federal registration. Although the jurisdictional needs for a section 12(2) or rule 10b-5 action in federal court have probably been satisfied, the suitability claim could also be pursued in state court. Their complaint would state at least four causes of action: one based on violation of the antifraud provision of California's Corporate Securities Law, one premised on violation of section 12(2) of the 1933 Act, as well as causes of action for common law fraud and negligence. As has just been discussed, the *Knox* and *Twomey* cases offer a powerful one-two attack for holding the sponsor and selling representative liable to Carolyn and David. Their arguments in state court would center around those two decisions.

**C. Effect of a Presumptive Standard on Civil Liability**

The use of a presumptive suitability standard in state regulation of real estate programs is likely to have a substantial impact upon the availability of a private cause of action for a seller's alleged suitability violation. The degree of this impact will, of course, depend on the


394. See note 367 supra. The slightly different jurisdictional requirement for section 12(2) actions is set out in section 22(a) of the 1933 Act, 15 U.S.C. § 77v(a) (1971). The federal courts, of course, have exclusive jurisdiction for 1934 Act violations. See note 386 supra.

395. See text accompanying notes 362-67 supra.

type of presumptive standard used, the financial level at which investors are deemed unsuitable, the flexibility of the standard, and the extent to which sponsors and selling representatives carry out—and are held responsible for—their efforts to determine investor suitability for their programs. It is an important thesis of this Comment that the existence of a presumptive standard for determining investor suitability for real estate programs tends inevitably toward a one-step, “not presumptively unsuitable, ergo suitable” process. This final part will examine the unfortunate effect this interpretation could have on the sponsor’s and selling representative’s broader responsibility for determining investor suitability.

1. Civil Liability Under the Existing California Rules

Return again to Carolyn and David’s hypothetical suit in federal court. This time, however, assume that one of defendants’ responses is a motion for summary judgment based on the California suitability rules, including the presumptive suitability language in their own prospectus required by the Department of Corporations, under which plaintiffs are not presumptively unsuitable. Defendants urge that Carolyn and David were therefore suitable under the California rules and that this specific determination of suitability means they could not have violated the more general suitability doctrine.

Such an argument should be disregarded. As was pointed out earlier, it is premised on a misreading of the California rules, although such a misreading is made all too easy by the drafting error in the “Sales to Appropriate Persons” section and by the lack of any clear guidance as to the “economic substance” aspect of investor suitability in the present rules. Most courts could be expected to spot the flaw in this defense, even without the necessary correction to the “Sales to Appropriate Persons” section suggested in this Comment. But it is not inconceivable that a court unattuned to the need forInvestor...
tor protection could find the argument persuasive. Although judicial interpretation of federal antifraud provisions in recent years has tended to expand the scope of investor protection, some courts are still likely to look with considerable skepticism on investor suitability claims.

Defendants' argument would also be improper for reasons going beyond the misreading of the California rules. State suitability standards should be viewed as complementing rather than supplanted federal suitability guidelines. This is clearly the proper function of state regulation of securities, a field heavily occupied but not fully preempted by federal regulation and NASD self-regulation authorized by federal law. Since the California rules as presently drafted provide no effective guidance as to the economic substance aspect of investor suitability, beyond their elimination of presumptively unsuitable prospective investors, a court's decision of the issue should be made after consulting the whole of existing law. Thus a court should apply the federal suitability doctrine to impose civil liability in those instances where the program seller knows or has reason to know that an investment is unsuitable for a prospective investor, even though the investor meets the minimum requirements of a state-imposed presumptive standard.

There is still a danger, however, that the California investor suitability rules as presently drafted could actually disserve the goal of in-

403. See, e.g., Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974), noted in 63 Calif. L. Rev. 563 (1975) (this issue); White v. Abrams, 495 F.2d 724 (9th Cir. 1974).


406. Further study of the federal suitability cases capsulized earlier reveals that persons who would not have been eliminated as presumptively unsuitable under the California rules have been allowed to maintain private actions under a nascent federal suitability doctrine. Although the decisions do not involve real estate program securities, they illustrate the possibility of an unsuitable investment by persons of quite considerable means—and the chance that broker-dealers making such unsuitable recommendations will be held civilly liable. For example, the unsuccessful plaintiffs in Avern Trust v. Clark, 415 F.2d 1238 (7th Cir. 1969), discussed in text accompanying notes 313-16 supra, had a net worth well in excess of that required by the alternative net-worth-only presumptive standard. The individual claimants in SEC v. First Securities Co., 463 F.2d 981 (7th Cir.), cert. denied, 409 U.S. 880 (1972), were also persons of considerable means, at least some of whom would presumably have met the California presumptive standard. And Bertha Hecht, who lost her suitability battle on technicalities but won the war on her excessive trading claim, had a securities portfolio worth more than half a million dollars when she entrusted it to the broker. Hecht v. Harris, Upham & Co., 283 F. Supp. 417, 424 (N.D. Cal. 1968), aff'd as modified, 430 F.2d 1202 (9th Cir. 1970), discussed at note 301 supra. Assuming at least a 4 percent yield from her investments (or some income from other sources), she would meet either prong of the present presumptive test.
vestor protection when it comes to imposing liability for sales to unsuitable investors. In part this can be attributed to the failure of the “Sales to Appropriate Persons” section to give adequate consideration to the economic substance aspect of investor suitability, but it can also be attributed to the natural tendency to read the presumptive standard as determining who is above the line it draws as well as below. Because of this tendency, mere correction of the drafting errors may not guarantee, in the important sanctioning context, vindication of the investor-protection goal of the California rules.

2. Civil Liability Under the Proposed Suitability Rules

Since a large portion of this Comment has been devoted to proposing new rules to replace the current presumptive standard in California, it is appropriate to consider briefly how the proposal would affect the potential civil liability of sponsors and selling representatives for suitability violations.

The most significant difference between the existing rules and the proposed standard is that the latter raises only a rebuttable presumption of unsuitability for prospective investors who do not meet the minimum economic substance standards, permitting the sponsor and selling representative to make exceptions for persons whose unique circumstances make the investment appropriate. While allowing such exceptions could lead to abuse, the proposed standard clearly places the responsibility for not misusing the rebuttable presumption with the sponsor and selling representative. Imposing civil liability in instances where the obligation is flouted is a natural concomitant to the proposed flexible standard.

The proposal clearly adds a duty not imposed by the present rules—the obligation to make suitability determinations for the few prospective investors who fail the presumptive standard but can make such strong showings of their sophistication or special financial situations that the sponsor and selling representative are convinced to a high degree of certainty that an exception is warranted. This new duty, however, should not add greatly to existing responsibility. In the first place, the present rules should be interpreted as making sponsors and selling representatives responsible for making similar suitability determinations for prospective investors who meet the minimum presumptive standard. The hypothetical case of Carolyn and David suggested that sponsors and selling representatives who abuse the responsibility should be held civilly liable to injured investors. The addition of a limited number of suitability determinations below the dividing line should not significantly expand a sponsor’s or selling representative’s potential exposure to liability. In fact, because the proposed standard draws the pre-
sumptive dividing line at a higher and generally more realistic level, the exposure may actually be lessened.

A second feature which distinguishes the proposed from the existing rules is that the new presumptive standard sets more stringent economic substance requirements for real estate programs that are principally tax oriented or that involve a high degree of risk.\textsuperscript{407} In practice, this requirement should help to prevent sales of such programs to persons for whom the investment is patently unsuitable. It should also put the sponsor on record as to one of the most important suitability determinants: the degree of tax orientation. Thus there are likely to be fewer cases in which a "capital appreciation program" sold to a lower-bracket investor turns out to be a pure tax shelter with no prospects for eventual gain.

It must be remembered, of course, that no state-imposed suitability rules should be regarded as displacing the small body of federal suitability law. One obvious advantage, however, to suitability rules such as those used by California in the regulation of real estate programs is that they provide more definitive guidance to sponsors and selling representatives than the nascent federal suitability doctrine. On this score, it is true that the present California standard, with a proper interpretation of the "Sales to Appropriate Persons" section, goes a long way toward laying down workable suitability rules. But the present standard employs too crude and arbitrary a line; the proposals of this Comment have sought to draw a more accurate line and give it needed flexibility. At the same time this Comment has attempted to suggest standards which, if conscientiously applied by sponsor and selling representative, would in almost every instance fully satisfy their legal and ethical suitability obligations.

\textbf{CONCLUSION}

Investor suitability is an important concern of securities regulators, especially in a field such as real estate syndication that is likely to involve securities with greater than ordinary risk and require a high degree of investor sophistication. But in its forward-looking and usually well-directed quest for investor protection, the California Department of Corporations has evolved suitability rules that may in some respects disserve investors and prospective investors in real estate programs.

\textsuperscript{407} Although such distinctions are also possible under the present rules, see 10 Cal. Admin. Code § 260.140.112.1 (1974), they are in fact seldom required. See note 187 \textit{supra} and accompanying text. It may be that because the present presumptive standard is irrebuttable, there is administrative reluctance to impose higher standards that could prevent otherwise suitable investors from participating.
The Commissioner should therefore consider amending the rules to correct the problems discussed in this Comment.

Even in their present form, however, the rules should not be misinterpreted to allow sponsors and selling representatives to avoid their responsibility for determining the suitability of prospective investors who meet the minimum requirements of the present presumptive standard. Allowing unsuitable investors to maintain private actions against unscrupulous sponsors and selling representatives will accentuate the responsibility for determining suitability that sellers of securities must assume and thereby augment the investor-protection goal underlying the suitability doctrine.

In the short run, given the uncertain legal and economic status of many existing real estate programs, the final section of this Comment may prove most useful, since it outlines some forms of relief available to injured investors. In the long run, assuming renewed interest in public real estate financing using the limited partnership form of organization, the earlier sections and suggestions may aid securities regulators and practitioners in establishing investor suitability standards with sufficient flexibility and accountability to do their important job more effectively.

Determining a prospective investor's suitability for investment in a real estate program requires an evaluation of many more figures than annual income and net worth. Recognizing this, the SEC developed an extremely comprehensive suitability questionnaire to be sent to investors pursuant to the American Agronomics consent decree, which contained an undertaking by the defendant to make rescission offers to unsuitable investors. Because this questionnaire could serve as a guide to syndicators seeking to fulfill their responsibility for determining investor suitability, the American Agronomics questionnaire is reproduced here in slightly altered form.

SUITABILITY QUESTIONNAIRE

Name
Address

Marital Status

FAMILY FACTS

Full name Relation Age Occupation

(husband)

(wife)

Children Age Education

Other dependents Age Relationship

Do you or any of your dependents have physical or other impairments? If so, describe briefly.


410. Because the American Agronomics questionnaire was sent after the fact of investment, it asked for current financial data as well as for figures at the time of the original purchase. For the original questionnaire, see id. at 113-17.
### ASSETS

#### Fixed Dollars
- Checking account: $\text{_________}$
- Savings account
- Certificates of deposit
- Cash value of life insurance (indicate loans under liabilities)
- Bonds
- Trust funds
- Other assets

#### Equity Securities
- Common and preferred shares
  - Cost: $\text{_________}$
  - Present market value
- Mutual fund shares
  - Cost
  - Present market value
- Tax Sheltered Investments (present value)
  - Real estate: $\text{_________}$
  - Oil and gas
  - Other

#### Real estate
- Description (list all properties except principal residence):
  -
  -
- Total value: $\text{_________}$
- Total equity
- What plans do you have for this property?

#### Business Interests
- Business name
- Net worth (show value of real estate above unless integral part of business): $\text{_________}$
- "Going concern" value (estimate)
- Value in liquidation (estimate)
INVESTOR SUITABILITY

Professional Practice

Accounts receivable $__________
Equipment, furniture and fixtures
Building
Other assets
Liabilities of practice

Pension or Other Retirement Plan

Life insurance
Cash value $__________
Death benefit
Equity values

Non-Income Producing Assets

Home and lot value $__________
Equity in home and lot
(Monthly mortgage payment $__________ at _______% interest)
Do you have mortgage insurance in case of death? __________
In case of disability? __________
Home furnishings, automobiles, jewelry, furs, hobbies, etc. (current value) $__________
Other (cemetery lots, gold coins held for investment, etc.)

LIABILITIES

Current and Long-Term

Current debts (to stores, etc.) $__________
Due to banks
Insurance cash value loans
Other ____________________________
______________________________

Contingent Liabilities
(e.g., co-signor on note, lease, etc.)
Describe ____________________________ $__________

ESTIMATED NET WORTH

$__________

INCOME

(If possible, use figures from federal income tax return for most recent year)
### Net Income (after business expenses)

<table>
<thead>
<tr>
<th>Income Type</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salary</td>
<td>$_____</td>
</tr>
<tr>
<td>Bonus</td>
<td></td>
</tr>
<tr>
<td>Fees</td>
<td></td>
</tr>
<tr>
<td>Commissions</td>
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<tr>
<td>Interest</td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
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</tr>
<tr>
<td>Rent</td>
<td></td>
</tr>
<tr>
<td>Capital gains</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td></td>
</tr>
</tbody>
</table>

**TOTAL INCOME** $_____

**What is your expected income next year?** $_____

**Long-range expectations?**

### OBJECTIVES

**What are your investment objectives?**

**Explain why**

**What is your single most important financial objective at this time?**

**What are your short-range investment goals?**

**Intermediate-range goals?**

**Long-range goals?**

**Projected retirement date**

**Is it likely that you or your spouse will inherit a substantial amount of money?** _______ **About how much?**

**Date** __________

**Signature**