



Department of Commerce
Division of Securities

OHIO SECURITIES BULLETIN

ISSUE 2016:2

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SECURITIES BULLETIN

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Is “Shall” Discretionary or Mandatory in the Ohio Administrative Procedures Act

By D. MICHAEL QUINN — DIVISION COUNSEL

Chapter 119 of the Ohio Revised Code (“R.C.”) deals with Administrative hearings, including those adversarial hearings agencies hold to determine licensing questions. R.C. Section 119.09 states, in part:

For the purpose of conducting any adjudication hearing required by sections 119.01 to 119.13 of the Revised Code, the agency may require the attendance of such witnesses and the production of such books, records, and papers as it desires, and it may take the depositions of witnesses residing within or without the state in the same manner as is prescribed by law for the taking of depositions in civil actions in the court of common pleas, and for that purpose the agency may, and upon the request of any party receiving notice of the hearing as required by section 119.07 of the Revised Code shall, issue a subpoena for any witness or a subpoena duces tecum to compel the production of any books, records, or papers, ***¹

In *Clayton v. Ohio Board of Nursing*,² decided February 23, 2016, the Supreme Court of Ohio determined that a hearing officer conducting a hearing for the state Board of Nursing was within his authority to quash a records subpoena that the Respondent had requested be issued.³

In August 2009, a patient died while under the care of Respondent, a nurse in an intensive care unit at a hospital. After an investigation, the Board of Nursing instituted an administrative disciplinary action with the issuance of a Notice of Oppor-

tunity for a Hearing on November 19, 2010. Respondent requested a hearing which was held on November 9 and 10, 2011, and February 29, 2012.⁴

Prior to the commencement of the hearing, Respondent requested the issuance of a number of subpoenas and several subpoena duces tecum seeking seven different collections of documents, including the “complete medical charts of all patients who received treatment at the ICU at any point during her [12-hour] shift” in order to demonstrate what conditions were like in the ICU.⁵ The Board filed motions to limit the subpoena requests as excessive and, also, specifically, that the request for the medical records of all ICU patients was unreasonable and would cause a breach of confidentiality, in which latter motions the hospital joined.

The hearing officer denied the Board’s motion, in part, but granted the request to limit the Respondent’s request to only those medical records belonging to the deceased patient. He held that the medical records for the other patients in the ICU were likely irrelevant and that privacy and confidentiality issues outweighed Respondent’s need for the records. He also determined that the same information Respondent sought could be obtained from witnesses she was already allowed to subpoena.⁶

After the hearing, at which Respondent failed to call the nurses to testify regarding the conditions that night, the hearing

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¹ Ohio Rev. Code § 119.09.

² *Clayton v. Ohio Bd. of Nursing*, 2016-Ohio-643, 2016 Ohio LEXIS 437 (Ohio 2016).

³ *Id.* at [P39].

⁴ *Id.* at [P6].

⁵ *Id.* at [P7].

⁶ *Id.* at [P11].

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officer determined that discipline was warranted, recommending an order suspending Respondent's license for at least one year and certain probationary terms.⁷

APPEAL TO THE TENTH DISTRICT

After the trial court upheld the Board's order, the Respondent appealed to the Tenth District Court of Appeals. As part of Respondent's arguments, both to the Court of Common Pleas and to the Tenth District Court of Appeals, she claimed that the hearing officer denied her the opportunity to be heard in a meaningful manner by rendering her unable to prove the extent to which she was overburdened by her duty to assist the other ICU nurses with the other ICU patients.

The Tenth District upheld the lower court. The Tenth District Court determined that the word "shall" in R.C. 119.09 required an administrative agency to issue a subpoena if requested by a respondent. However, that court then indicated that "...to secure a reversal on the basis that the administrative agency failed to issue a requested subpoena, a party must demonstrate that the failure resulted in prejudice."⁸ The Court of Appeals pointed out that the failure of Respondent to call the witnesses who could testify regarding the conditions of the ICU during her shift meant that she failed to demonstrate their testimony was deficient without the medical records and, therefore, failed to establish prejudice.

OHIO SUPREME COURT

Respondent appealed to the Ohio Supreme Court, which accepted the appeal on one proposition of law. In a 4-3 decision, the majority differentiated between the language of R.C. Section 119.09, that the agency "shall" issue a subpoena upon the request of a respondent, from the authority to limit or quash a subpoena. Acknowledging that R.C. Chapter 119 does not indicate if an agency – or its hearing officer – has the power to quash or limit a subpoena, "[t]he express grant of power implies a grant of other powers reasonably necessary to make the express power effective."⁹ The Court determined "that the ability to limit or quash subpoenas must necessarily be inferred from the power to issue subpoenas '[f]or the purpose of conducting any adjudication hearing.'"¹⁰

Although the analysis began with a discussion of the rules relating to hearings before the Board of Nursing and the question if the rule allowing a hearing officer to quash a subpoena exceeded the authority of the Board, the Opinion of the Court was more far-reaching. The majority stated:

"Having been granted the power to issue subpoenas, all administrative agencies must have the corollary power to quash subpoenas in licensure-related hearings. Hearings are a necessary incident to the agencies' licensure powers." *See State ex rel. Mayers v. Gray*, 114 Ohio St. 270, 275, 151 N.E. 125 (1926).

Agencies must have at least some minimal authority to control those hearings, subject to a

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for information on how to join.

⁷ Id. at [P18] - [P22].

⁸ Id. at [P25].

⁹ Id. at [P33].

¹⁰ Id.

¹¹ Id. at [P34].

Is “Shall” Discretionary or Mandatory in the Ohio Administrative Procedures Act

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Friday, October 21st,
2016

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duty to maintain fairness and impartiality.¹¹

The Court concluded that, in this case, in addition to having the authority to limit or quash a subpoena, it was not an abuse of discretion for the hearing officer in the Clayton hearing to limit Respondent’s subpoena requests.

DISSENT

The dissent by Justice Pfeiffer, Justice O’Donnell concurring, focused on the second part of Appellant’s propositions of law: that, regardless of whether the hearing officer had the authority to quash or limit a

subpoena, in this case he abused his discretion and violated Clayton’s due-process rights, causing Clayton to lose the opportunity to demonstrate that any failure was a result of the system she worked within.¹² There was no discussion whether the hearing officer had the authority to quash a subpoena, only that it was herein an abuse of discretion.

Justice Kennedy’s dissent concentrated on the lack of authority for an agency, or its hearing officer, to limit a subpoena requested by a Respondent due to the mandatory language in R.C. 119.09; specifically that the agency “shall issue a sub-

poena.” Because there is no authority in R.C. Chapter 119 to quash a party’s subpoena, Justice Kennedy would hold that the Board rule allowing the hearing officer to quash a subpoena is beyond the Board’s statutory authority and invalid.¹³ The matter should be remanded to the Board for a new proceeding.

CONCLUSION

The holding of the majority was that a hearing officer of an administrative agency has the discretion to limit or quash subpoenas requested during adjudication hearings for the purpose of conducting a fair and efficient hearing.

¹² *Id.* at [P41], [P44].

¹³ *Id.* at [P58].

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Definition of a “Security”

BY: JEFF COLEMAN — CORPORATION FINANCE ATTORNEY

A significant portion of Ohio securities laws, including those related to registration (sometimes known in other states as “corporation finance”), antifraud, and broker-dealer conduct, apply, as their name suggests, to “securities” as defined by Ohio law. Therefore, the question of whether such securities laws govern a particular instrument, transaction, or advice depends on whether a “security” is involved. The first step in answering that question is to look at [Ohio Revised Code \(R.C.\) 1707.01\(B\)](#), Ohio’s basic statutory definition of the term.

According to R.C. 1707.01(B), a security is “any certificate or instrument, or any oral, written, or electronic agreement, understanding, or

ital, assets, profits, property, or credit of any person or of any public or governmental body, subdivision, or agency.” This statute also provides a non-exhaustive list of certain investments that meet the definition, including: shares of stock; membership interests in a limited liability company (LLC); bonds, debentures, or other evidence of indebtedness; investment contracts; rights to purchase certain securities, including warrants, options, or subscription rights; and interests in oil, gas, or other mineral leases. The examples cited here are merely some of the more common varieties of securities—1707.01(B) lists numerous other investments that constitute securities under Ohio law. This section also makes clear the fact that

opportunity, that represents title to or interest in, or is secured by any lien or charge upon the cap-

while the sale of real estate does not constitute a security, a sale of interests in real estate may prove to involve the sale of a security and the Division routinely registers such offerings as a matter of course.

Based on the above, one can reasonably conclude that if a particular instrument or transaction is identified as a security in R.C. 1707.01(B), then under Ohio law, a security probably exists and the Ohio securities laws likely apply. However, while R.C. 1707.01(B) identifies the most common types of securities, there are probably just as many types of investment (which may or may not be securities) about which the statute is silent. What about an instrument or transaction not addressed by the statute?

A prudent person will seek to answer that question in two ways. First, many Ohio cases resolve the question of whether a particular in

Complex Products and Schemes

BY: JANICE HITZEMAN — ATTORNEY INSPECTOR

A person intent on committing fraud has an infinite number of vehicles by which to perpetrate it. The Division continually encounters new and evolving schemes which lure investors into relinquishing hard-earned dollars to fraudulent and deceptive schemes that seem, at quick glance, plausible for investment. This article will explore complex investment products and schemes identified by the Division which have been used in Ohio as a conduit for fraudulent and manipulative conduct, including prime bank instruments and letters of credit, leveraged and inverse exchange-traded funds (“ETFs”), and natural resource and mining investments.

PRIME BANK INSTRUMENTS AND LETTERS OF CREDIT

Prime bank instruments, including letters of credit, are a contractual agreement between one bank (the issuing bank) on behalf of one of its customers, authorizing another bank (the advising or confirming bank) to make payment to the beneficiary. The issuing bank, on the request of its customer, opens the letter of credit, and by doing so commits to honor drawings made under the credit. The beneficiary in these situations is typically the provider of goods and/or services and the issuing bank essentially replaces the bank’s customer as the payor of the transaction. These prime bank instruments and letters of credit sometimes are solicited as a “get rich quick” scheme where investors are provided a copy of a forged or fraudulent letter of credit and told that if they invest in a relatively small percentage of the business being provided the loan, they will receive a significant return immediately through the proceeds of the loan. The issuing bank is generally located in a foreign country and the letter of credit or prime bank instrument is provided to the investor as evidence of collateral for the investment.

Tips for avoiding letter of credit fraud:

- ◇ If an “opportunity” appears too good to be true, it probably is.
- ◇ Do not invest in anything unless you understand the deal. Con artists rely on complex transactions and faulty logic to “explain” fraudulent investment schemes.
- ◇ Do not invest in or attempt to “purchase” a “letter of credit.” Such investments simply do not exist.
- ◇ Be wary of any investment that offers the promise of extremely high yields.
- ◇ Independently verify the terms of any investment that you intend to make, including the parties involved and the nature of the investment.

LEVERAGED AND INVERSE ETFs

The Division recently discussed ETFs and the risks associated with these investments in a previous publication of the Ohio Securities Bulletin.¹ The traditional index ETF is designed to deliver the returns of the index in

equal measure for a specified period. An inverse ETF is designed to earn the return of the index if it were sold short – that is, the negative of the index return or –1X the index return. If an ETF is leveraged, it is designed to earn more than the return of a simple long or inverse ETF. Currently, most leveraged ETFs are either 2X, 3X, --2X, or –3X, and therefore offer investors the opportunity to earn two or three times (and lose two or three times) the daily return of a simple long or short position in the index.² Research has established that investors who hold these products for periods longer than a day expose themselves to substantial risk as the holding period returns will deviate from the perceived returns of the originally purchased leveraged or inverse ETF of the index.³ It’s also possible for an investor in a leveraged ETF to experience negative returns even when the underlying index has positive gains. Based on research conducted by the Investment Company Institute, the total number of index-based and actively management ETFs, including commodity ETFs, domiciled in the

Definition of a "Security"

(Continued from page 3)

vestment not addressed by the statute is or is not a security under Ohio law. The results of these cases are reported to the public and are available for research both on the internet and in law libraries. Second, the Division is available to assist any member of the public seeking to learn about Ohio securities laws, including 1707.01(B).

The Division does not issue “no-action” letters or similar binding statements regarding whether a particular investment is a security, or provide

legal advice of any kind. The Division can, however, identify legal resources that may be helpful, and may be able to determine whether a particular investment has been treated in the past as a security. To the extent you are seeking legal advice on whether a particular investment constitutes a security—or otherwise relating to Ohio or other securities laws—you should consult a securities attorney, who may be able to help.

¹ D. Michael Quinn, *Exchange Traded Funds: Cousins to Mutual and Index Funds*, *Ohio Securities Bulletin*, Issue 2015:4, 5-6 (2015).

² Patricia Knain Little, *Inverse and Leveraged ETFs: Not Your Father's ETF*, *The Journal of Index Investing*, Vol. 1, No. 1, 83-89 (2010).

³ See Ilan Guedj, Guohua Li & Craig McCann, *Leveraged ETFs, Holding Periods and Investment Shortfalls*, Securities Litigation and Consulting Group, Inc. (2010).

Complex Products and Schemes

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United States has grown from 1,411 in 2014 to 1,609 as of March of 2016; additionally, the total net assets in these ETFs has grown from \$1.9 trillion to over \$2.1 trillion over the same period.⁴

The leveraging process is built to achieve an objective quite different from that of the simple, traditional ETF. Like the traditional ETFs, leveraged and inverse ETFs trade intraday, but they differ from traditional ETFs in terms of fees, expenses and tax efficiency. Fees and expenses are higher, often exceeding 1% per annum. Tax efficiency is lower because most trades settle in cash rather than in kind, and realized gains from the use of derivatives are generally taxed at ordinary income tax rates instead of the lower capital gains tax rates.⁵

Inverse and leveraged ETFs are complex products requiring adequate disclosure so that investors are well-informed of the nature of this type of investment, the elevated fee structure, unfavorable tax consequences, and risks. The Division recently issues two final Orders related to the recommendation and sale of inverse and leveraged ETFs. The first Division Order revoked the Ohio investment adviser license of an Ohio licensee based, in part, on recommending unsuitable investments in inverse and leveraged ETFs to his senior and elderly clients based on misrepresentations that the clients' investments were low-risk and fool-proof.⁶ The second Order was issued against an Ohio resident who wasn't licensed with the Division but engaged in the purchase and sale of securities in the accounts of six investors resulting in substantial losses.⁷ The respondent's website promised annual returns of 42% based upon trading in ETFs, including inverse and leveraged ETFs.

NATURAL RESOURCE AND MINING

The Division has recently seen an increase in complaints based on investments in natural resource and mineral mining. Many of these investments involve limited or general partnerships or fractionalized interests in mining or well leases, which offer significant returns based on the work of others to operate, maintain, mine or drill for the resources.⁸

While these investments may seem simple, the operation of the issuer and the offering materials are often complex and incomprehensible to unsophisticated investors. The sales tactics used in these types of transactions include assurances that the investment involves minimal risk, the wells in the area are known producers, the investment window is short, and that the offer is only being made to a select few investors. In many instances, the wells or mines are located in states geographically distant from where the investors reside, forcing them to rely on assurances made by nameless, faceless solicitors cold-calling them through boiler room operations. Ohio investors have recently been cold-called to solicit in oil and gas wells located in Nebraska,⁹ Texas, Kentucky,¹⁰ and Oklahoma.

Prior to investing or advising a client to invest in natural resource mining or well operations, confirm with the proper state or local authority that the well or mine exists. For example, the [Ohio Department of Natural Resources](#) maintains a database for oil and gas wells and mines which are located within the state. Similarly, the [Railroad Commission of Texas](#) maintains a database for oil and gas wells, which can even include production levels for specific wells. Investors can use sources like these to determine who owns the well or mine and who has been granted drilling or mining permits to operate

them. After confirming that the well or mine exists and that the proper permits have been issued, investors should also consider the following questions:¹¹

- ◇ Is the offering registered for sale in Ohio or subject to an applicable state or federal exemption from registration? Keep in mind that the federal exemption under [Rule 506\(b\)](#) is not available if the offering involves general solicitation and the federal exemption under [Rule 506\(c\)](#) is available for offerings sold only to verified accredited investors.
- ◇ Who will be responsible for payment of taxes? Will they be paid out of the investor's share?
- ◇ What is the location of available pipelines, or what method will be used to transport and sell any production?
- ◇ What are the name and address of the operator? What is her/his experience with ventures of this nature? What are the terms of the agreement with the operator, including the compensation terms?
- ◇ How will the decision be made for completing the well or abandoning it? Who will make that decision? What is to become of funds received from the salvage value of equipment on the lease?

CONCLUSION

Prime bank instruments and letters of credit, leveraged and inverse ETFs, and natural resource and mineral mining are just a sampling of the types of investments being sold to Ohio investors recently through fraudulent and deceptive practices. The instrumentalities of fraud are limited only by the imagination of those intent on siphoning the funds of others for their own purposes. As with all investments, Ohio residents should be wary of red flags and offers that seem too good to be true.

⁴ Exchange-Traded Funds March 2016 Release, Investment Company Institute (April 28, 2016); [Frequently Asked Questions About the U.S. ETF Market](#).

⁵ See Little, *supra*.

⁶ Final Order Revoking Ohio Investment Adviser Representative License of Timothy K. Fife, [Division Order No. 16-012](#) (2016). A Notice of Appeal for this Order has been filed as Case No. CV-16-862093 in the Cuyahoga County Court of Common Pleas.

⁷ Waldemar Kazana, Cease and Desist Order, [Division Order No. 16-009](#) (2016).

⁸ See generally [Oil and Gas Securities: A Primer](#), [Ohio Securities Bulletin, Issue 2012:1](#), 1-2 (2012).

⁹ Horizon Energy, LLC and Harrison Owens, Notice of Opportunity for Hearing, [Division Order No. 15-021](#) (2015); Termination Order, [Division Order No. 16-004](#) (2016).

¹⁰ Jewell Jackson Oil and Gas, LLC et al., Cease and Desist Order, [Division Order No. 14-016](#) (2014); Holland Turner, Cease and Desist Order, [Division Order No. 14-011](#) (2014).

¹¹ See North American Securities Administrators Association, [Oil & Gas Investment Fraud](#).



A to Z with L & E

FINRA MEMBER UPDATES

New FINRA Rule Requires “Educational Communications” be Provided to Clients During Recruitment and Account Transfers

By ANNE FOLLOWELL – LICENSING CHIEF

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This section of the Bulletin, the Licensing and Examination Section of the Division (“L & E”), discusses timely and important topics impacting our licensees. The goal is to cover a wide-range of issues – from “A to Z” – that are of greatest interest to you!

We welcome your suggestions for future topics.

OHIO DIVISION OF SECURITIES

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On March 23, 2016, the U.S. Securities and Exchange Commission (SEC) approved FINRA’s proposed [Rule 2273](#), which will require FINRA-member dealer firms to provide an “educational communication” to clients when a registered representative switches between member firms.¹ Specifically, the rule requires the firm which hires or associates with a registered representative (the recruiting firm) to provide to the representative’s former customer a concise, plain-English “educational communication,” either in paper or electronic form, highlighting the potential implications of transferring assets. FINRA’s concern in proposing this rule was that a customer’s confidence in and prior experience with their registered representative may be the only factors a customer considers when making a decision to transfer assets to the recruiting firm along with the registered representative. The “educational communication” serves to provide the customer with a more complete picture of all of the potential direct and indirect implications of the decision to transfer assets. The customer can use the communication as a tool in asking the registered representative questions about all aspects of the transfer. In May of 2016, FINRA released [Regulatory Notice 16-18](#), which provides additional guidance for Rule 2273.

Under what circumstances is the “educational communication” required?

There are two triggering events. The first occurs when there is individualized contact with a former customer by either the registered representative or the recruiting

firm discussing the customer transferring assets. The second is when the former customer attempts to transfer assets to an account assigned, or to be assigned, to the registered representative at the recruiting firm, without any prior individualized contact from the registered representative.

What is the form and content of the “educational communication”?

The required “educational communication” consists of a two-page uniform communication, developed by FINRA and titled “Issues to consider when your broker changes firms.”² Firms cannot use any alternative format or content. The communication includes the following five subsections along with additional explanations of the direct and indirect impacts of asset transfers:

- ◇ Could financial incentives create a conflict of interest for your broker?
- ◇ Can you transfer all your holdings to the new firm? What are the implications and costs if you can’t?
- ◇ What costs will you pay – both in the short term and ongoing – if you change firms?
- ◇ How do the products at the new firm compare with your current firm?
- ◇ What level of service will you have?

When must the “educational communication” be delivered?

In the case of the registered representative or their recruiting firm having individualized discussions with the former

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¹ To view the documents involved in FINRA Rule 2273’s approval process, please see [SR-FINRA-2015-057](#).

² The educational communication discussed is included as “Attachment B” to FINRA’s [Regulatory Notice 16-18](#).

FINRA Member Updates

(Continued from page 6)

customer about transferring assets, the “educational communication” must be delivered to the client at the first contact with the client. If this first contact is by way of a letter or other written form, the “educational communication” must be included with that writing. In the case of electronic written communications, the “educational communication” could be included as an attachment or provided via a hyperlink. If the first contact with the client is oral, then the member or registered representative must send the “educational communication” to the former client no later than three business days after the first contact.

In the case of the former customer attempting to transfer assets to the recruiting firm before the registered representative or firm has contacted the client, then the “educational communication” shall be delivered to the client with the account transfer approval documentation.

Who is a “former customer” under Rule 2273?

The Supplementary Material to the rule provides that the term “former customer” shall mean any customer that had a securities account assigned to a registered person at the registered person’s previous firm. “Former customer” does not include an account of a non-natural person that meets FINRA’s definition of an “institutional account.”

How long after the registered representative switches firms must the representative and the recruiting firm comply with Rule 2273?

The “educational communication” delivery requirement applies for three months following the date the registered representative begins employment or association with the recruiting firm.

What is the effective date of FINRA Rule 2273?

The effective date is November 11, 2016. FINRA has 60 days from the date of SEC-approval (here, March 23, 2016) to announce an effective date for the rule. The effective date should be no later than 180 days following the SEC’s approval announcement.

Compliance with Manual Exemption

Licensed dealers may rely on an exemption in the Ohio Securities Act at R.C. Section 1707.03(M)(3)(a) for the sale of securities in Ohio that are issued and outstanding and are listed in a recognized securities manual. The Division has been informed that Standard & Poor’s Financial Services, LLC has discontinued its publication of the Standard & Poor’s Standard Corporation Records effective May 2, 2016. Licensed dealers who have previously relied on this manual for an exemption in compliance with R.C. Section 1707.44(C)(1) should verify that the issuer is listed in another recognized securities manual with the requisite information contained in such manual pursuant to R.C. Section 1707.03(M)(3)(a); or ensure that another exemption from the registration requirement under R.C. Section 1707.44(C)(1) is available. As always, the burden of proof with an exemption is upon the person selling the securities pursuant to R.C. Section 1707.45. Finally, the manual exemption is common among other jurisdictions, therefore, compliance professionals may wish to assess other state securities laws as well to avoid the sale of unregistered securities.

OHIO DEPARTMENT OF COMMERCE SUPPORTS OHIO VETERANS IN WORKFORCE INITIATIVE

The Ohio Department of Commerce is committed to honoring the service of the men and women of the U.S. Armed Forces by assisting veterans.

OHIO DEPARTMENT OF COMMERCE VETERANS RESOURCE GUIDE

<http://www.com.state.oh.us/OhioVeteransWorkforceInitiative.aspx>

This page contains links and resources for veterans from across all of the divisions of Commerce.



Department
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Division of Securities

Q&A

Q: *The Division is routinely asked the companion questions: (1) What is the de minimis exemption for Investment Adviser licensing? and (2) What is the definition of “client” as it pertains to the de minimis exemption?*

A: The Division is often contacted by an out-of-state adviser that is looking to expand its business by advising Ohio-based clients. One exemption from being required to obtain Ohio licensure under this scenario is set forth in Ohio Revised Code (R.C.) Section 1707.141(A)(4) and is commonly referred to as the *de minimis* exemption. Advisers looking to utilize this exemption should take note that the exemption does not extend to IAs that are SEC-licensed under R.C. Section 1707.141(A)(2).

In order to meet the *de minimis* exemption, the IA must:

- (1) not be registered with the SEC;
- (2) not have an actual place of business in Ohio; and
- (3) have, within the last twelve (12) month period, not more than five (5) clients in Ohio. (See R.C. 1707.141(A)(4)).

For purposes of determining the number of clients for the *de minimis* exemption, in accordance with Ohio Administrative Code (O.A.C) 1301:6-3-01(H), the following are counted as ONE client:

- ◇ A natural person;
- ◇ Any minor child of the natural person;
- ◇ Any relative, spouse, or relative of the spouse of the natural person who has the same principal residence; and
- ◇ All accounts and trusts held in the name of the natural person and/or those persons described above, so long as they are the only primary beneficiaries.

A legal organization is considered ONE client if it is a corporation, general partnership, limited partnership, limited liability company, trust (other than the family trust as described above) or other legal organization that receives investment advice based upon the legal organization’s investment objectives, NOT the objectives of the individual owners in the legal organization.

Advisers looking to take advantage of the *de minimis* exemption should also refer to additional special rules regarding the calculation of clients, set forth in O.A.C 1301:6-3-01(I). For instance:

What if the IA is not compensated for the investment advice?

Pertaining to the client count set forth in the *de minimis* exemption, the rule excludes “free advice” so an adviser need not count a client for whom advice was rendered without compensation.

It is important to note that once the *de minimis* threshold of clients is met, the whole panoply of Ohio licensing requirements will apply to all client interactions.

LICENSING

David Melito

Is a Senior Examiner for the Division and a Certified Public Accountant. As an examiner David has an important role with the Division to ensure licensee compliance within the Ohio Securities Act and associated rules. David has been with the Division for 29 years, after earning his degree at Cleveland State University. When asked what David enjoys about his work he responded: “Meeting the licensees and working in a collaborative effort to build a strong foundation of compliance and financial record keeping.” In addition to his duties as an examiner, David also assists the Division with its education efforts through community outreach regarding how to be a smart investor and not fall prey to securities fraud. In his spare time, David enjoys playing in a community baseball league.

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The Division’s Enforcement Section is a criminal justice agency authorized to investigate and report on all complaints and alleged violations of the Ohio Securities Act and related rules.

The Enforcement Section attorneys represent the Division in prosecutions and other matters arising from such complaints and alleged violations.

OHIO DIVISION OF SECURITIES

Enforcement

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DIVISION ORDER NO. 16-002 STOEVER, GLASS & COMPANY, INC. CRD NO. 7031 NEW YORK, NEW YORK

On January 20, 2016, the Division issued a Cease and Desist Order with Consent against Stoever, Glass & Company, Inc. (“Stoever”) based on findings that they acted as an unlicensed dealer for a period in excess of four years and transacted 568 transactions in the accounts of 23 clients prior to applying for an Ohio securities dealer license in May of 2015. As part of the Consent Order, the Ohio dealer license for Stoever was approved and Stoever agreed to commence and complete a rescission offering to the effected clients under R.C. 1707.43.

DIVISION ORDER NOS. 16-003 AND 16-007 SCOTT D. MCQUATE MOUNT VERNON, OHIO

On January 26, 2016, the Division issued a Notice of Opportunity and Notice of Intent to issue a Cease and Desist Order against Scott D. McQuate based on allegations that he acted as an unlicensed dealer by receiving commissions for the sale of securities issued by The Ohio Company. The Notice Order further alleged that McQuate misrepresented the investment on his website (www.paxeonllc.com), his LinkedIn page, and in a letter sent to retired employees of Gorman Rupp, in part, by stating that The Ohio Company had consistently paid 10 percent returns for 30 years when the company had only been in business since 2010. McQuate did not request a hearing and a final Cease and Desist Order was issued on March 14, 2016.

DIVISION ORDER NO. 16-004 HORIZON ENERGY, LLC; HARRISON OWENS COLORADO SPRINGS, COLORADO

On February 18, 2016, the Division issued a Termination of Order No. 15-021 based on a finding that Harrison Owens passed away on or about October 18, 2015, four days after the Notice Order was issued. The Termination Order further found that Horizon Energy, LLC dissolved and is no longer an active limited liability company.

DIVISION ORDER NOS. 16-005 AND 16-009 WALDEMAR KAZANA CANTON, OHIO

On February 24, 2016, the Division issued a Notice of Opportunity and Notice of Intent to issue a Cease and Desist Order against Waldemar Kazana based on allegations of securities fraud and acting as an unlicensed dealer by receiving commissions for conducting trades in the Scottrade accounts of at least eight Ohio residents, one of whom was elderly. Kazana met several investors through bible studies at a local church. The Notice Order alleged that the accounts sustained losses in excess of \$275,000. The Order further alleged that Kazana fraudulently touted his investment strategy on his website, www.marketrecon.webs.com, through statements indicating that his trading strategy would accumulate “gains to nearly 42% per year” based on trading in ETFs and inverse ETFs. Kazana did not request a hearing and the Division issued a final Cease and Desist Order on March 31, 2016.

ENFORCEMENT SECTION UPDATE (Continued)

Administrative Actions

DIVISION ORDER NOS. 16-006 AND 16-010

**JAMES D. PINKERMAN; JENNIFER ALWOOD; HERITAGE PROPERTY INVESTMENTS, LLC; FAIRWOOD 773, LLC; FAIRWOOD 817, LLC
LEWIS CENTER, OHIO**

On February 24, 2016, the Division issued a Notice of Opportunity and Notice of Intent to issue a Cease and Desist Order against James D. Pinkerman, Jennifer Alwood, Heritage Property Investments, LLC, Fairwood 773, LLC and Fairwood 817, LLC based on allegations that the Respondents engaged in securities fraud and misrepresented material and relevant facts in the sale of promissory notes issued by Heritage Property Investments, LLC, Fairwood 773, LLC and Fairwood 817, LLC to three Ohio investors. A hearing was not requested and the Division issued a final Cease and Desist Order on March 31, 2016 based on findings that Respondents failed to disclose to investors that James D. Pinkerman, a principal with the issuing companies, was convicted of felony theft and forgery in Franklin County, and by misrepresenting that the investors' funds would be used to purchase and rehabilitate real estate when the funds were actually used for personal expenses.

Division Order No. 15-018 LPL Financial, LLC CRD No. 6413 Boston, Massachusetts

On March 14, 2016, as part of a global settlement negotiated through a task force appointed by the North American Securities Administrators Association (NASAA), the Division issued a Consent Order against LPL Financial, LLC ("LPL") a broker-dealer

and investment adviser firm registered in Ohio with principal offices in Boston, Massachusetts. The Order included findings that, from 2008 to 2013, LPL failed to implement an adequate supervisory system reasonably designed to achieve compliance with Ohio concentration limits for the sale of non-traded Real Estate Investment Trusts ("REITs"). As part of the Consent Order, LPL agreed to remediate losses for clients who invested in identified non-traded REITs sold by LPL during the specified time period under terms set forth in the Order. In addition to investor remediation, LPL agreed to pay \$32,522.13 to the Ohio Division of Securities Investor Education and Enforcement Expense Fund, representing a portion of a total civil penalty of \$1,425,000.00 to be paid by LPL to states participating in the global settlement.

DIVISION ORDER No. 16-011 WRK INVESTMENTS, LLC CRD No. 156457 RYAN LEE KITSON CRD No. 5312687 SOLON, OHIO

On April 7, 2016, the Division issued a Consent Order Suspending Ohio Investment Adviser License No. 156457 and Ohio Investment Adviser License No. 5312687 for fourteen days for failing to maintain and supply books and records requested during a routine examination. The books and records were eventually provided to the Division after the licensees were ordered to appear at Division offices for an investigative hearing.

DIVISION ORDER No. 16-012 TIMOTHY K. FIFE CRD No. 2437888 WESTLAKE, OHIO

On April 7, 2016, the Division issued a Final Order Revoking the Ohio Investment Adviser Representative License of Timothy K. Fife after an administrative hearing based on the report and recommendation of the administrative hearing officer. The Division found, in part, that Fife engaged in fraudulent and manipulative conduct in advising clients, some elderly, to invest in ETFs that were unsuitable for his clients' investment needs and objectives. The Division further found that Fife was not of good business repute. Fife, through counsel, filed a Notice of Appeal with the Cuyahoga County Court of Common Pleas in case number CV-16-862093.

DIVISION ORDER No. 16-013 THOMAS HENRY ROULSTON III CRD No. 1038010 THOMAS ROULSTON III INVESTMENT PARTNERS, INC. CRD No. 118822 ROULSTON BUYSIDE RESEARCH, LLC CLEVELAND, OHIO

On April 29, 2016, the Division issued a Consent Order Revoking the Ohio Investment Adviser Representative License of Thomas Henry Roulston III ("Roulston") and the Ohio Investment Adviser License of Thomas Roulston III Investment Partners, Inc. ("TRIP"). Included in the Consent Order was a Cease and Desist Order against Roulston, TRIP, and a non-licensed entity, Roulston Buyside Research, LLC ("RBR"). The Order included

Criminal Cases

findings that Roulston solicited investments in the form of convertible promissory notes issued by RBR based on assurances that the investment funds would be used for research and the operation of RBR. The Order found that investment funds were used, instead, to financially sustain TRIP, an insolvent investment adviser firm. As part of the Consent Order, Roulston, TRIP and RBR agreed to a lifetime ban on acting as an investment adviser, investment adviser firm, securities dealer or securities salesperson in Ohio, as well as a lifetime ban on the sale of securities in or from Ohio.

**STATE V. THOMAS CANIFORD
CASE NO. 2015CRA03618**

STARK COUNTY COURT OF COMMON PLEAS, OHIO

On March 11, 2016, following a referral from the Ohio Division of Securities and an indictment, Thomas Caniford of North Canton, Ohio, pleaded guilty in the Stark County Court of Common Pleas to 19 counts of securities fraud, 72 counts of publishing false investment statements, 20 counts of theft, six counts of theft from the elderly, and 18 counts of selling unregistered securities. The guilty plea resulted from a joint investigation conducted by the Ohio Division of Securities and the Canton Police Department, with assistance from the forensic accounting unit with the Ohio Bureau of Criminal Investigation. Caniford owned and operated Caniford and Company Capital Management, Inc. and was a general partner in Fundcap Growth Portfolio Limited Partnership, both operating from the same office located in North Canton, Ohio. Caniford convinced his clients to invest in his hedge fund, Fundcap Growth Portfolio, by promising them that the hedge fund would provide a more stable portfolio which would offset market losses. Thirty-four victims, including a local church, lost close to half a million dollars in the scheme. The scheme was prolonged because of false investment statements that were provided to victims by Caniford and by third-party trust companies administering self-directed Individual Retirement Accounts (IRAs) for years after Caniford misappropriated the investment funds for personal use and to pay back previous investors. Caniford was sentenced to 12 years in prison.

**STATE V. JON PATRICK HORVATH
CASE NO. B1307440**

HAMILTON COUNTY COURT OF COMMON PLEAS

On April 29, 2016, Jon Patrick Horvath was arrested on an outstanding warrant issued on January 15, 2014, based on an indictment charging him with nine felony criminal counts, including securities fraud, sale of unregistered securities, false representations in the sale of a security, theft, and forgery following a referral from the Division. Horvath is accused of selling \$95,000 in unregistered securities to two investors and converting the funds for his personal use.

**PETER A. BECK
C 1500539**

**FIRST DISTRICT COURT OF APPEALS
HAMILTON COUNTY, OHIO**

On September 15, 2015, Peter A. Beck filed a notice of appeal stemming from his criminal conviction in Hamilton county for multiple felony counts, including perjury and misrepresentations in the sale of securities. Beck was sentenced to four years in prison and remanded to custody on August 20, 2015.

**STATE V. FRANK KAUTZMAN
WARREN COUNTY COURT OF COMMON
PLEAS**

This case was mentioned in the last issue of the Ohio Securities Bulletin. The criminal trial is currently set to begin on September 26, 2016.

CRIMINAL TRIALS AND HEARINGS

ADMINISTRATIVE HEARINGS

**TAP MANAGEMENT, INC. ET AL.
DIVISION ORDER NO. 15-022**

The Division Order was mentioned in the last issue of the Ohio Securities Bulletin. The administrative hearing is currently scheduled to begin on June 27, 2016.



Department
of Commerce
Division of Securities

SECURITIES EXCHANGE

A Summary of the SEC and Ohio Crowdfunding Provisions

BY THOMAS E. GEYER

OHIO SECURITIES EXCHANGE

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OHIO SECURITIES EXCHANGE

The Ohio Securities Exchange provides a platform where views and opinions relating to the securities industry can be shared from sources outside the Division.

The Division encourages members of the securities community to submit articles pertaining to securities law and regulation in the state of Ohio.

If you are interested in submitting an article, please contact our new Editor-In-Chief,

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OHIO DIVISION OF SECURITIES

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– T.S. ELIOT

Without further commentary from T.S. Eliot, on October 30, 2015, the U.S. Securities and Exchange Commission adopted Regulation Crowdfunding, its set of regulations implementing the registration exemption for crowdfunding transactions contained in Section 4(a)(6) of the federal Securities Act of 1933. This article provides an overview of the federal provisions and the companion Ohio provisions. This article is summary in nature, and is not a substitute for a thorough review of the statutory provisions and regulations. Regulation Crowdfunding took effect on May 16, 2016. Notably, the Ohio companion exemption, set out in R.C. 1707.092(C), was already in place on that date.

I. BACKGROUND

Crowdfunding is a relatively new and evolving method of using the Internet to raise capital to support a wide range of ideas and ventures. An entity or individual raising funds through crowdfunding typically seeks small individual contributions from a large number of people. Individuals interested in the crowdfunding campaign – members of the “crowd” – may share information about the project, cause, idea or business with each other and use the information to decide whether to fund the campaign based on the collective “wisdom of the crowd.”¹

In 2012, Congress recognized the popularity of crowdfunding by including the “CROWDFUND Act” as Title III of the Jumpstart Our Business Startups (JOBS) Act. Title III amended the 1933 Act to add Section 4(a)(6), which generally provides an exemption from federal registration for transactions involving the offer or sale of

securities by an issuer if: the aggregate amount sold to all investors by the issuer, during the 12-month period preceding the date of such transaction, is not more than \$1,000,000; the aggregate amount sold to any investor by an issuer, including any amount sold in reliance on the exemption during the 12-month period preceding the date of such transaction, does not exceed certain thresholds based on the annual income or net worth of the investor; the transaction is conducted through an SEC-registered broker or funding portal; and the issuer complies with certain disclosure and reporting requirements.

Title III also amended the 1933 Act to add Section 4A, which imposes the disclosure and reporting requirements on the issuer of securities in a crowdfunding transaction; sets forth the requirements for crowdfunding intermediaries; and outlines the civil liability for misstatements and omissions of material facts in crowdfunding offerings.

Regulation Crowdfunding amplifies Sections 4(a)(6) and 4A. Thus, like other federal registration exemptions, e.g. Section 4(a)(2), certain terms of the exemption are set out in the statute, and certain additional terms are set out in SEC regulations.

II. NATURE OF THE ISSUER

By statute, the federal crowdfunding exemption is available only to issuers. However, certain issuers are not eligible to use the exemption, including: non-U.S. companies; companies that are reporting companies under the federal Securities Exchange Act of 1934; certain investment companies; companies that are disqualified under Regulation Crowdfunding’s disqualification rules; companies that have failed to comply with the

¹ SEC Release No. 33-9974 (Oct. 30, 2015).

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BAILEY CAVALIERI LLC



Tom serves as coverage and claims monitoring counsel for directors and officers liability insurers. He provides coverage opinions and represents insurers during the claim resolution process, including mediation efforts and other settlement negotiations.

Tom also practices in the areas of corporate and securities law, including advising clients regarding securities offerings, securities enforcement matters, and regulatory compliance, and also serves as an expert witness on securities law topics. Tom is a former Commissioner of the Ohio Division of Securities and a former Assistant Director of the Ohio Department of Commerce.

annual reporting requirements under Regulation Crowdfunding during the two years immediately preceding the filing of the offering statement; and companies that have no specific business plan or have indicated their business plan is to engage in a merger or acquisition with an unidentified company or companies. Securities sold by the issuer may take the form of common stock, preferred stock, another form of equity interest in the issuer, or debt. However, securities purchased in a crowdfunding transaction generally cannot be resold for a period of one year. Holders of these securities do not count toward the threshold that requires an issuer to register its securities with the SEC under Section 12(g) of the 1934 Act if: the issuer is current in its annual crowdfunding-related reporting obligation; retains the services of a registered transfer agent; and has less than \$25 million in assets.

III. NATURE OF THE OFFERING

A. Issuer Filing and Disclosure Obligations

THE MOST VALUABLE COMMODITY I KNOW OF IS INFORMATION.

— GORDON GEKKO

Section 4A(b)(1) of the 1933 Act requires that an issuer making a crowdfunding offering file with the SEC and provide to investors and the relevant broker or funding portal, and make available to potential investors, the following:

- The name, legal status, physical address and website address of the issuer;

dress and website address of the issuer;

- The names of each director and officer of the issuer (and any person occupying a similar status or performing a similar function), and each person holding more than 20% of the shares of the issuer;
- A description of the business of the issuer and the anticipated business plan of the issuer;
- A description of the financial condition of the issuer, which must be certified by the issuer's principal executive officer, reviewed by an independent public accountant, or audited by an independent public account, depending on the size of the offering and whether the issuer has previously made an offering in reliance on Section 4(a)(6);
- A description of the stated purpose and intended use of the proceeds of the offering sought by the issuer with respect to the target offering amount;
- The target offering amount, the deadline to reach the target offering amount and regular updates about the progress of the issuer in meeting the target offering amount;
- The price to the public of the securities or the method for determining the price; and
- A description of the ownership and capital structure of the issuer.

This information is to be provided on the Form C: Offering Statement, which was promulgated as a part of Regulation Crowdfunding, and is to be filed with the SEC through the EDGAR system (and

unless otherwise indicated in the form, Form C must be filed in the standard format of extensible Markup Language (XML)). In addition to the foregoing, the following information must also be disclosed on the Form C:

- The name, SEC file number and CRD number (as applicable) of the funding portal or broker-dealer through which the offering will be conducted;
- The amount of compensation paid to the intermediary to conduct the offering, including the amount of referral and other fees associated with the offering;
- Any other direct or indirect interest in the issuer held by the intermediary, or any arrangement for the intermediary to acquire such an interest;
- Risk factors;
- Information about indebtedness, prior exempt offerings and related-party transactions;
- Whether oversubscriptions will be accepted and, if so, how they will be allocated;
- Maximum offering amount (if different from the target offering amount);
- Current number of employees of the issuer;
- Selected financial data for the prior two fiscal years; and
- The jurisdictions in which the issuer intends to offer the securities.

B. Issuer Advertising

Section 4A(b)(2) of the 1933 Act prohibits issuers from advertising the terms of a crowdfunding offering, "except for notices which direct investors to the funding portal or broker." Pursuant to Regulation Crowdfunding, a notice may advertise a crowdfunding offering if it directs investors to the intermediary's platform and includes no more than the following information:

A statement that the issuer is conducting an offering pursuant to Section 4(a)(6), the name of the intermediary through which the offering is being conducted, and a link directing the potential investor to the intermediary's platform; the terms of the offering; and factual information about the legal identity and business location of the issuer, limited to the name of the issuer of the security, the address, phone number and website of the issuer, the e-mail address of a representative of the issuer

A Summary of the SEC and Ohio Crowdfunding Provisions (continued)

and a brief description of the business of the issuer.

Regulation Crowdfunding provides that, notwithstanding the prohibition on advertising, an issuer, and persons acting on behalf of the issuer, may communicate with investors and potential investors about the terms of the offering through communication channels provided by the intermediary on the intermediary's platform, provided that an issuer identifies itself as the issuer in all communications. Persons acting on behalf of the issuer must identify their affiliation with the issuer in all communications on the intermediary's platform.

C. Issuer Reporting

Section 4A(b)(4) of the 1933 Act provides that, not less than annually, a crowdfunding issuer must file with the Commission and provide to investors reports of the results of operations and financial statements of the issuer. As amplified by Regulation Crowdfunding, the annual report must: contain information similar to that required in the offering statement; include disclosure about the issuer's financial condition; be filed no later than 120 days after the end of the most recently completed fiscal year covered by the report; and be posted to the issuer's website.

IV. NATURE OF THE INVESTORS

THE MOB RUSHES IN WHERE INDIVIDUALS FEAR TO TREAD.

— B.F. SKINNER

There are no financial sophistication or financial wherewithal requirements applicable to a crowdfunding investor. However, Section 4(a)(6)(B) of the 1933 Act limits the amount that an issuer may raise from an individual investor. Specifically:

Investor's Financial Status	Maximum Crowdfunding Investment
Annual Income or Net Worth < \$100,000	Greater of: (a) \$2,000; or (b) 5% of the lesser of the Annual Income or Net Worth
Annual Income and Net Worth ≥ \$100,000	Lesser of: (a) 10% of Annual Income; (b) 10% of Net Worth; or (c) \$100,000

V. INTERMEDIARIES

Section 4(a)(6)(C) of the 1933 Act requires a crowdfunding transaction to be conducted through a broker or funding portal that complies with the requirements of Section 4A(a) of the 1933 Act. The term "broker" is generally defined in Section 3(a)(4) of the 1934 Act as any person that effects transactions in securities for the account of others. Section 3(a)(80) of the 1934 Act defines the term "funding portal" as any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to Section 4(a)(6), that does not: (1) offer investment advice or recommendations; (2) solicit purchases, sales or offers to buy the securities offered or displayed on its website or portal; (3) compensate employees, agents or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; (4) hold, manage, possess or otherwise handle investor funds or securities; or (5) engage in such other activities as the SEC, by rule, determines appropriate.

Funding portals must register with the SEC on the new Form Funding Portal, and become a member of a national securities association, i.e., FINRA. However, Regulation Crowdfunding exempts funding portals that meet certain requirements from registration as a broker-dealer. All funding portals must have policies and procedures reasonably designed to prevent violations of federal securities laws.

Regulation Crowdfunding also requires intermediaries (brokers and funding portals) to, among other things:

- Provide investors with educational materials that explain, among other things, the process for investing on the platform, the types of securities being offered, and the information a company must provide to investors, resale restrictions, and investment limits;
- Take certain measures to reduce the risk of fraud, including having a reasonable basis for believing that a company complies with Regulation Crowdfunding and that the company has established means to keep accurate records of securities holders;
- Make an issuer's required disclosures available to the public on its platform for a minimum of 21 days before any

security may be sold in the offering, and throughout the offering period;

- Provide communication channels to permit discussions about offerings on the platform;
- Provide disclosure to investors about the compensation the intermediary receives;
- Refrain from accepting an investment commitment from an investor until after that investor has opened an account with the intermediary;
- Have a reasonable basis for believing an investor complies with the annual individual investment limitations;
- Provide investors notices once they have made investment commitments and confirmations at or before completion of a transaction;
- Comply with maintenance and transmission of funds requirements; and
- Comply with completion, cancellation and reconfirmation of offering requirements.

VI. CIVIL LIABILITY

Section 4A(c) of the 1933 Act provides for civil liability if an issuer relying on Section 4(a)(6) of the 1933 Act makes an untrue statement of a material fact, or omits to state a material fact required to be stated or necessary in order to make the statements in the light of the circumstances under which they were made not misleading, provided that the purchaser did not know of such untruth or omission. An issuer may avoid such liability if it sustains the burden of proof that it did not know, and in the exercise of reasonable care could not have known, of such untruth or omission. Further, an issuer may avoid or limit liability through the "negative causation" defense in Section 12(b) of the 1933 Act. An action against the issuer may be brought by any purchaser in the crowdfunding offering, either at law or in equity, to recover the consideration paid for such security with interest, less the amount of any income received, upon the tender of such security, or for damages if such person no longer owns the security. The cause of action is subject to the one year/three year statute of limitations in Section 13 of the 1933 Act.

VII. OHIO

The JOBS Act amended Section 18(b)(4) of the 1933 Act to include securities offered pursuant to the Section 4(a)(6) exemption in the definition of "covered secu-

A Summary of the SEC and Ohio Crowdfunding Provisions (continued)

rities.” As a result, Ohio’s notice filing provision – R.C. 1707.092(C) – is the Ohio companion provision for a federal crowdfunding offering made pursuant to Section 4(a)(6).

A. Issuer Filing Obligations

The JOBS Act also amended Section 18(c)(2) of the 1933 Act to add a new paragraph (F), which addresses the filing and fee that a state may require in connection with an offering of crowdfunding securities that qualify as covered securities. Specifically, a filing with, and a payment to, the Division is required in connection with federal crowdfunding offering made pursuant to Section 4(a)(6) only if: (1) the issuer has its principal place of business in Ohio; or (2) purchasers of 50% or greater of the aggregate amount of the issue are residents of Ohio.

If a filing with the Division is required, R.C. 1707.092(C) provides that such filing shall consist of: (1) any document filed with the SEC, i.e. a copy of the Form C, and a copy of the periodic report required by Section 4A(b)(4) of the 1933 Act (the filing of this periodic report also will satisfy the “annual or periodic reports” requirement in R.C. 1707.092(C)(2)); (2) a consent to service of process; and (3) a filing fee consisting of \$100 plus one-tenth of one percent of the aggregate price at which the securities are to be sold to the public in Ohio (which calculated fee shall not be less than \$100 nor more than \$1,000).

Consistent with Section 18(a) of the 1933 Act, such filing with the Division shall be in the nature of a notice filing, and no Ohio law, rule, regulation, order, or other administrative action shall directly or indirectly prohibit, limit, or impose conditions, based on the merits of such offering or issuer.

B. Intermediaries

The JOBS Act amended Section 15(i) of the 1934 Act to include SEC-registered funding portals within the category of securities professionals subject to limited state regulation. However, pursuant to Section 15(i)(2)(B) of the 1934 Act, an SEC-registered funding portal with its principal place of business in Ohio is subject to Division examination and enforcement of any Ohio law, rule, regulation, or administrative action, provided that such law, rule, regulation, or administrative action is not in addition to or different from the requirements for registered funding portals established by the SEC.

C. Enforcement

Pursuant to Section 18(c)(1) of the 1933 Act, the Division retains jurisdiction under Ohio law to investigate and bring enforcement actions regarding securities or securities transactions in connection with a federal crowdfunding offering made pursuant to Section 4(a)(6) of the 1933 Act, with respect to fraud or deceit, or unlawful conduct by a broker, dealer, funding portal, or issuer.

Pursuant to Section 18(c)(3) of the 1933 Act, the Division may suspend the offer or sale of securities in a crowdfunding offering as a result of the failure to submit any filing or fee required under law and permitted by Section 18 of the 1933 Act.

NOBODY GOES THERE ANYMORE. IT’S TOO CROWDED.

-- YOGI BERRA

THE OHIO SECURITIES BULLETIN

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**OHIO DEPARTMENT OF COMMERCE
DIVISION OF SECURITIES**

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The Ohio Administrative Code prohibits advertisements which contain any untrue statement of a material fact or that are otherwise false or misleading.¹ Unfortunately, many Registered Investment Advisers (“RIAs”), Investment Adviser Representatives (“IARs”), and Chief Compliance Officers (“CCOs”) are unaware that some of their advertisements are misleading. They may not realize that promissory language, marketing hyperbole, and statements that cannot be proven with objective evidence, might be viewed as false or misleading by an examiner.

Before approving an advertisement, the CCO for an RIA should scrutinize the:

- Form or content of the communication;
- Implication or inferences arising out of the communication in view of its context; and
- Prospect’s sophistication.²

Examiners are particularly concerned about advertisements that might mislead unsophisticated investors.

After a firm has been examined, the RIA typically receives a letter which lists the deficiencies found by examiners and recommends corrective action. Deficiency letters from SEC examination teams, as well as state examiners from across the U.S., provide guidance regarding the words, phrases, and statements that are of concern to securities regulators. The advice that follows is based upon years of reviewing examiners’ criticism of RIAs’ marketing efforts.

LANGUAGE THAT CAN CAUSE AN ADVERTISEMENT TO BE MISLEADING

On occasion, RIAs promise too much in their advertisements or guarantee a successful outcome. Furthermore, it is common for RIAs’ advertisements to

assure investors that they will have peace of mind once they become clients. Those statements are potentially misleading because some clients will still worry about their finances, even if the market is booming and their adviser is making excellent investment decisions.

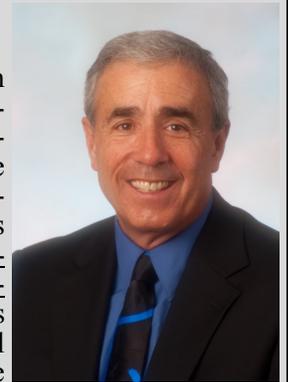
As RIAs articulate their philosophy and strategy in advertisements, they must avoid giving the impression that success is a sure thing. For example, it could be misleading for an RIA to advertise that the firm utilizes a proven investment strategy that ensures success. Examiners might take issue with the word “proven” and could dispute the so-called proof that the strategy will always work.

One approach for avoiding false or misleading advertisements is to couch content as a goal, not a guarantee. For example, instead of assuring clients that they will reach their investment objectives, an RIA might advertise that this is the firm’s mission or goal. There are risks, however, when using this approach. As an example, it would still be misleading for an RIA to advertise that its goal is to identify “can’t-miss” investment opportunities. Although this statement stops short of being a guarantee, it still promises far too much.

IF YOU CAN’T PROVE IT, YOU CAN’T SAY IT

Using exaggerations and superlatives in advertisements will inevitably lead to compliance problems. Some RIAs foster the impression that their investment strategies are superior to other advisory firms. For example, stating that the firm’s strategies are

LES ABROMOVITZ is an attorney and a senior consultant for National Compliance Services, Inc., the sister company of Regulatory Compliance LLC. Les is the author of The Investment Advisor’s Compliance Guide, which was published by the National Underwriter Company. He is also the author of Growing within the Lines: The Investment Adviser’s Advertising and Marketing Compliance Guide.



“exceptional,” “top-tier,” or “world class” might be viewed as marketing hyperbole, which is inherently misleading. Similarly, RIAs sometimes describe their approach to investing as “state-of-the-art,” “ground-breaking,” or “cutting edge.” Those kinds of descriptions are difficult to substantiate. An RIA must be able to prove all advertising claims with objective evidence. An RIA that advertises it is the top firm in the region or the most qualified, would find it difficult to substantiate those descriptions with objective evidence.

RIAs occasionally advertise that the firm and its IARs are well respected by their peers and are highly thought of in the community. They might claim to have an outstanding reputation or national prominence. These kinds of statements are almost impossible to prove with objective evidence and are likely to be viewed as false or misleading.

RIAs sometimes attempt to set themselves apart with generalizations that are not quite accurate. A few RIAs’ advertisements give the impression that they are the only firm in town that puts clients’ interests ahead of their own.

¹ See Ohio Admin. Code § 1301:6-3-44(A)(1)(e).

² See SEC No-Action Letter to Anametrics Investment Management (pub. avail. May 5, 1977).

WORDS MATTER, ESPECIALLY IN RIA ADVERTISEMENTS (Continued)

Many RIAs inadvertently refer to their performance in advertisement, which raises additional compliance issues. Advertising that the firm has delivered solid long-term returns is vague and potentially misleading. Do solid long-term returns mean that accounts outperformed their relevant benchmarks? Is that statement true after advisory fees are deducted? If not, the advertisement is potentially misleading. The Ohio Adviser Package points out that an advertisement using performance data must disclose all material facts to avoid any unwarranted inference.³

RIAs sometimes oversell their accomplishments in advertisements. The firm might boast that IARs are sought out by the media for interviews. Examiners are likely to question that assertion if IARs have not been recently interviewed or quoted by the media.

IMPRECISE AND INCONSISTENT ADS CAN CAUSE COMPLIANCE PROBLEMS

Content that is inconsistent with an RIA's Form ADV and/or advisory contract is likely to be viewed as misleading. One advertisement stated that the firm worked on a fee-only basis, but the RIA's Form ADV disclosure brochure indicated otherwise. Although RIAs are required to update their

Forms ADV as their business models and personnel change, they do not always revise their websites and social media advertisements in a timely manner.

Credentials and degrees used by members of an RIA can be misleading. For example, it might be misleading to include a PhD after an IAR's name without disclosing if the doctorate degree was earned in a field unrelated to personal finance or investing. Furthermore, it may be misleading for an IAR to advertise that he is an attorney if he never passed the bar or his license has lapsed. Similarly, it could be misleading for an IAR to tout that she is a CPA if her license is now inactive. In order to reference those achievements, they would need to make full disclosure of the relevant information.

In addition, securities regulators are very concerned about credentials and designations that imply expertise in dealing with senior investors. Ohio adopted the NASAA model rule governing the use of senior-specific designations.⁴

DISCLOSURES ARE NOT ENOUGH TO PREVENT ADVERTISEMENTS FROM BEING MISLEADING

Robust disclosures in plain English help to prevent an advertisement from being false or misleading. Never-

theless, disclosures will not necessarily correct an advertisement that contains misstatements. For example, RIAs occasionally advertise that they are an award-winning firm. To avoid being misleading, it is not enough that the RIA and/or IARs are the recipients of awards from third-party rating services like Barron's. The advertisement must also disclose the criteria on which the award was based, as well as other disclosures to avoid misleading clients and prospects.⁵

Advertising content can become misleading as it ages. If assets under management ("AUM") go up or down significantly, an RIA should make sure that it changes those figures in all advertisements, including websites and social media. At a minimum, an RIA should disclose the date on which AUM were calculated, but the advertisement might still be misleading if the current value of investments managed is materially different.

Social media used to market the firm may be misleading. A seemingly innocent Twitter message can be misleading without a link to disclosures. Like all advertisements, the content must be kept for the period required by the Ohio's Books and Records Rule.⁶

WATCH OUT FOR OTHER ADVERTISING PITFALLS

Just as a poor choice of words can cause compliance problems, marketing gurus can steer RIAs in the wrong direction. These marketing experts may be unfamiliar with the advertising restrictions that apply to RIAs and sometimes go overboard in their efforts to differentiate a firm from its competitors.

Advertisements containing false or misleading content are more than just a compliance problem. These kinds of advertisements can inflate clients' expectations. When those expectations are not met, clients are likely to be very dissatisfied.

RIAs, IARs and CCOs should not forget about Ohio's other advertising restrictions, including a prohibition against the use of testimonials in advertisements. The best testimonial for your firm's advertisements is when examiners don't find any compliance deficiencies in them. In answer to your next question, however, you should not advertise that examiners found no compliance issues at your firm as one RIA in another state tried to do.

³ [General Information About the Oversight of Investment Advisers and Investment Adviser Representatives Operating in Ohio](#), Ohio Division of Securities, 27 (June 2004). This compilation of material and information was prepared by the Ohio Division of Securities to provide general information and assistance about the Division's oversight of investment advisers and investment adviser representatives in Ohio. This information should not be construed as legal advice and is not a substitute for a thorough review of the relevant statutory provisions set out in Chapter 1707 of the Ohio Revised Code and related administrative rules set out in Chapter 1301:6-3 of the Ohio Administrative Code.

⁴ See OHIO ADMIN. CODE § 1301:6-3-44(J).

⁵ See SEC No-Action Letter to the Investment Adviser Association, Investment Advisers Act of 1940 Rule 206(4)-1(a)(1), December 2, 2005.