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ohio securities bulletin

State of Ohio
John J. Gilligan, Governor

Department of Commerce
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Division of Securities
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COMMENTS OF THE COMMISSIONER
Important Weeks Ahead

The successful resolution during the next several weeks of a number of substantive issues which have come into focus during the past month will be very important to the implementation of the Division of Securities' Program for 1973. The most significant of these issues are discussed below.

1. *Integrity of the Division:* The question of the integrity of the Division and its employees, a matter which until recently had been taken for granted by those of us in positions of responsibility, has assumed ominous proportions in the wake of the Realty National investigation and the continuing series of public inquiries involving the Division of Securities and other divisions of the Department of Commerce. It appears that for some time companies dealing with the Department have been the target of a number of attempted shakedowns by outside persons falsely representing themselves as being able to exert influence over regulatory decisions, and that matters within the jurisdiction of the Division of Securities have been in the center of this activity.

To my knowledge, there is no evidence that any Department or Division personnel have had any connection with shakedown attempts which have been recently discovered. However, the mere fact that a pattern of such occurrences has arisen is sufficient reason for administrators to become deeply concerned about taking appropriate steps to minimize and, if possible, to eradicate the possibility of such activity continuing to occur within the boundaries of their regulatory jurisdictions.

(A) *Security Measures:* A number of specific measures are being undertaken by the Division of Securities to tighten security with respect to information relating to pending matters. The Chief Counsel of the Division has been assigned responsibility for implementing and supervising all security measures.

At the risk of reducing our responsiveness to complaints and inquiries, the Division is requiring that all questions concerning pending matters from persons outside the Division other than the designated representatives of the party at interest be submitted in writing to the supervisor of the section which is considering the matter. Copies of all such written communications and written replies will be forwarded to the Chief Counsel of the Division. All Division personnel have been instructed to refuse to discuss pending matters with persons outside the Division other than the designated representatives of the party at interest and to report to the Chief Counsel any oral communications received from other outside parties.

Exceptions to the foregoing requirements will be allowed with respect to discussions with third parties during the course of field examinations and investigations being conducted by Division personnel, but such personnel have been cautioned against unnecessarily disclosing material information to third parties. Exceptions will also be allowed for communications between the Division and other regulatory agencies with a common interest in the subject matter, but all Division personnel have been instructed to prepare file memoranda in each instance outlining the contents of such communications.

Written requests will be required of all persons outside the Division desiring to inspect Division files and other matters of public record. Such requests must include a statement setting forth a legitimate purpose for the inspection. Inter-office memoranda, information obtained through investigation, and all additional material other than items submitted to the Division by the party at interest will be removed from the file prior to its inspection by any outside person.

Section supervisors have been instructed to notify the Chief Counsel of the Division of the existence of any matter which has been pending before the Division for an unusually long period of time or which has been the subject of unusual publicity or controversy. All persons and entities having matters pending before the Division are cautioned to be wary of any person representing himself as having influence with the Division and are urged to report immediately to the Chief Counsel of the Division and to the appropriate law enforcement authorities any apparent or implied solicitation regarding a matter of Division regulation.

Open communication between employees of the Division concerning all matters of common interest will continue to be encouraged to promote learning and the exercise of sound judgment. A complete veil of secrecy over all Division activities is not believed to be in the best interests of good government. However, if necessary, additional protective measures will be developed and implemented during ensuing weeks.

(B) *Ultimate Solution:* In the long run, specific security measures will not be the determining factor for the Division with respect to the integrity of the regulatory process. The real key to this question lies with the capacity of the Division to regulate by means of sound policies, widely publicized, promptly and reasonably applied. For this reason, the development and publication in this bulletin of written regulatory standards for all areas of Division regulation takes on added importance as the first priority of the Division's administrative plan. Similarly, efforts to increase responsiveness to applications and to reduce backlogs will continue to be given strong emphasis. The ultimate attainment of Division objectives in these areas should go a long way toward eliminating completely the illusion of cronyism and arbitrary regulation which lends plausibility to representations of influence. We are doing our best to move ahead in these areas as rapidly as the limitations of time and energy allow.

2. *Impact Upon the Division Staff:* One possible result of the major upheaval which has been caused by the Realty National investigation and related inquiries may be a serious adverse impact upon the Division staff and upon its capacity to vigorously pursue the ambitious regulatory program which has been undertaken.

Morale has already been seriously affected. Much time has been spent responding to the inquiries of reporters. A large proportion of the energies of a number of people has been diverted to the analysis of questions arising from the investigation.

Many persons have expressed serious doubts about the ability of the Department to shield itself from a certain proportion of criticism which is politically inspired. As an election year approaches, they fear that the Division may become a political battleground besieged by a continuous wave of adverse publicity.

Some members of the Division staff are now pondering the question of how long they should remain in the middle of what could be a personally dangerous situation. What young attorney can afford to risk his career against the possibility of having his reputation damaged by being publicly associated with a future controversy like the Realty National case which he can neither foresee nor avert? What corresponding rewards does he receive to make those risks worth taking other than the satisfaction of contributing to an attempt to improve state government?

Staff members who pledged to remain with the Division for at least one year when we began planning the Division program in January have been released from those pledges. Each staff member must make his own decision based upon his individual analysis of the risks and rewards involved. The outcome of these decisions may well serve as a useful barometer of the overall health of the Division and of the administrative structure of state government. If the administrative environment of the Division is such that capable, aggressive, idealistic young people cannot remain in this agency without undue risk, then perhaps steps should be taken to neutralize the Division as a political issue and structurally insulate it from the political process.

3. *Role of the New Securities Act:* Hearings before the Senate Commerce and Labor Committee on the proposed new Ohio Securities Act began on May 23, 1973.

The Division had been concerned that the substantial merits of this legislation might be overlooked and that too much attention might be focused upon the recent adverse publicity to which the Division has been subjected. Fortunately this has not been the case to the considerable credit of the chairman and members of the committee and all of the other participants in the legislative process. However, it is appropriate that some consideration be given to statutory characteristics that might underlie the causes of such publicity and the Division has faced this question squarely in the hearings.

The new Securities Act contains features which will reform Division operations in such a manner as to aid in reducing the potential for future shakedown schemes. Specifically, the requirement of written rules, the specification of deadlines for Division action on applications, and the provision for a Securities Board of Review to hear appeals from Division orders all encourage the kind of governmental responsiveness which removes the motivation for extralegal measures.

The Division has attempted to generate bi-partisan support for the new Securities Act and continues to seek such support because it believes this legislation to be in the best interest of all segments of the Ohio population and economy. The Division also continues to seek the endorsement of the Ohio State Bar Association for the new Securities Act and is optimistic about receiving the helpful stamp of approval of that organization.

At this point it appears likely that due to the broad scope and complexity of this bill, it will be assigned to a special study committee for further consideration. Although the Division hopes to move forward on this bill as rapidly as possible, it is unlikely that Senate action can be achieved before adjournment, now anticipated for the end of July.

4. *Three Important Cases:* Three recent court cases have raised significant issues which may have a dramatic impact upon the operations of the Division.

In the case of *State of Ohio vs. Abdulla,* decided on March 4, 1973, the Common Pleas Court of Summit County declared the existing Ohio Securities Act and its implementation by the Division in criminal prosecutions to be unconstitutional. The Court concluded that the Act confers upon the Division too much latitude in making classifications for purposes of penal enforcement and that the Division exercised "conscious intentional discrimination" in the application of its enforcement powers under the Act. This decision, which is currently being appealed, raises complex questions about how Division enforcement activities can be conducted.

Now pending before the Common Pleas Court of Franklin County is the case of *Van Raalte vs. Ohio Department of Commerce,* filed on March 17, 1973, in which the plaintiff seeks a declaratory judgment restraining the Division from applying unwritten policies to securities registrations. This case goes to the heart of the rulemaking questions which have been a matter of concern to the Division for years.

Perhaps most significant of all in the long run, however, is the case of *Tcherepnin vs. Franz,* decided on February 28, 1973, by the United States District Court for the Northern District of Illinois, Eastern Division. In this case, involving administration by a state agency of the Illinois Savings and Loan Act, the court declared that by entering into a sphere of activities that is subject to Congressional regulation (the federal securities laws) the state had *ipso facto* waived its sovereign immunity, and that because of the failure to exercise the degree of care necessary to protect public investors (depositors), the state was liable to an award of damages in the amount of twenty million dollars. This landmark decision may have a grave and far-reaching effect upon the willingness of states to embark upon regulatory functions. The Division of Securities recognizes the importance of the principle upon which this case is based and will endeavor to pursue its regulatory responsibilities as thoroughly and vigorously as possible.

All three of these recent cases are symptomatic of deeply rooted regulatory problems which all agencies, and the Division of Securities in particular, are facing and serve as timely reminders to the Division in its ordering of priorities and allocation of resources.

5. *Foreign Real Estate — Special Regulatory Efforts Needed:* The Division has been attempting to set new directions in all areas of its activity and because of limited resources has been approaching the implementation of its administrative plan on a section by section basis. During April, special staff support was concentrated upon the Credit Union Section, and in May this support was transferred to the Foreign Real Estate Section of the Division.

During the second and third weeks in May, a special investigation was conducted by the Division into a number of land sales activities in the greater Cleveland area in an attempt to gauge the effectiveness of Division regulation. We were disturbed to discover as the result of a relatively brief investigation an apparently extensive pattern of violations, including examples of fraudulent and misleading sales pitches, unethical practices, unlicensed and unsupervised sales representatives, stolen Division brokers' and salesmen's examinations, illegal sub-brokerage arrangements, inadequate capitalization, concealed personal and corporate identities, and complex relationships between competing organizations. The possibility of underworld activity in this area is of particular concern to the Division.

Obviously, past Division regulation of this industry has been less than adequate. A complete cleanup of the type that would appear warranted is far beyond the capacity of the Division to carry out. Manpower is simply not available and other operations cannot be discontinued. However, in an effort to make meaningful inroads in this area, a special task force has been assembled including one investigator from the Enforcement Section, one examiner from the Audit Section and the Staff Attorney of the Division, who will be in charge, to take action against foreign real estate violations as a matter of first priority.

Foreign land brokers and salesmen found participating in material violations will be suspended. Willingness to satisfy complainants will not be sufficient to avert administrative action by the Division. Those found participating in illegal activities will be referred for prosecution. Interstate land developers will be held ultimately responsible for deeply rooted patterns of violations on the part of their representatives. Their land registrations will be on the line. We do not intend to allow the public to be subjected to unconsiderable land sales activities any longer. Permissiveness on the part of the Division in the past will not be allowed as an excuse for continuing violations.

The Division is cooperating with the HUD Interstate Land Sales Administrator and with various regulatory authorities of neighboring states in assembling information regarding violations and in developing new regulatory standards for the industry. Special hearings regarding industry activities may be held by the Division later in the year if such a step might appear to be productive. Anyone having information which might be helpful to regulatory efforts is urged to contact Mr. Gregory D. Seeley at the Division.

Note: For interesting reading on the subject of interstate land sales, see Morton C. Paulson, *The Great Land Hustle,* Henry Regnery Co., 1972.

6. *More on the Division's Administrative Plan: Broker-Dealer Section:* The Broker-Dealer Section faces an immense task in processing the large volume of applications and other items of documentation filed with the Division. Much progress has been made during the past year toward the automation of a significant portion of this paperwork. However, like other sections of the Division, the Broker-Dealer Section is hampered by long outmoded regulatory standards and procedures. An effort will be made this year to implement changes in a number of areas.

The $10,000 minimum net capital requirement for licensed broker-dealers contained in existing Division regulations is too low and will be increased, by the adoption and promulgation of an amendment, to at least $25,000. Many states are presently considering raising their net capital requirements to $50,000 or more. Hopefully a significant increase will help to eliminate the large proportion of unfunded liability risk which is represented by marginal broker-dealer operations, particularly in the area of foreign real estate sales. In addition, the practice of satisfying the net capital requirement by means of a guarantee submitted by an affiliate without any actual infusion of capital into a prospective corporate licensee will be eliminated. Real assets are required to evidence the financial stability of a broker-dealer as well as his capacity to cover liabilities arising from his sales activities.

Standards and procedures must be developed for implementing meaningful suitability principles in broker-dealer transactions. There is evidence that suitability considerations are too often ignored by many licensees.

Written examinations for broker-dealers and salesmen must be revised to be made more relevant to current industry principles and practices and to better distinguish between persons qualified and those unqualified to engage in the securities business. Ninety percent or more passing scores call into question the proper level of difficulty currently incorporated into the examinations. Also, measures need to be taken to prevent the examination process from being further compromised.

The broker-dealer field-auditing procedure also needs revision. Field examinations are not sufficiently directed toward the discovery of substantive violations. Greater use of surprise spot-check examinations directed toward specific violations would be beneficial. The Broker-Dealer Section will have its hands full in attempting to deal with these problems in the future.

7. *Regulatory Standards:* This issue of the bulletin contains the first major group of regulatory standards which have been distributed to the Bar and the industry in some time. As Ken Royalty states in his introductory remarks, these are merely a restatement of previously unwritten policies which have been followed by the Division in considering applications for securities registration. More will follow in the July issue of the bulletin. At that point Ken will begin concentrating upon the restatement of unwritten policies for other sections of the Division, the completion of important changes required in existing policies, and the development of new policies in areas where the Division has had no clear policy before.

We appreciate the patience with which everyone has awaited the appearance of a meaningful product of this undertaking. Those of you who find these guidelines helpful can thank Ken as well as Bill Boardman, Bernard Boiston, and Lee Passell for our progress on regulatory standards.

8. *Institutionalization of the Division Program:* Efforts to improve operations of the Division have been undertaken several times in the past to be later abandoned as a result of personnel changes, austerity programs, dissipation of energy, or a failure to follow through by firmly committing all levels of Division personnel to the realization of specific objectives. State government has an alarming capacity to swallow attempts at change and to leave no visible trace.

In order to assure, to the extent that is humanly possible, that expressed commitments to change are fulfilled by the Division, a mechanism is being created to institutionalize its regulatory program by causing implementation to be pursued vigorously at the section level. This objective has already been accomplished to some extent in the Registration and Credit Union Sections where new policies are being carried forward very efficiently by section supervisors. In order to further strengthen regulatory and administrative commitments in all sections, a system of adopting, distributing and cataloging internal directives is being established. The Deputy Commissioner of Securities has been assigned responsibility for working with all section supervisors to implement specific reform measures on a continuous basis. Section supervisors are required to report periodically to the Deputy Commissioner regarding progress being made and difficulties being encountered in all areas.

An all-day planning and review session was recently held involving members of the Commissioner's staff and all section supervisors to focus upon the institutionalization process. This process will be critical to the production of lasting substantive policy results.

Note: Some of the above comments may appear to be ununusually direct but I consider it important in the interest of better understanding to communicate to the Bar and the securities industry the various motivating factors underlying the development of Division policies, and I will continue to do so in this bulletin.

William L. Case, III

POLICY DEVELOPMENTS
Fairness Hearings

Section 1707.04 of the Ohio Securities Act confers discretion upon the Division to exempt business reorganizations from the registration and licensing requirements of the Act by conducting public hearings upon the fairness of the terms of issuance and exchange of securities in such transactions.

Most companies filing applications for fairness hearings under Section 1707.04 do so for the purpose of avoiding federal registration through compliance with the provisions of Section 3(A)(10) of the Securities Act of 1933. The substitution of Rule 145 for Rule 133 this year has created even stronger incentives for seeking exemption from federal registration via this route.

In the past the Division has routinely accepted applications for fairness hearings in all cases with the exception of those involving contested transactions and has more or less perfunctorily completed its determinations by means of rather summary proceedings.

The Division has re-evaluated its policy with respect to the granting of fairness hearings and has concluded that, in light of the principles underlying Section 3(A)(10), the regulatory interests and the manpower resources of the Division, and the widespread existence of market pre-conditioning (gun jumping) in connection with reorganization transactions for which applications have been made in the past, the exercise of its discretion in the granting of fairness hearings should, as a matter of policy, be restricted to transactions which are particularly suitable for determination by this agency. Accordingly, the Division will, in its discretion, refuse to grant a hearing upon an application for which its action will serve no meaningful regulatory purpose for any of the following reasons:

(a) the acquired corporation has no shareholders residing in Ohio and the shares to be issued in the transaction represent less than 25% of the shares to be outstanding following the completion of the transaction;

(b) another exemption from federal or state registration is available for the transaction;

(c) the market for the shares to be issued has been preconditioned by sales activities of either of the constituent corporations prior to the receipt of the application by the Division, or;

(d) the applicant has otherwise participated in any way in the violation of the securities laws of the United States, the State of Ohio or any other state.

The gun jumping question is of particular concern to the Division because of the confusion which exists with respect to what type of pre-filing activity constitutes an offer or sale and, therefore, a violation in the corporate reorganization context. Pre-filing communications between the constituent corporations are not considered to be violative of the Ohio Securities Act. On the contrary, the negotiation of merger agreements between boards of directors and other communications allowed by Rule 145 are acknowledged as entirely permissible business procedures. However, communications to corporate shareholders to whom securities are proposed to be offered in such transactions are considered to be in the nature of market pre-conditioning activities whether in the form of exchange offers or proxy solicitations. Votes of shareholders at annual or special meetings on the approval of reorganization transactions and executed contracts for the exchange of shares will be considered to be prima facie violations. Clearly the Division would serve no regulatory purpose if it simply ratified plans of reorganization where transactions have previously been substantially completed or shareholders substantially influenced with respect to their investment decisions.

All hearings pursuant to Section 1707.04 will be conducted in compliance with the requirements of the Administrative Procedure Act, sections 119.01 to 119.13, inclusive, of the Ohio Revised Code. Applicants will be required to demonstrate by affirmative testimony the applicability of the exemption, compliance with relevant state and federal laws, and the fairness of the reorganization transaction. The Division will require that the recipients of offers for the exchange of securities be presented with adequate disclosure documents which will be subject to Division approval. Applicants should allow sixty days from the date of filing for the completion of proceedings under Section 1707.04.

The proposed new Ohio Securities Act does not contain an equivalent of existing Section 1707.04. This fact reflects the opinion of the Division that this provision does not involve a sufficiently important regulatory interest to justify a commitment of the additional manpower resources required for this type of proceeding. While the existing law remains in effect, the Division will continue to judge each application on the basis of the general criteria outlined above and will publish in this bulletin at a later date a more definitive expression of its position in the form of a statement of policy.

The general subject of mergers, including exemption, registration, and licensing under the existing Act, will be treated separately. Until specifically modified, the position of the Division with respect to the interpretation of Ohio Revised Code Section 1707.03(K)(2), expressed in the statement of policy published in *Ohio Bar* on September 20, 1971, shall be considered to remain in effect.

William L. Case, III

INTERPRETIVE OPINIONS
Recreational Memberships as Securities

I. Investment Contract Theory

Several Midwestern States, including Ohio, are evaluating sales of various recreational organization memberships to determine whether such memberships constitute investment contracts and are, therefore, "securities".

Presently, the Division is concerned with two such recreational ventures. One involves the sale of life memberships in a resort *to be constructed* in the western United States. In return for providing risk or venture capital in the form of a partially non-refundable deposit, a member is entitled to certain benefits and privileges upon completion of the organizational facilities, to include "preferential rights" to use such facilities and discounted prices on room and board at a lodge. The other is similar in concept, but appeals to a more "rugged" membership class: for rather large sums of money, a member is "entitled" to assignment of a particular camp site, and rights to use various facilities constructed by the sponsor. Members of both are subject to annual assessments, in addition to the initial fee, but do not participate or have any rights to share in the gross proceeds or net profits of the development.

Conceptually, the Securities and Exchange Commission and various Blue Sky Agencies have had difficulty analyzing recreational organization memberships in investment contract terms. Certainly, most of these membership arrangements fall outside a strict interpretation of the classic *Howey* test: For purposes of the Securities Act of 1933, an investment contract means a contract, transaction or scheme whereby persons invest money in a common enterprise and are led to expect profits solely from the efforts of the promoter or a third party. . . . See *SEC v. W. J. Howey Co.*, 328 U. S. 193 (1946). Under Ohio law, judicial interpretation of the term "investment contract" for purposes of Section 1707.01(B) of the Ohio Revised Code, is no more helpful than a strict reading of *Howey*. In *State v. Silberberg*, 166 Ohio St. 101, 139 N. E. 2nd 342 (1956) the Ohio Supreme Court stated:

> In determining whether an interest is an investment contract or an interest in a real estate transaction, the principal test is the individual control which the purchaser has over the property or business venture in which he has acquired the interest. If the purchaser is to share in the gross proceeds or net profits of operations managed by the one who is disposing of the interest transferred [it] is generally considered as an investment contract . . . *Id* at 101,342.

In the context of *Silberberg*, the above-cited membership transactions would *not* constitute investment contracts for purposes of Section 1707.01(B) of the Ohio Revised Code, because the member does not share in the gross proceeds or net profits.

To date, most of these recreational developments have avoided securities regulation by arranging their programs so as to fall outside the definition of "security". Various developments have successfully obtained "no-action" letters from the Securities and Exchange Commission so long as sales practices and the provisions for transfer of interests carefully avoid the inference that some benefit over and above the value of the initial investment would accrue to the member. *Compare Caribbean Beach Club, Inc., ['72-73 Transfer Binder] CCH Fed. Sec. L. Rep. ¶78,819 (April 25, 1972)* with Great Western Campers Association, ['71-72 Transfer Binder] CCH Fed. Sec. L. Rep., ¶78,386 (August 13, 1971). The courts will probably follow the same general approach. See *Oregon v. American Campground, Inc.*, 3 *CCH Blue Sky L. Rep. ¶71,064 (December 15, 1972)*

In response to these and other sophisiticated investment transactions, the Division has been interpreting the term "investment contract" more broadly than the narrow confines of a strict *Howey* formulation or the *Silberberg* case. In its attack on pyramid sales schemes, the Division has adopted an "economic realities" approach toward Section 1707.01(B). See *Shaul v. Consumer Companies of America, Inc.*, 3 *CCH Blue Sky Reporter* ¶71,022 (1972). As Professor Coffey suggests, the subjection of the investor's money to the risks of an enterprise over which he exercises no managerial control is the basic "economic reality" of a securities transaction. See Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?* 18 *Case Wes. Res. L. Rev.* 367, 412 (1967). But we have not considered the existence of "risk capital" alone to result in an investment contract; an investment contract results when the promoter couples risk capital with the promise of some valuable benefit resulting over and above the initial value furnished. Therefore, the Division has adopted a modification of Professor Coffey's approach consistent with the pronouncement in *State of Hawaii v. Hawaii Market Center, Inc.* 485 P. 2d 105. (1971) There, the Supreme Court of Hawaii was faced with a complex pyramid sales scheme and developed the following test based on Professor Coffey's Law Review article:

(A) An investment contract is created whenever:

(l) an offeree furnishes initial value to an offeror, and

(2) a portion of this initial value is subjected to the risks of the enterprise, and

(3) the furnishing of the initial value is induced by the offeror's promise or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and

(4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.

In applying this standard to sales of "memberships" in recreational organizations, the Division has concentrated particularly on the representations made to prospective members regarding the "benefit" that will accrue through membership. This is not to say that we have adopted a form-over-substance approach; we have interpreted broadly the resultant "benefit" of these arrangements and have not confined ourselves to the more traditional concept of monetary "profit". In appropriate circumstances, we have adjudged them "investment contracts" and, therefore, "securities".

II The Risk Capital Theory

Although *SEC v. C. M. Joiner Leasing Corp.*, 320 U. S. 344 (1943) may have been the first case to recognize "risk of loss" as an essential attribute of a security, the "Risk Capital" theory did not develop until the decision in *Silver Hills Country Club v. Sobieski*, 361 P. 2d 906 (1961). That case involved the sale of memberships in a country club that was still in the promotional stage. Since the promoters tendered $400 to the venture, clearly the public sale of memberships was needed to complete the acquisition and construction of necessary facilities. In return for providing venture capital, an investor had the right to use club facilities commensurate with his membership status, but received no rights in the income or assets of the club.

On these facts, the Commissioner of Corporations for the State of California brought suit alleging that such a membership is a "beneficial interest in property" within the meaning of the California Corporate Securities Act, and, therefore, a security. Furthermore, it was argued that the purchase of the membership interest was attended by the very risks the securities act was designed to minimize. In upholding the Commissioner, the Supreme Court of California noted:

> We have nothing like the ordinary sale of a right to use existing facilities. Petitioners are soliciting the risk capital with which to develop a business for profit. The purchaser's risk is not lessened merely because the interest he purchases is labelled a membership. Only because he risks his capital along with other purchasers can there be any chance that the benefits of club membership will materialize. 361 P. 2d 909

Interestingly enough, the *Silver Hills* case is *not* an investment contract case, and departs substantially from investment contract theory in at least one critical respect: the court thought it unimportant that the purchaser expected no material benefit or "profit" from his investment other than the use of club facilities. The *Silver Hills* court reached this conclusion because, in its opinion, the California act "extends even to transactions where capital is placed without expectation of material benefits". From this premise, the court reasoned, "(I)t seems all the more clear that [the Act's] objective is to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return on their capital in one form or another." 361 P. 2d at 909 Hence, in California, a securities transaction will arise through the sale of memberships in a promotional venture wherein the purchaser provides risk capital in return for a "beneficial interest in property", *without* the expectation of "profit".

The extension of the Ohio Securities Act to incorporate the "risk capital" theory is a matter which has not yet been completely resolved. Although some cases have held that "memberships" do constitute securities for purposes of the Act, these cases did involve the expectation of profit. *See e.g., Groby v. State,* 109 Ohio St. 543, 143 N. E. 126 (1924). The Securities Staff of the Attorney General's office and the Division are presently considering the applicability of the "risk capital" theory in the context of recreational memberships. The Division expects to adopt in the future an aggressive attitude in regulating the sale of such memberships, to the extent that the current state of the law allows.

Robert J. DeLambo

ILLUSTRATIVE RULINGS

The Effect of Listing as a Condition Subsequent

This is the first in a series of discussions of the application of regulatory standards of the Division to fact situations which are representative of those presented to the Registration Section on a recurring basis. Although the Division's decision in each case is dispositive of only the specific matter described, it is hoped that these discussions will aid the practitioner in anticipating the response of the Division to filings involving similar considerations.

Corporation A has been in operation for three years, the last two being very successful. Although fertilizer is not a product with much glamour, the fact that the average American is spending more time and money tending his lawn and garden has confirmed the president's suspicion that his corporation has entered a segment of the economy that has a lot of "growth" potential. A few months prior to the filing of an application for registration of a public offering, the president caused the closely held corporation to issue to him at a nominal price a substantial amount of stock which he conceded to be cheap stock and therefore subject to escrow and subordination until such time as it has produced net earnings of at least 6% for two consecutive years. If and when Corporation A applies for listing on the AMX, in all probability its application will be favorably considered. However, for various reasons it has not yet done so; therefore, Corporation A cannot avail itself of the listed securities exempt pursuant to 1707.02(E)(1).

Based upon the above information, the question posed to the Division is whether the Division will agree to an automatic cancellation of the restrictions imposed upon the cheap stock when listing is completed subsequent to execution of the Division order.

Fully cognizant of arguments to the contrary, i.e., that listed corporations can issue cheap stock without having the stock subjected to escrow and subordination, the Division has determined not to accede to the proposal on the following grounds:

1. The detriment to the public investor caused by the issuance of the cheap stock will continue to exist regardless of the listing of the stock.

2. The fact that a company is listed does not necessarily mean that its officers will not attempt to "walk away" or "dump" their stock (witness Penn Central and more recently Equity Funding).

3. If Corporation A continues to be highly profitable, only the passage of time would be required for dissolution of the escrow requirements (Query - Why does the holder of the cheap stock want to have the escrow cancelled prior to two years?).

4. The legislature has already expanded the ambit of 1707.02(E)(1) by allowing the exemption to apply to securities listed upon issuance. Thus, at this time, and without the benefit of additional and convincing arguments to the contrary, the Division is not prepared to indirectly dilute the legislative intent concerning the exemption of listed securities.

Bernard G. Boiston

REGULATORY STANDARDS

STATEMENT OF POLICY 1973-3
Organization and Operation of the Registration Process

I. Introduction

In addition to efforts which are currently being exerted to remove uncertainties from the registration process, the Registration Section and its procedures have been reorganized to increase efficiency and to orient the section to identified positions rather than individuals. It is hoped that this reorientation will result in a greater degree of consistency and continuity in the process of dealing with registration matters. The following procedures will take effect on July 1, 1973, and remain in effect thereafter until further notice.

II. Examination of Filings

A. Upon its filing, an application will be assigned to one of four teams which have been established to process various types of registrations. These teams are identified as follows: Intrastate Corporate, Interstate Corporate, Non-corporate, and Notification and Description. The function of the Notification and Description team is the processing of forms 3-O and 6. Each team is composed of a sufficient number of attorneys and/or financial analysts to handle registration applications on a timely basis.

B. The registration teams are each captained by an experienced examiner who will have direct supervisory responsibility for the functioning of his particular team. The team captain will, in the course of these duties, review all objection letters, orders, and other correspondence.

C. Division Orders approving registrations will be drawn by team members and approved by the team captain and Supervisor of the Registration Section.

D. In addition to the assignment, control, and supervision of various pending registrations and the implementation of established regulatory standards, the Supervisor of the Registration Section will confer with team captains and, when time permits, with applicants regarding:

1. requests for variances from established regulatory standards, and

2. questions involving areas where no established regulatory standards exist.

III. Communications With Examiners

A. Telephone inquiries regarding applications will be accepted only from persons identified in the application as the appointed representatives of the applicant. These inquiries should be addressed to the team member processing the application, or in his absence, to the team captain.

B. No representative of an applicant will be received at the Division without an appointment.

C. There will be no oral approvals; telegrams, however, will be issued, subject to SEC effectiveness in the case of interstate registrations.

IV. Internal Appeals

A. It is the opinion of the Division staff that the interests of both applicants and the Division will be best served if the appeal procedure set forth below is followed and attempts are not made to circumvent this procedure by attempting to contact higher authorities by other means.

B. Comment letters will in most instances be drafted by team members. It is hoped that discussions among team members, team captains and applicants will resolve the substantive problems raised by most comment letters.

C. An applicant desiring to appeal a decision made at the team level, including any item which has not been resolved to mutual satisfaction, must do so in a written request addressed to the Supervisor of the Registration Section. Such request should describe the disposition of each item set forth in the Division's comment letter and present support for any contrary position taken by the applicant. The Supervisor of the Registration Section will review this documentation, schedule meetings if appropriate and attempt to resolve substantive areas of disagreement. If an impasse is reached, he will issue a letter requesting that the application be withdrawn. This letter will briefly set forth those substantive questions which are yet to be resolved and which form the basis for the request for withdrawal.

D. An applicant may either withdraw its application or appeal the decision of the Supervisor of the Registration Section to the Deputy Commissioner. Such appeal must be in writing and the Deputy Commissioner may, at his discretion, convene a meeting to discuss the basis for the request for withdrawal. If no appeal is made from the decision of the Supervisor of the Registration Section, or if, following his consideration of the matter, any substantive questions still remain to be resolved, the Deputy Commissioner will issue a notice pursuant to O.R.C. Section 119.07, which shall set forth the intention of the Division to enter an order denying the application for registration.

E. The Deputy Commissioner will have direct responsibility for the day to day operation of the Registration Section and the Commissioner will ordinarily become involved only following a formal hearing pursuant to the provisions of Chapter 119 O.R.C. or under circumstances wherein he deems that the broad policy impact of a specific matter would warrant his involvement at an earlier stage.

V. Special Procedures

In addition to his supervisory responsibilities, the Supervisor of the Registration Section will personally implement certain special procedures related to the registration process.

A. He will maintain a special filing system to provide consistency in the application of Division regulatory standards. In addition to the latest regulatory standards, these files will contain a record of and reasons for significant variance from such standards. These files of standards and variances will be open for review at reasonable times by all interested persons.

B. He will arrange for pre-filing conferences with prospective applicants in situations limited to the two set forth in II(D) above. However, once an application has been filed, the team concept and written comment procedure must be followed.

C. Following a pre-filing conference, a prospective applicant may set forth in writing the facts presented to the Supervisor of the Registration Section at the conference and request an advance ruling regarding whether such facts should be regarded by the Division as constituting an offering on "grossly unfair terms". If a favorable ruling is issued, it may be relied upon by the registrant, within a reasonable period of time not to exceed six months, to effect a registration of securities.

D. The Supervisor of the Registration Section will also entertain written requests for expedited treatment of an application for registration. While it is hoped that all applications will be processed in a timely fashion, requests for expedited treatment will be considered when:

1. the applicant demonstrates that deadlines which must be met have been imposed for tax or other reasons beyond the control of the applicant;

2. the applicant demonstrates neglect on the part of the Division in processing the application;

3. expedited treatment has been granted by the SEC; or

4. there exists some other just cause for expedited treatment.

Clearly the procedures which have been outlined above do not anticipate all of the problems which may arise in connection with an application for registration. It is hoped, however, that members of the Bar and others will attempt to follow these procedures where applicable and use them as a guide in dealing with those situations which the Division has failed to anticipate in this statement of policy.

WRITTEN POLICY GUIDELINES 1973-2

GENERAL STANDARDS USED IN DETERMINING WHETHER A PROPOSED OFFERING OF SECURITIES IS BEING MADE ON GROSSLY UNFAIR TERMS

Applicability of General Standards

These Guidelines contain the general standards which have traditionally been and are currently being applied by the Ohio Division of Securities in making determinations under sections 1707.09 and 1707.13 of the Ohio Revised Code as to whether or not a proposed offering of securities of a corporate issuer is to be made on grossly unfair terms. For the most part, these Guidelines merely state in general terms what the standards "are", not what they "should" or ultimately will be. No attempt has been made at this point in time to evaluate and revise such standards, as it is the Division's belief that, before the "rules" can be re-evaluated and revised, they must first be identified, organized and stated with a reasonable degree of clarity. Thus, these Guidelines are intended to serve primarily as a restatement of the existing policies, standards, practices and procedures of the Division for the purpose, and as part of the process of developing, adopting and publishing uniform regulatory standards and rules which govern the registration of securities and the regulation of the persons who sell them.

The standards set forth in these Guidelines generally apply to the registration and sale of securities issued by corporate issuers and "quasi-corporate" issuers, that is, those issuers which, because of the form and manner in which they are organized, operated and managed, are the functional equivalents of corporations (such as, for example, certain business trusts). These standards also apply to debt as well as equity securities, unless the text of the standard clearly indicates otherwise. In addition, the principles expressed in these Guidelines apply by analogy to securities issued by non-corporate issuers; but, where a specific statement of policy or set of guidelines covers the particular type of security sought to be registered, the latter controls over the former.

The general standards, as expressed in these Guidelines, are designed in part to aid the Division in the exercise of its discretion with respect to the evaluation of a given application to register securities. However, any determination as to the gross unfairness of a particular offering of securities will be made on a case-by-case basis after evaluating all of the facts and circumstances of the proposed offering, including the terms and characteristics, and the proposed plan of distribution, of the security sought to be registered, in the light of all of these standards, considered collectively. Thus, the fact that a proposed offering conforms, or appears to conform, to each specific standard set forth herein does not necessarily mean that the registration application will automatically be approved. Conversely, non-conformity to one or more of these standards will not necessarily result in the denial of a particular registration application. Each proposed offering will be judged upon its own merits. However, the failure to satisfy one or more of these standards will, unless there are other redeeming features of the proposed offering, be a persuasive factor in leading the Division to conclude that a proposed offering is to be made on grossly unfair terms.

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GENERAL STANDARDS WITH RESPECT TO DETERMINATIONS AS TO GROSSLY UNFAIR TERMS

I. General Terminology

All of the terms used in these Guidelines have the same meanings as they have in sections 1707.01 to 1707.46 of the Ohio Revised Code. In addition, the following terms and phrases are the ones generally used by the Division of Securities to signify the securities, persons, or matters so described, unless the context requires otherwise:

(A) *Affiliate.* An "affiliate" of a specified person means a person directly or indirectly controlling or controlled by, or directly or indirectly under common control with, the specified person. For purposes of these Guidelines, an "affiliate" of an issuer includes an employee as well as an officer or director of the issuer.

(B) *Amount.* The term "amount", when used in regard to securities, means the principal amount if relating to notes, bonds, or other evidences of indebtedness, the number of shares times the price per share if relating to shares, and the number of units times the price per unit if relating to any other kind of security.

(C) *Application.* The terms "application", "registration application", or "application to register securities" are used to refer to an application filed with the Division pursuant to either section 1707.08 or 1707.09 of the Ohio Revised Code for the registration of securities or transactions.

(D) *Control.* The term "control" is used to refer to the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

(E) *Director.* The term "director" includes a director or trustee of a corporation, a trustee of a trust, a general partner of a partnership (except a partnership association), a manager of a partnership association, or any person vested with directory power over an issuer not having a board of directors or trustees [see O.R.C. §1707.01(H)].

(F) *Employee.* The term "employee" does not include a director or an officer.

(G) *Equity Security.* The term "equity security" refers to any share or similar security; or any security convertible into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Division of Securities deems to be of a similar nature and considers necessary or appropriate for the protection of security-holders to treat as an equity security.

(H) *Fiscal Year.* The term "fiscal year" means the annual accounting period or, if no closing date has been adopted, the calendar year ending on December 31.

(I) *Going Concern.* The term "going concern" is used to refer to any issuer which:

(1) has been continuously engaged in and conducting bona fide business operations, either directly or through a predecessor or subsidiary, for at least three (3) fiscal years;

(2) has had substantial revenues from the sale of its products or services or the use of its assets and substantial net income either from its business operations or from any other regular, recurring source during each of the three (3) fiscal years preceding the date on which an application to register its securities is filed; and

(3) is not otherwise considered a "promotional company" within the meaning of division I(O)(4) of these Guidelines.

(J) *Management and Manager.* The term "management" is used to refer to the officers, directors, and controlling shareholders of an issuer collectively, and the term "manager" is used to refer to an officer, director, or controlling shareholder of an issuer individually.

(K) *Most Recently Completed Accounting Period.* The phrase "most recently completed accounting period" is used to refer to an issuer's fiscal year ending as of a date within fifteen (15) months prior to the date a registration application is filed, plus all subsequent quarters of the issuer's current fiscal year (if any) ending as of a date within the ninety (90) day period preceding the date of filing.

(L) *Most Recently Completed Quarter of the Issuer's Current Fiscal Year:* The phrase "most recently completed quarter of the issuer's current fiscal year" means the quarter of the issuer's current fiscal year ending as of a date within the ninety (90) day period preceding the date a registration application is filed.

(M) *Officer.* The term "officer" is used to refer to a president, vice president, secretary, treasurer, or principal financial officer, comptroller, or principal accounting officer, or any other person occupying a similar status or performing similar functions with respect to any organization or entity, whether incorporated or unincorporated.

(N) *Promoter.* The term "promoter" includes:

(1) any person who, acting alone or in conjunction with one or more other persons, directly or indirectly takes the initiative in founding and organizing the business enterprise of an issuer; or

(2) any person who, in connection with the founding and organizing of the business enterprise of an issuer, directly or indirectly receives (or is to receive) in consideration of services or property, or both services and property, ten per cent (10%) or more of any class of the issuer's securities, or ten per cent (10%) or more of the proceeds resulting from the sale of any class of the issuer's securities; but, a person who receives such securities or proceeds either solely as underwriting compensation (commissions) or solely in consideration of cash or tangible property shall not be deemed a promoter within the meaning of this division or any other provision of these Guidelines if such person does not otherwise participate or take part in the founding and organizing of the business enterprise of such issuer.

(O) *Promotional Company.* The term "promotional company" is used to refer to any issuer which:

(1) has not commenced to engage in or conduct bona fide business operations at the time an application to register its securities is filed (i.e., a "start-up company");

(2) has no significant record of prior business operations or earnings, even though it has engaged in or conducted some form of limited business operations before such a registration application is filed (i.e., a "start-up company");

(3) has not had any substantial revenues from the sale of its products or services or the use of its assets and any substantial net income either from its business operations or from any other regular, recurring source during each of the three (3) fiscal years preceding the date on which such a registration application is filed; or

(4) has not engaged in or conducted business operations of the type or on the scale contemplated by such a registration application or as a result of the receipt and use of the proceeds of the proposed offering, even though it has previously engaged in and conducted business operations, either directly or through a predecessor or subsidiary, and has earned substantial net income from its business operations for three (3) or more fiscal years.

(P) *Promotional Shares.* The term "promotional shares" (or "cheap stock") refers to any equity securities of either a going concern or a promotional company which have been issued or sold within the three (3) year period preceding the first date on which any other equity securities of the same issuer are proposed to be offered for sale to the public (including any equity securities issued or sold as a result of the exercise of any options, warrants, or conversion privileges during such period), or any such equity securities which are to be issued or sold in connection with a proposed public offering of any other equity securities of the same issuer, to any person who was or will be, at the time of issuance or sale, an underwriter, finder, promoter or affiliate of the issuer (1) for a consideration less than the proposed net public offering price of such other equity securities, without any corresponding substantial change in the market price of securities of the same class (if any) or without any substantial change in the earnings, financial position, or other circumstances of the issuer which would account for the difference in price, or (2) in consideration of services rendered in connection with the founding or organizing of the business enterprise of the issuer, or (3) in consideration of any intangible property transferred to the issuer.

(Q) *Share.* The term "share" refers to a share of stock in a corporation or a unit of interest in an unincorporated person.

(R) *Tangible Assets.* The term "tangible assets" is used to refer to tangible property as that term is defined in section 1707.01(L) of the Ohio Revised Code.

(S) *Voting Securities.* The term "voting securities" refers to any securities which presently entitle the holders to vote for the election of directors.

II. Offering Price of Equity Securities of Corporate Issuers
(A) Market Price
Applicability: The market price standard applies to a proposed offering of the securities of a going concern if securities of the same class are publicly traded in an active market of substantial depth. However, the market price standard may also be applied to a proposed offering of the securities of a promotional company if it has been engaged in and conducting bona fide business operations for at least two (2) fiscal years and has had net income earned from operations during that period, and if its securities are publicly traded in an active market of substantial depth.

General Standard: The proposed offering price of the securities of either a going concern or a promotional company of the type described above is not considered to be excessive or grossly unfair to public investors under this standard if it is the same as, or closely related to (i.e., e.g., within a few points of), a recent market price of securities of the same class, and if such securities are publicly traded in an active market of substantial depth.

The phrase "recent market price" refers to the average of the mean between the highest independent bid price and lowest independent asked price on six (6) different days, selected by the applicant, within thirty (30) days prior to the date the registration application is filed.

The applicant has the burden of establishing or demonstrating to the satisfaction of the Division that securities of the same class are publicly traded in an active market of substantial depth.

An issuer's securities are presumed to be publicly traded in an active market of substantial depth if:

(i) there are at least 750 public (non-affiliated) shareholders of the issuer's securities;

(ii) there are at least 250,000 shares of the issuer's securities outstanding and held by public (non-affiliated) shareholders;

(iii) there has been an average of approximately 100 trading transactions per month for the six (6) month period preceding the date the registration application was filed;

(iv) there are at least five (5) licensed dealers who are making a market in the issuer's securities; and

(v) market prices for the issuer's securities have been quoted on an inter-dealer quotation system or in an inter-dealer quotation service (e.g., the "pink sheets") on at least six (6) of the thirty (30) days preceding the date of filing.

Evidence relating to the foregoing criteria must be furnished to the Division with the registration application in order to establish the existence of such a market.

(B) *Multiple of Earnings per share (P/E ratio)*
Applicability: The multiple of earnings per share (or "earnings multiple") standard applies to a proposed offering of the securities of either a going concern or a promotional company of the type described in division I(O)(4) of these Guidelines in cases where there is no existing market for securities of the same class or where, even though an identifiable market for such securities does exist, it is not an active market of substantial depth as described in division II(A) of these Guidelines.

General Standard:

1. *Going Concern:* The proposed offering price of the securities of a going concern is considered to be excessive and therefore grossly unfair to purchasers under this standard if it exceeds the product of twenty-five (25) times the average annualized net earnings per share of the issuer for the most recently completed accounting period.

For purposes of this standard, the phrase "average annualized net earnings per share" refers to the net income earned from operations, after the deduction of an adequate allowance for taxes and exclusive of extraordinary, non-recurring income and expense items (such as, for example, gains on the sale of capital assets, tax loss carry-forwards, initial organizational or other non-recurring start-up costs, etc.), for the most recently completed accounting period divided by the average number of shares outstanding during such accounting period and adjusted to reflect such net earnings per share on a twelve (12) month basis; provided, however, that, if the net income earned from operations during such accounting period is not reasonably indicative of the issuer's prior earnings history, then the average annualized net earnings per share of the issuer shall be computed on the basis of the net income earned from operations during the three (3) fiscal years preceding the date on which the registration application is filed.

Restated, the proposed offering price of the securities of a going concern is presumed to be excessive and therefore grossly unfair to purchasers under this standard if the proposed "price-earnings" ratio (P/E), determined by the proposed offering price and the average annualized net earnings per share of the issuer for the most recently completed accounting period, exceeds a ratio of 25:1.

2. *Promotional Company:* The proposed offering price of the securities of a promotional company which has previously engaged in and conducted business operations of the type, but not on the scale, contemplated by the registration application or as a result of the receipt and use of the proceeds of the proposed offering may be viewed as excessive and therefore grossly unfair to public investors under this standard if the proposed price-earnings ratio, determined by the proposed offering price and the average annualized net earnings per share of the issuer for the most recently completed accounting period, exceeds a ratio of 25:1 even though the proposed offering price is equal to or less than the product of five (5) times the net book value per share of the issuer's tangible assets as of the end of the most recently completed quarter of the issuer's current fiscal year.

(C) *Comparison of the Earnings Multiples of Similar Securities of Issuers in the Same Industry*
Applicability: A standard based upon the comparison of the earnings multiples of similar securities of issuers in the same industry (sometimes referred to as the "industry comparison method") may be applied in lieu of the foregoing market price and earnings multiple standards to a proposed offering of the securities of either a going concern or a promotional company which has been engaged in and conducting bona fide business operations for at least two (2) fiscal years and has had net income from operations during that period, even though the applicant is unable to establish that securities of the same class are publicly traded in an active market of substantial depth as described in division II(A) of these Guidelines, and even though the proposed "price-earnings" ratio of the securities to be sold exceeds a ratio of 25:1.

General Standard: The proposed offering price of the securities of either a going concern or a promotional company of the type described above is not considered to be excessive or grossly unfair to purchasers under this standard if the proposed "price-earnings" ratio (P/E) or earnings multiple at which such issuer's securities are to be sold is the same as, or closely related to, the actual price-earnings ratios (P/E) or earnings multiples at which similar securities of reasonably comparable issuers in the same industry are being publicly traded, provided that such P/E ratios or earnings multiples are appropriately adjusted to reflect any significant dissimilarities between the issuers being compared.

The applicant has the burden of establishing or demonstrating to the satisfaction of the Division that the issuers in the same industry which are being compared are in fact reasonably comparable and that the securities of such issuers are in fact similar and being publicly traded.

Evidence relating to the following comparability factors and market information, for a minimum of three (3) issuers, must be furnished to the Division to establish the foregoing facts:

(a) Issuer comparability factors:

(i) net sales
(ii) net earnings
(iii) product lines or services
(iv) income-producing assets
(v) management experience
(vi) age and prior earnings history
(vii) goodwill (e.g., amount of advertising, market or customer recognition, etc.)
(viii) title and terms of securities being compared
(ix) other relevant factors.

(b) Market information with respect to the securities being compared (i.e., data comparable to that set forth in division II(A) of these Guidelines).

(D) *Book Value Per Share*
Applicability: The book value per share standard applies to a proposed offering of the securities of either a going con-

cern or a promotional company in cases where none of the aforementioned tests is applicable due to the absence of a market of the type described in division II(A) of these Guidelines for securities of the same class and due to the fact that the issuer did not have net earnings during the most recently completed accounting period; but, in the case of a proposed offering of the securities of a promotional company which has previously engaged in and conducted business operations of the type, but not on the scale, contemplated by the registration application or as a result of the receipt and use of the proceeds of the proposed offering, the earnings multiple standard described in division II(B)(2) of these Guidelines may be applied in addition to the standards set forth herein.

General Standard:

1. *Going Concern.:* The proposed offering price of the securities of a going concern is considered to be excessive and therefore grossly unfair to investors under this standard if it exceeds the net book value per share of the issuer's tangible assets as of the end of the most recently completed quarter of issuer's current fiscal year.

For purposes of this standard, the phrase "net book value per share of the issuer's tangible assets" refers to the quotient resulting from the difference between the book value of the issuer's tangible assets and its liabilities divided by the total number of shares of the issuer outstanding as of the date such book values are determined.

2. *Promotional Company:* The proposed offering price of the securities of a promotional company is presumed to be excessive and therefore grossly unfair to purchasers under this standard if it exceeds the product of five (5) times the net book value per share of the issuer's tangible assets as of the end of the most recently completed quarter of the issuer's current fiscal year (or, in the case of a proposed offering of the securities of an issuer which is a "start-up company" as defined in division I(O)(1) of these Guidelines, as of the most recent practicable date).

Exception as to Insolvent Issuers: In the event that a registration application is filed by an issuer which is insolvent, that is, insolvent in the sense that the issuer cannot meet its obligations as they mature, then this standard shall not apply; but ordinarily an application to register the securities of an insolvent issuer (except for an issuer which is a "start-up company" as defined in division I(O)(1) and (2) of these Guidelines) will not be approved unless the applicant establishes or demonstrates to the satisfaction of the Division that:

(1) the proposed offering or plan of distribution of the securities, if followed, will not involve a public offering within the meaning of section 4(2) of the federal Securities Act of 1933; and

(2) the infusion of additional capital into the business enterprise of the issuer will probably result in future earnings available for distribution to prospective security holders and will otherwise not be grossly unfair to prospective purchasers.

(E) *Limitation on Offering Price due to Dilution*

Terminology: For purposes of this standard, the term "dilution" means the difference between the proposed offering price of the security sought to be registered and the projected net book value per share of the issuer's tangible assets. Dilution is usually expressed in terms of a percentage of the proposed offering price.

For purposes of this standard, the phrase "projected net book value per share of the issuer's tangible assets" is used to refer to (a) the sum of (i) the net book value of the issuer's tangible assets as of the end of the most recently completed quarter of the issuer's current fiscal year (or, in the case of a proposed offering of securities by an issuer which is a "start-up company" as defined in division I(O)(1) of these Guidelines, as of the most recent practicable date), plus (ii) the aggregate net proceeds (i.e., the aggregate gross proceeds adjusted by deducting both the commissions to be paid to underwriters and the selling expenses to be incurred by the issuer in connection with the offering) to be received by the issuer from the sale of all of the securities which will be outstanding at the completion of the offering or at the termination of any required escrow arrangement, if applicable, (b) divided by the following:

(i) the total number of shares of the issuer which will be outstanding at the completion of the offering (i.e., assuming that all of the securities being offered or proposed to be offered, whether or not they are proposed to be registered or offered in this state, are issued), if the proposed offering is not subject to the escrow requirements set forth in division V(B) of these Guidelines; or

(iii) the total number of shares of the issuer which will be outstanding at the termination of any required escrow arrangement (i.e., assuming that the escrow requirements are met), if all or a specified percentage of the proposed offering is subject to escrow requirements set forth in division V(B) of these Guidelines.

Applicability: The limitation on the proposed offering price of a security as a result of the potential dilution in the value of a prospective purchaser's investment applies to a proposed offering of securities to be made by either a going concern or a promotional company.

General Standard:

1. *Going Concern:* The proposed offering price of securities to be issued or sold by a going concern is considered to be excessive and therefore grossly unfair to public investors under this standard if the dilution which would result from the sale of all of the securities to be outstanding at the completion of the offering or at the termination of any required escrow arrangement, if applicable, exceeds an amount equal to eighty per cent (80%) of the proposed offering price.

2. *Promotional Company:* The proposed offering price of securities to be issued or sold by a promotional company is presumed to be excessive and therefore grossly unfair to purchasers under this standard if the dilution which would

result from the sale of all of the securities to be outstanding at the completion of the offering or at the termination of any required escrow arrangement, if applicable, exceeds an amount equal to fifty per cent (50%) of the proposed offering price.

(F) *Limitation on Offering Price due to the Price Paid for Promotional Shares*
Applicability: The limitation on the proposed offering price of a security as a result of the price paid or to be paid for promotional shares by underwriters, finders, promoters, or affiliates of the issuer applies only to a proposed offering of equity securities to be made by a promotional company. The issuance or sale of promotional shares by a going concern to such persons (except as compensation paid to underwriters) or the sale of promotional shares by a selling shareholder within two (2) years of or in connection with a public offering of such issuer's equity securities is considered to be a justifiable basis for finding that the proposed offering is to be made on grossly unfair terms (see division IV(A) of these Guidelines).

General Standard: The proposed offering price of equity securities to be issued or sold by a promotional company is presumed to be excessive and therefore grossly unfair to public investors under this standard if it exceeds the product of five (5) times the price at which promotional shares (or cheap stock) were issued prior to, or are proposed to be issued in connection with, a proposed public offering of such issuer's securities.

III. Capitalization of a Promotional Company: Promoters' and Managers' Contributions to Capital and the Use of Proceeds

(A) Minimum Equity Investment of Promoters and Managers
Applicability: The requirements concerning the minimum equity investment of the promoters and managers of an issuer only apply to proposed public offerings of equity securities to be made by a promotional company; proposed public offerings of securities to be made by a going concern or a selling shareholder are not subject to this standard.

General Standard: A proposed public offering of the equity securities of a promotional company is presumed to be grossly unfair to public investors under this standard unless the fair value of the equity investment of the promoters and managers of such issuer, determined as of the first date such securities are to be offered for sale to the public, is equal to either of the following amounts, whichever is applicable:

(a) an amount equal to at least ten per cent (10%) of the aggregate equity investment which will have been made in such issuer as a result of the sale of all of the equity securities being offered or proposed to be offered, if such aggregate equity investment will, as a consequence of such sales, be equal to or less than one million dollars ($1,000,000); or

(b) $100,000 plus an additional amount that is substantial in relation to the aggregate equity investment which will have been made in such issuer as a result of the sale of all of the equity securities being offered or proposed to be offered, if such aggregate equity investment will, as a consequence of such sales, exceed one million dollars ($1,000,000).

For purposes of this standard, the phrase "fair value of the equity investment" of the promoters and managers of the issuer means the total of all sums contributed to the capital of the issuer in cash, together with the fair market value (measured in dollars) of all tangible assets contributed to the capital of the issuer by such persons, as determined by independent appraisal or otherwise and as adjusted by the earned surplus or deficit of the issuer between the dates of the contributions and the first date on which the equity securities of such issuer are to be offered for sale to the public.

For purposes of this standard, the phrase "aggregate equity investment" which will have been made in such issuers means the total projected paid-in capital of such issuer, which includes the (i) par or stated value of all of the securities which will be outstanding if all of the securities being offered or proposed to be offered (whether or not they are proposed to be registered or offered in this state) are issued, plus (ii) the amount of surplus of any kind, regardless of description and whether or not restricted.

(B) *Use of Proceeds*
Applicability: The limitation on the use of the net proceeds to be received from a public offering of securities only applies to proposed public offerings of equity securities to be made by a promotional company; proposed offerings of securities to be made by a going concern or a selling shareholder are not subject to this standard.

General Standard: A proposed public offering of the equity securities of a promotional company is considered to be grossly unfair to public investors under this standard if the issuer intends to allocate and use in its business enterprise more than twenty-five per cent (25%) of the aggregate net proceeds of the offering for working capital or other unspecified purposes.

IV. Profits and Compensation of Promoters and Affiliates of the Issuer

(A) Promotional Shares (or Cheap Stock)
Applicability: The requirements and limitations with respect to the issuance or sale of promotional shares (or cheap stock) apply to the extent specified herein to all proposed public offerings of equity securities.

General Standard:

1. *Going Concern:* A proposed public offering of the equity securities of a going concern is presumed to be grossly unfair to public investors under this standard if the issuer has issued or sold promotional shares to its promoters or affiliates (other than its employees) within the two (2) year period preceding the first date on which such equity securities are proposed to be offered for sale to the public, or if the issuer proposes to issue or sell promotional shares to its promoters or affiliates (other than its employees) in

connection with a public offering of such equity securities; but the term "promotional shares", as used in this standard, shall not be deemed to include any securities issued or sold to managers of the issuer as a result of the exercise of stock options, provided that such stock options were previously issued pursuant to a bona fide stock purchase, profit-sharing or similar employee-benefit plan.

2. *Promotional Company.* In the case of a proposed public offering of the equity securities of a promotional company, the issuance or sale of promotional shares (or cheap stock) by such issuer to its promoters and/or its affiliates prior to or in connection with such proposed offering is not considered to be grossly unfair to purchasers unless:

(a) the price at which such promotional shares were issued or are proposed to be issued to such promoters and/or affiliates is less than one-fifth (1/5) of the proposed public offering price;

(b) the amount or number of promotional shares issued or to be issued would cause or result in a dilution in the value of the securities to be sold to the public which is in excess of fifty per cent (50%) of the proposed public offering price;

(c) the amount or number of promotional shares issued or to be issued to promoters and affiliates of the issuer, together with the amount or number of promotional shares issued or to be issued to underwriters and finders, is more than fifty per cent (50%) of the total amount or number of the equity securities which will be outstanding at the completion of the proposed offering or at the termination of any required escrow arrangement, if applicable;

(d) the promotional shares held by, or to be issued to, promoters or affiliates of the issuer are not deposited in escrow with a bank or other escrow agent under the terms and subject to the conditions prescribed in division V(A) of these Guidelines; or

(e) the terms of any such promotional shares fail to provide for the subordination of such securities in favor of those to be sold to the public with respect to dividends and liquidation rights or preferences in the event of liquidation, bankruptcy, receivership, or a sale of assets, as specified in division V(A) of these Guidelines.

3. *Selling Shareholder:* The proposed public offering of any securities which are considered to be promotional shares within the meaning of division I(P) of these Guidelines by a person who is a promoter or an affiliate (other than an employee) of the issuer is presumed to be grossly unfair to public investors unless such securities have previously been deposited in escrow as required by these Guidelines and have been released therefrom with the approval of the Division.

(B) *Stock Options to Officers, Directors, and Employees of the Issuer:*

Applicability: The standards relating to stock options issued or granted to officers, directors, or employees of the issuer apply to any application to register the equity securities of either a going concern or a promotional company.

General Standard: The issuance or granting of stock options to officers, directors, and/or other key supervisory employees of an issuer, in the nature of restricted or qualified stock options for incentive purposes (whether or not they meet the requirements of sections 421 to 425 of the Internal Revenue Code of 1954), or to all or certain specified classes of employees of such issuer, pursuant to stock purchase, profit-sharing, or similar employee-benefit plans, either prior to or in connection with a proposed public offering of the equity securities of such issuer, is not considered to be grossly unfair to purchasers under this standard unless:

(1) the exercise price of the options, other than those granted or proposed to be granted to employees pursuant to a stock purchase, profit-sharing, or similar employee-benefit plan, is less than the fair market value of the shares covered by the options on the date of issuance;

(2) in the case of options granted or proposed to be granted to all or certain specified classes of employees of the issuer pursuant to the aforementioned employee-benefit plans, the exercise price of the options is less than eighty-five per cent (85%) of the fair market value of the shares covered by the options on the date of issuance;

(3) the number of shares covered by the options granted or to be granted to the management and employees of the issuer, together with the number of shares covered by the options issued or to be issued to all other persons (except financial institutions and except in connection with acquisitions) exceeds ten per cent (10%) of the total number of shares which will be outstanding at the completion of the proposed offering or at the termination of any required escrow arrangement, if applicable; or

(4) the number of stock options issued or granted, or the method of their exercise, is unreasonable, particularly in relation to:

(a) the number of shares which are the subject of the proposed offering;

(b) the total number of shares which will be outstanding at the completion of the proposed offering or at the termination of any required escrow arrangement, if applicable;

(c) the voting securities which affiliates of the issuer will hold or the control which such affiliates will possess in the event that all or a substantial number of the options are exercised;

(d) the dilution which will result to all of the outstanding shares of the issuer in the event that all or a substantial number of the options are exercised;

(e) the period of time during which such options are exercisable, or the conditions or circumstances under which they may be exercised; or

(f) the amount or number of promotional shares which has been and/or is to be issued, and the salaries and other compensation which have been and/or are to be paid to the managers of a promotional company.

(C) *Management Compensation and Employment Contracts:*
Applicability: Limitations on the compensation payable to, or the employment contracts made with, the management of an issuer only apply to proposed public offerings of the equity securities of a promotional company; proposed offerings of the securities of a going concern are not subject to this standard unless the compensation paid or to be paid to the management is so substantial in relation to the gross revenues and net income of the issuer that it may be considered unusually excessive.

General Standard: The proposed public offering of the equity securities of a promotional company is presumed to be grossly unfair to public investors under this standard if:

(1) the issuer has paid or has agreed to pay salaries, fees, or other remuneration to its officers or directors for services rendered by them in their respective capacities as officers or directors prior to the date the issuer actually commenced to do business (i.e., the actual manufacturing or selling of products, the rendering of services or the use of assets, which constitutes the proposed business of the issuer); or

(2) the issuer is paying or has agreed to pay, during the first year following the initial public offering date, salaries, fees, or other remuneration to its officers or directors for services rendered by them in their respective capacities as officers or directors which are substantially in excess of the salaries, fees or other remuneration customarily paid by comparable issuers for like services to persons similarly situated.

(D) *Loans and Other Material Transactions Between the Issuer and its Management:*
Applicability: Limitations on loans made to management and on other material transactions between the issuer and its management apply to all proposed public offerings of the equity securities of both going concerns and promotional companies to the extent indicated herein.

General Standards with Respect to Loans:

1. *Going Concern:* The proposed public offering of the equity securities of a going concern is presumed to be grossly unfair to purchasers under this standard if:

(a) a loan of cash or property made by the issuer to one or more of its managers is not (as of the date of the filing of the registration application) evidenced by a promissory note which names the issuer as the payee;

(b) the maturity date of any outstanding loan made by the issuer to one or more of its managers (prior to the date the registration application is filed) extends beyond the end of the sixth (6th) month following the initial public offering date; or

(c) an issuer which has previously made substantial loans of cash or property to one or more of its managers (prior to the date the registration application is filed) does not file with its application an undertaking whereby the issuer guarantees that it will not make any additional loans to any of its managers for a period of three (3) years following the initial public offering date, except loans made for relocation and travel expenses and for bona fide, employment-related emergencies, and that any such loans so authorized and made will:

(i) be evidenced by a promissory note which names the issuer as payee;

(ii) become due and payable in full within six (6) months of the date of issuance; and

(iii) bear interest at a rate which is reasonably comparable to that normally charged by commercial lenders for similar loans made in the issuer's locale.

(2) *Promotional Company:* The proposed public offering of the equity securities of a promotional company is considered to be grossly unfair to purchasers under this standard unless:

(a) all outstanding loans of cash or property made by the issuer to one or more of its managers (prior to the date the registration application is filed) are paid in full prior to the first date on which such securities are to be offered for sale to the public; and

(b) the issuer makes a commitment, either in its governing instruments, by an undertaking or otherwise, not to make any loans of cash or property to any of its managers for a period of three (3) years following the initial public offering date.

General Standards with Respect to Other Material Transactions Between the Issuer and its Management: The proposed public offering of the equity securities of either a going concern or a promotional company may be considered grossly unfair to purchasers under this standard if one of the principal purposes of the offering, as evidenced by the intended use of the net proceeds of the offering or otherwise, is to enable the issuer to consummate a contract or transaction between it and one or more of its managers, whereby it will pay a sum of money which is substantially in excess of the fair market value of any assets to be so acquired, or whereby it will sell and convey assets at a price which is substantially less than the fair market value of the assets to be so transferred.

(To be continued)

SENATE BILL 338
Definitions of the Terms "Security and Sale"

Since OSA §1707.02 requires that a security be either registered or exempted before it is offered or sold in this state, the definitions of the terms "security" and "sale" assume positions of fundamental significance; for it is these terms which determine the applicability of the act to any given transaction.

The term "security" is broadly defined in OSA §1707.01(Q) to include practically every kind of "interest or instrument commonly known as a "security", including any "certificate of interest or participation in any profit-sharing agreement", "transferable share" or "investment contract" as well as the more traditional forms of securities, such as, for example, stocks, bonds, debentures, notes, evidences of indebtedness, preorganization certificates or subscriptions, certain kinds of trust certificates, and so on. The general phraseology of this definition was taken verbatim from Uniform Securities Act ("USA") §401(l), which in turn was taken from Section 2(1) of the Securities Act of 1933 (except for the definition of interests in oil, gas and other mineral rights and also the exclusion for insurance and endowment policies and annuity contracts).

With respect to oil gas and mineral interests, the OSA follows the broader language of the USA and uses the phrase "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" instead of the phrase "fractional undivided interest in oil, gas, or other mineral rights", which is the one appearing in the federal Securities Act. As stated in the Comments to the USA, the last phrase of this definition is intended to make it clear that "oil payments" are in fact securities regardless of whether they may be viewed as *interests* in a mining title or lease.

The reasons for the use of the USA's general language, rather than that found in existing §1707.01(B), are relatively simple: while existing §1707.01(B) covers everything covered by the new OSA definition and vice versa, the latter is not only more concise than the former, but it has also been interpreted more frequently; and therefore, it is better understood by those in the securities industry who are affected by it. Further, existing §1707.01(B) appears to place more emphasis on the "certificate" or "instrument" which evidences or represents an investor's interest or participation in a given business arrangement than it does on the "interest" itself [see, for example, the initial clause and the reference to foreign "currency" in existing §1707.01(B); see also, e.g., the exemption in existing §1707.03(Q)]. The USA definition, on the other hand, tends to emphasize the investor's "interest" at least as much as it does the "instrument" which evidences it. Equally important, it also tends to touch upon those things which the courts have come to recognize as constituting the essential ingredients of a security, namely, an interest or participation in an entity, association, contract, transaction, scheme, or other profit-seeking venture whereby a person invests his money in, or transfers his property to, such a common enterprise with the expectation that he will earn a profit or receive a valuable benefit over and above his initial investment solely through the efforts of the promoter or some other third party. [See generally, I *Loss, Securities Regulation* pp. 483-496, (1961).] Because of this, it was felt that the general phraseology of the uniform act more accurately reflected modern notions of what constitutes a "security" for purposes of determining when the securities laws should apply. In sum, it was clearly preferable to that contained in existing §1707.01(B).

The foregoing discussion also illustrates the kind of policy choices which were made throughout in the course of preparing the new act. In analyzing each significant provision of existing law, the USA, and the federal statutes, those who were involved in this project consciously tried to select the language which most accurately reflected either the most familiar concepts or the most recent developments in the field of securities regulation or the policies to be promoted by the new act. Usually, but not always, this resulted in the selection of the language appearing in the USA and/or in federal law.

This process of selection is also evident from the decisions which were made with regard to interests in foreign real estate and variable annuity contracts issued by insurance companies. In the case of interests in foreign real estate, the decision was made to include such interests within the definition of the term "security" even though typical interests in land are not in themselves ordinarily thought of as securities. (However, a persuasive argument can be made that, because of the methods by which such interests are sometimes promoted and sold, i.e., as speculative "investments" with their value dependent to a considerable extent upon the improvements to be made by the developer, etc., they do have many of the features of a "security"; see generally, *Loss, supra* pp. 489-494). The justification for this is largely historical. Since the trend in recent years has been for many governments to undertake to regulate the sale of foreign real estate in much the same way as they regulate the sale of securities, and since the regulation of foreign land sales has been a feature of the existing Ohio law for many years, it was believed that the present statutory scheme ought to be continued. Thus, interests in foreign real estate are treated in the new act as if they were securities even though they are ordinarily not considered to be such. Likewise, whiskey warehouse receipts were similarly included within the new regulatory framework for much the same reasons.

With respect to insurance policies and annuity contracts, the problem of deciding whether to include or exclude from the definition of the term "security" the so-called "variable annuities" was much more difficult, and was further compounded by the fact that the legislature had specifically acted upon this matter in recent years. The problem basically stems from the way in which insurance securities generally are treated under the proposed new act, particularly in comparison with their treatment under existing law.

To explain briefly, under the present law, all instruments issued and sold by insurance companies in this state, regardless of whether they are corporate stocks and bonds or other equity and debt securities, or insurance policies, annuity contracts or whatever, are subject to regulation and supervision by the Ohio Superintendent of Insurance. In the case of insurance "securities" (as distinguished from insurance "policies" and ordinary "annuities", which are not usually regarded as "securities" [see e.g., I *Loss, Securities Regulation* pp. 496-499 which characteristizes §3(a)(8) of the Securities Act as clear "supererogation"]), this policy is carried out by means of existing §§1707.02(H) and 1707.32, Under §1707.02(H), securities issued or guaranteed by an insurance company are exempted from regulation under Chapter 1707. of the Ohio Revised Code if the issuer is supervised, and the issuance of its securities is regulated by a state. Existing §1707.32 operates to confer upon the Superintendent of Insurance all of the powers which the Division of Securities ordinarily has in such matters, and to make him responsible for the regulation of securities issued by insurance companies. On the other hand, the Division of Securities exercises the power to regulate the issuance and sale of securities issued by "insurance holding companies" (i.e., those financial concerns whose principal subsidiaries are insurance companies).

The proposed new OSA does not contain an exemption for the securities issued by insurance companies, and the repealer provision calls for the repeal of 1707.32. Thus, the effect of S.B. 338, if enacted as proposed, would be to transfer the responsibility for the regulation of such securities from the Superintendent of Insurance to the Commissioner of Securities, i.e., in the same way that the securities of insurance holding companies are now regulated. However, in order to insure that the Superintendent of Insurance retains his traditional jurisdiction over the issuance and sale of insurance policies and annuity contracts, OSA §1707.01(Q) does specifically except from the definition of the term "security" all insurance or endowment policies and annuity contracts (Including those of the "variable" variety) issued by insurance companies authorized to do business in Ohio. Thus, the absence of a securities exemption for insurance securities and the exclusion for such policies and contracts reflects this basic change in regulatory policy.

As previously indicated, the decision was made to exclude variable annuities along with other insurance and annuity contracts in spite of the fact that variable annuities are usually acknowledged to be "securities" as distinguished from insurance [see, e.g., I *Loss supra,* at pp. 499-501, and the treatment of variable life insurance contracts by the SEC in Securities Act Rel. 5360, Sec. Exch. Act Rel. 9972, I.C. Act Rel. 7644 and I.A. Act Rel. 356 (Jan. 31, 1973); but compare, IV *Loss, Securities Regulation* pp. 2513-2516 (Supp. 1969)]. The reasoning which led to the conclusion to do this is somewhat complicated and beyond the scope of this article; but basically, the decision was grounded upon four factors:

(1) Most state securities administrators do not regulate variable annuities [see IV, *Loss, supra,* pp. 2513-2516, which reports that, in 1967, about forty states did not require the registration of variable annuities under their respective Blue Sky Laws].

(2) The Ohio Division of Securities does not now have, nor can it reasonably be expected that it ever will receive, sufficient funds and manpower to regulate either the securities themselves or the persons who sell them.

(3) The policy arguments which favor the regulation of insurance "securities" by the Division of Securities do not apply with equal persuasive force to variable annuities. That is to say, the basic justification for shifting the responsibility for regulating insurance securities to the Division of Securities is that a potential conflict in regulatory objectives exists when the Department of Insurance seeks to fulfill the roles of both securities administrator and insurance regulator. For example, while the Department of Insurance might be inclined in certain situations to approve the sale of a new issue of capital stock in order to make sure that the issuing company has sufficient assets to meet its legal reserves and minimum capital requirements, and thus to protect its policyholders, the Division of Secuities might not be so disposed, especially when the offering price of the stock might be "grossly unfair" to the company's new securityholders. With respect to variable annuities, however, the "securityholders" are also "policyholders"; they are the purchasers of the "product" which the Department of Insurance has been established to regulate. Hence, this basic policy justification for the shift in regulatory responsibility does not appear to be as persuasive in the latter case as it does in the former.

(4) Finally, the one factor which tended to override all others was that, in Ohio, as in most states, the issuance and sale of insurance policies and annuity contracts, including those of the "variable" variety, are matters which traditionally have been, and are currently being regulated by the insurance authorities (whereas such is not the case under federal law). If variable annuities were to be treated as securities instead of, or as well as, insurance under state law, then two different state agencies would become involved in the regulatory process; and frequently their respective jurisdictions, policies and roles could become overlapping, contradictory and confusing to those being regulated. Hence, even though a variable annuity contract may have all of the indicia of a "security", rather than embark on a program involving a major reallocation of the responsibilities of two different state agencies for the regulation of this particular type of "insurance" — and the people who sell it — it was considered preferable to leave the authority and duty to regulate such matters where the legislature had originally placed it — with the Department of Insurance [see, e.g., §§3911.011 and 3905.20-3905.21 of the Ohio Revised Code].

Considerations similar to those described above were also involved in the process of fashioning the scope of the definition of the term "sale" in OSA §1707.01(N). Insofar as the general phraseology was concerned, it was decided that the USA language [a substantial portion of which was borrowed from §2(3) of the Securities Act] should be adopted here because it is more concise, more frequently interpreted and better understood by most people than that contained in existing §1707.01(C). Thus, clauses (1) through (5) of §1707.01(N) are identical to clauses (1) through (5) of USA §401(j): clause (1) defines a "sale" as including "every contract of sale of, contract to sell, or disposition of, a security or interest in a security for value"; and clause (2) defines an "offer" or "offer to sell" as including "every attempt or offer to dispose of, or solicitation of an offer to buy . . . " the same. Clause (3) states the standard rule that a warrant or other security given with, or as a bonus on account of, the purchase of another security is considered to constitute part of the subject of the purchase and to have been offered and sold for value. Clause (4) expresses the usual interpretation given to purported gifts of assessable stock, i.e., that such gifts are considered to involve offers and sales.

Clause (5), which is concerned with warrants and convertible securities, traces the language of the USA. It provides in substance that there is always an "offer" of the security called for by a warrant or conversion privilege:

"(5) Every sale or offer of a warrant or right to purchase or subscribe to another security of the same or another issuer, as well as every sale or offer of a security which gives the holder the present or future right or privilege to convert into another security of the same or another issuer, is considered to include an offer of the other security."

As a consequence of this wording, the underlying security issuable upon exercise or conversion would have to be registered along with the warrant or convertible security (unless an exemption was found to be available) before either of the latter is offered for sale. The effect of this provision is described in the Comments to the USA as follows:

"Even if the warrants are themselves distributed without consideration, so that the warrants are not 'sold', a gift of the warrant involves an offer to sell the stock called for by the warrant. Hence registration of the *stock* is necessary before the warrants may even be given away. Moreover, since the security called for is being continuously, 'offered' so long as the conversion privilege or the purchase right remains exercisable, the security called for remains registered all that time under [OSA §1707.11(J)(1)] and the person who files the registration statement is subject to the [Commissioner's] power to require the filing of reports [or amendments under OSA §1707.11(K)]."

In other words, the underlying security continuously being offered by a warrant or a convertible security, and the "sale" of such security pursuant to the exercise thereof, would (unless an exemption is available) have to be the subject of a continuously effective (or "evergreen") registration statement. Of course, several of the exemptions provided for in OSA §1707.04 are specifically designed to cover certain kinds of transactions in such securities, and these will be reviewed in connection with the discussion on exemptions.

Unlike the first five clauses of OSA §1707.01(N), clause (6), which deals with exceptions from the definition of the term "sale", differs from its USA counterpart in two important respects. First, the exclusions for corporate reorganizations (mergers, consolidations, reclassifications of securities, and sales of corporate assets in consideration of the issuance of securities of another corporation) and for judicially approved reorganizations were omitted from the OSA's definition of "sale" and the transactions covered by these exclusions were treated as exempt transactions rather than as "non-sales". This was done because it was believed to be more in keeping with the federal approach to the special problems posed by these types of transactions [see, e.g., §3(a)(10), which exempts judicially or administratively approved reorganizations and which has always been viewed by the SEC as a transaction exemption, and Securities Act Release 33-5316, effective Jan. 1, 1973, which adopts the SEC's new Rule 145, repeals Rule 133 and, in so doing, carries out the SEC's determination that corporate reorganizations should be subject to the registration provisions of the Securities Act]. Consequently, while such transactions will still be exempted from the registration requirements of the new act (provided of course that the conditions of these exemptions are met), they will not be exempted from its fraud and civil liability provisions. Such is the effect of this difference in treatment.

Second, with regard to loans, pledges and stock dividends, it was decided to follow the USA approach and treat such transactions as not involving dispositions of "a security or interest in a security for value" in spite of the fact that even these have been called into question in several recent cases. This treatment is consistent with the existing law. However, in order to insure that the blanket "exemption" provided for such transactions is not abused, special emphasis was placed upon the concept of "good faith" in effecting them. Thus, clause (6) reads as follows:

(6) The terms defined in this division do not include either of the following:

(a) Any bona fide pledge or loan if made in good faith and not for the purpose of avoiding Chapter 1707. of the Ohio Revised Code;

(b) Any bona fide share or stock dividend, including a stock split, whether the corporation distributing the dividend is the issuer or not, if nothing of value is given by the security holder for the dividend other than the surrender of a right to a cash or property dividend when each security holder may elect to take the dividend in cash or property or in stock and if the dividend is distributed in good faith and not for the purpose of avoiding Chapter 1707. of the Ohio Revised Code."

For a further discussion of loans, pledges and stock dividends, see e.g., I *Loss, Securities Regulation,* pp. 516-518, 645-651, especially the discussion of the case of *SEC v. Guild Films Co., Inc.,* 178 F. Supp. 418 (S.D.N.Y. 1959), *aff'd,* 279 F. 2d 485 (2d Cir. 1960) *cert. denied sub nom. Santa Monica Bank v. SEC,* 364 U.S. 819; *SEC v. Harwyn Industries Corp.,* 326 F. Supp. 943 (S.N.D.Y. 1971) Securities Act Release 33-929 (July 29, 1936) and SEC Div. of Corp. Fin. Letter to First Midwest Corp. dated Feb. 2, 1973, CCH Fed. Sec. L. Rep. ¶79, 181.]

The other important definitions set forth in OSA §1707.01, such as, for example, the definition of the terms "broker-dealer", "agent", "investment adviser", "institutional investor", etc., will be reviewed in subsequent articles when the exemptions and registration provisions are considered.

Kenneth M. Royalty

OTHER DEVELOPMENTS

Registration Personnel

Bernard Boiston, Supervisor of the Registration Section, is currently acting as head of the registration team which handles intrastate corporate offerings. One of the two new attorney-examiners joining the Division this month will probably replace Bernard as team leader to allow him to devote full time to supervisory activities. Also on the intrastate corporate team is Tom Simon. Tom will soon be reviewing certain filings pursuant to Section 1707.06(A)(1) as well as intrastate filings pursuant to Section 1707.09. All other Form 6 filings are handled by Bob Almond.

Interstate corporate filings are reviewed by a team of examiners headed by Warren Williams. Team members include Bob Bibler and Joe Bellino.

Non-corporate filings are being reviewed by the third team, which is headed by Lee Passell. This team handles real estate limited partnerships, oil and gas programs, mutual funds, and all other non-corporate applications which are filed under Section 1707.09. Current members of the team include Mike Jones and Mike Sewell.

New Attorney in Enforcement Section

Jeff Ginther has recently joined the Enforcement Section as an assistant attorney-inspector following graduation from University of Denver Law School in March of 1973.

Fred Elefant

THE SECTIONS

BROKER-DEALER SECTION

"Churning" and "Suitability"

The current state of the economy has proved to be troublesome for firms and individuals for a variety of reasons. Many companies are reporting record earnings, but stock prices have shown no proportionate increase. Because of the unfavorable market conditions, many proposed new offerings are being withdrawn from registration or are being postponed until the market improves. The Division is concerned that this atmosphere may cause difficult problems in broker-dealers' relations with their customers, especially in the areas of "churning" and "suitability". Supervisory procedures should be reviewed and closely followed to insure that abuses in these areas are avoided.

"Churning" is a particularly hard abuse to detect. Whether the number of transactions which a broker-dealer executes for a customer's portfolio is excessive, must be determined in light of all surrounding circumstances. The major elements required to establish "churning" are: control by the dealers of the trading in an account; the abuse of that control, i.e., excessive trading; and, the broker's motivation for engaging in the transactions being to make money for itself. In dealing with a customer's portfolio, the broker-dealer's primary concern must be generating profits for the customer rather than for its own behalf. The broker-dealer must be keenly attuned to the financial circumstances of its customer, and to his investment objectives. It behooves the broker-dealer to keep complete up-to-date records of each customer's finances and investment objectives. Adequate customer information is a must for the responsible broker-dealer.

Penalties for "churning" are very severe. Aside from civil remedies which may be sought by an aggrieved customer, the broker-dealer may have its registration revoked by the Securities and Exchange Commission, and be expelled from membership in the National Association of Securities Dealers. It is important to note, that if fully informed and knowledgeable customers initiate excessive trading orders, without inducements by the broker-dealer, no "churning" will be found to exist.

Knowing one's customer is the key element of the "suitability" doctrine. Before a broker-dealer can recommend any security as suitable for its customer, it must know its customer's financial condition and investment objectives. The broker-dealer has a positive duty to obtain enough customer information to allow it to render the expert advice which it represents itself as being capable of giving. If a customer has improper investment objectives, this should be disclosed to him. The broker-dealer has the responsibility of alerting a customer to the risks which are involved in a transaction, and whether the investment is appropriate, in light of customer's financial condition and weighing the surrounding circumstances.

"Suitability" responsibility of the broker-dealer has been recognized by the National Association of Securities Dealers since its inception:

"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 securities holdings and as to his financial situation and needs. NASD — Manual D-5. Article III — Section 2 (1938)

Violation of this rule may result in disciplinary action by the Securities and Exchange Commission.

(The close alliance between "churning" and "suitability" is evidenced by the fact that the early excessive trading cases were the first cases decided under this rule).

In connection with development by the Division of control procedures relating to matters of "churning" and "suitability", the Division believes it to be in the best interest of the public to require that every broker-dealer make and keep current a separate file for all complaints by customers and persons acting on behalf of customers. Such complaints should be filed alphabetically by customer's names and should include copies of all material relating to the complaint, and a record of what action, if any, has been taken by the broker or dealer. Copies of such material and a record of actions taken should be kept in the office in which the customer account is handled.

The Division intends to take steps to integrate into its regulatory program the concepts of "churning" and "suitability" in accordance with Sections 1707.19(G) and (I). Further information concerning this policy will be forthcoming in future issues of this bulletin.

Elbridge Lewis

CONSUMER FINANCE

I. N.A.C.C.A. Meeting

I attended the Annual Convention of the National Association of Consumer Credit Administrators during the week of May 14th. This was held concurrent with the convention of the National Consumer Finance Association.

The record attendance by both state administrators and industry delegates was, in my opinion, precipitated by concern over the impact of the report and recommendations of the National Commission on Consumer Finance. Robert Meade of the Commission discussed the report and urged that the recommendations be adopted in their entirety.

Both administrators and the industry intend to digest the report and recommendations cautiously. Although the Uniform Code has been adopted by several states, no Consumer Credit utopia has resulted and new laws affecting consumer credit are being introduced faster than the impact of their predecessors can be measured. Although not a U.C.C.C. State, Ohio has kept abreast of many administrative developments under these laws and, with few exceptions, its pattern of regulation is very similar.

The industry pointed out to administrators fifteen areas of difficulty in dealing with state administration and in particular with compliance examinations. Only three of these areas were applicable to Ohio. Of particular importance is the need for development of a uniform format for annual reports.

II. Credit Life Insurance

There has been some confusion in the interpretation of Ohio Revised Code Section 1321.57(C), regarding credit life on loans made by a registrant under the Mortgage Loan Act. The last sentence of this paragraph reads: "Credit life insurance shall be payable without exception on proof that the insured obligor died during the term of the loan contract, and the death benefit shall be equal to the balance of the loan contract outstanding on the day of death after rebating any unearned charge for the loan."

There is some indication that the confusion has been caused by the Division's interpretation which prohibited the collection by a registrant of any deficiency remaining after the application of credit life proceeds. The present staff of the Division is of the opinion that the question of whether such a deficiency may be collected should be resolved upon consultation between the registrant and its legal counsel as it involves a question of private remedies. The Division continues, however, to take the position that failure to maintain the required credit life coverage would be a violation of the Mortgage Loan Act for which disciplinary action could be taken.

To resolve the registrant's dilemma caused by the nonavailability of group credit life in excess of $10,000.00, the Division is attempting to work with the Department of Insurance to bring about a change in that department's regulation by increasing the maximum credit life group coverage from the current $10,000.00 to $25,000.00.

Robert P. Fickell

ENFORCEMENT SECTION

Enforcement With Respect to Licensees

The Enforcement Section is presently concerned with the licensing of dealers in and salesmen of securities and foreign real estate. Because the very act of issuing a license connotes the approval of the Division of Securities, there is the undeniable inference that any licensee is an ethical, responsible individual in whom the potential Ohio investor can place his trust. Such responsibility requires that this Section act upon every complaint alleging unethical sales practices and upon all cases of misrepresentation on license applications. The Division's responsibility for that public trust requires positive utilization of Section 1707.19 of the Ohio Revised Code; the suspension, refusal or revocation of the license of a dealer or salesman for any of the ten reasons specified therein.

An investigation will commence immediately either upon the receipt of a complaint from an investor or upon the receipt of information indicating a fraudulent misstatement by a license applicant. Upon the verification of the irregularity, a Division order will be sent to the licensee or applicant, and in the case of a salesman, a copy will be sent to his employer.

The issuance of a Division order will benefit both the licensee and the industry as a whole, because:

1. A Division order assures the licensee or applicant that his constitutional rights are protected in that he is informed as to the charges and has the right to a hearing.

2. Such hearing will be afforded, upon request, to any individual who receives a suspension, denial, or revocation of his license, pursuant to Section 1707.19 of the Ohio Revised Code.

3. A Division order is a public document which will give notice to investors and to the investment industry that irregularities exist with respect to the particular individual's application or license.

Such positive action on the part of this Section of the Division will aid the industry in fulfilling its public obligation.

However, one manner in which the industry could be of immense help is for dealers to be more candid in their reference letters and termination reports, especially with regard to individuals whose employment has been terminated because of the commission of culpable acts. It should be pointed out that a misrepresentation to the Division by a dealer of the unsatisfactory nature of a former salesman's employment may be considered grounds for the suspension of that dealer's license. The failure to disclose a serious deficiency on the proper form could result in the subjection of investors to further abuses which might otherwise be averted.

It is our hope to restore to the Ohio investor the trust he should have in our public licensing agency in this era of concern for protection of the consumer.

Suit Against Cathedral of Tomorrow, Inc.

The Cathedral of Tomorrow, Inc. and the State of Ohio have been involved in negotiations since the first of this year. The Common Pleas Court of Cuyahoga County has restricted publicity with respect to the negotiations, so that this report will only relate what is already a matter of Court record.

In August of 1972, the State of Ohio and the Securities and Exchange Commission both initiated investigations of the Cathedral of Tomorrow, Inc. Both agencies were concerned about the sale of unregistered securities, specifically time payment certificates, life loans and call payment certificates. On February 12, 1973 the State of Ohio secured a temporary order restraining the Cathedral of Tomorrow, Inc. from any further sale of such securities and from any activities other than normal business operations.

A preliminary injunction was granted March 1, 1973, the terms of which were as follows:

1. The provisions heretofore outlined in the temporary restraining order were to be continued.

2. The Cathedral of Tomorrow, Inc. would hire a professional business manager to institute reliable management procedures and conduct a re-evaluation of various business activities not related to ministry functions.

3. The Cathedral of Tomorrow, Inc. would prepare a plan of rescission which would allow securityholders the opportunity to obtain a repayment of their investments. As a part of this plan, the Cathedral of Tomorrow would submit to the State of Ohio and to the court periodic financial reports.

4. The Court appointed a management representative to supervise the implementation of the terms of the preliminary injunction.

Judge Paul E. Riley signed a Journal Entry on May 25, 1973 incorporating an agreement reached between the Cathedral of Tomorrow, Inc. and the State of Ohio which contains the following provisions:

1. All securities of the Cathedral of Tomorrow, Inc. named in the temporary restraining order are deemed payable on demand as of May 25, 1973. A notice to that effect will be sent to all securityholders.

2. A trust fund is to be established in an Ohio bank by June 8, 1973 for the sole purpose of repaying these obligations.

3. On or about November 1, 1973, an offering circular will be sent to all securityholders, notifying them that they may tender their securities and be paid from the trust fund. As an alternative, they may hold their securities and continue to collect interest. So long as there are any outstanding securities, the trust fund will continue and the securityholders will receive annually a financial report of the Cathedral of Tomorrow, Inc.

With respect to the Cathedral of Tomorrow, Inc., it has been the primary objective of enforcement activities to protect the interests of the securityholders.

Veronica M. Dever

FOREIGN REAL ESTATE
Mimicry in Gimmickry

Use a titillater and be assured you will soon have an imitator followed by an innovator. The sale of real estate, whether foreign or domestic, should be subject to standards for advertising and other promotional means. Ohio securities regulation has thus far been successful in thwarting the use of "gimmicks", i.e., the offering of frying pans and radios as gifts for exposure to a securities investment. An unadorned prospectus should not require the use of a set of steak knives as a gift to induce a potential investor to grant an interview to a salesman. Domestic and foreign real estate transactions should likewise equate the interest of buyer and seller and rely upon their ability to negotiate at arm's length without a gimmick.

In the fifties, registered foreign land subdivisions were located primarily in Florida with homesites averaging less than $500 per one-half acre lot. No gimmicks were needed then. Competition beginning in the mid-sixties presented a challenge to developers. The southwestern states as well as Florida were offering subdivisions of up to 100,000 acres.

Buyer interest could no longer be equated with seller interest. Getting the mule's attention with a clout on the head translated into the use of gimmicks for gaining the attention of prospects who were unaware that they needed a lot in Florida or Arizona.

Marketing programs, through mimicry, became stereotyped in the case of the dinner party concept. A mailed invitation culminated in a dinner, a film, and a one-on-one sales closure at a local motel. Ohio resisted efforts to include gifts, green stamps and door prizes as attendance gimmicks in connection with these dinners.

The banquet era has been on the wane for the past eighteen months. The registrant-developer (innovator) substituted a U. S. bond for the erstwhile popular dinner meeting. The use of this gimmick was given acceptance as a substitute for the banquet on the basis of a maximum cost outlay of the equivalent of the maximum dinner party expense previously allowed. Then gift certificates became popular. They were within the guidelines restricting developer and broker to a maximum advertising budget of five percent of the selling price. Mimicry now is popularizing cameras for gifts as inducements to on-site property inspection trips. Other gimmicks now used include fruit boxes, miniature palm trees, cactus specimens and ersatz gems.

An overview gives evidence that innovators are often really imitators. Recognizing the continued need for the release and expression of advertising ingenuity, it is nevertheless regrettable that liveable land, whether here or there, must be packaged and marketed like toothpaste under a cheapened coupon or gift incentive sales philosophy.

The interstate land industry, like Topsy, has grown and grown. State regulators should not stifle this major industry, but should make sure that the attire is more appropriate to the wearer. Mimicry in gimmickry is inappropriate and, regrettably, is yet unharnessed. It is commendable that a substantial number of foreign land developers do, in fact, stress the importance of on-site inspection by prospects and make group inspection trips available at minimal cost with rights of rescission upon reasonably timed inspection given to purchasers.

George A. Ward.

REGISTRATION SECTION

Note on "Practice of Law"

In recent months, the Division has taken note of the fact that notices of claims of exemption pursuant to Section 1070.03(O) and registrations by description pursuant to Section 1707.06, Ohio Revised Code, are filed by laymen on behalf of applicants with whom they have no connection whatsoever (other than the fact that they are filing applications for a consideration of one kind or another). A high percentage of these filings contain errors or are otherwise incomplete.

The increase in the number of such filings has been of great concern to the Division. The Committee on Unauthorized Practice of Law of the Ohio State Bar Association has indicated that it considers the filing of registrations and claims of exemption by laymen to constitute the unauthorized practice of law and has expressed its intention to initiate action to curb such activities. It is not the position of the Division to enforce the cannons of ethics of the Bar. The Division will, however, be sympathetic to any efforts which are designed to promote the quality of applications for registration.

Bernard G. Boiston

Tie-in Sheets for Selected Filings

In a continuing effort to facilitate the review of applications for qualification of securities, the Division has instituted a new procedure which allows the examiner to perform a substantive review of an application in a reasonable period of time. The procedure requires registrants applying for qualification of securities issued by Real Estate Investment Trusts, Investment Companies and Cattle Programs to provide the Division examiner with a Tie-in Sheet cross-referencing compliance in the issuer's documents respectively with *all* the provisions of the Midwest Statements of Policy on Real Estate Investment Trusts dated July 16, 1970; Ohio Regulation COs-1-06(c) (1), formerly O-3(A); and the Midwest Guidelines for Registration of Publicly Offered Cattle Feeding Programs dated February 28, 1973. The suggested form of the Tie-in Sheet is a vertical listing of the sections of the appropriate guideline on the left side of the sheet and a vertical listing of the area or areas of compliance in the documents on the right side of the sheet.

In addition, the procedure requires the registrant to red line and tag those sections in the pertinent documents of the issuer cross-referenced in the Tie-in Sheet.

If the applicant fails to submit a Tie-in Sheet with the initial filing of the application, the Division examiner will submit a letter to the applicant explaining review of the application is contingent upon receipt of the appropriate Tie-in Sheet, and red-lined and tagged documents.

The Division Staff will deeply appreciate the cooperation of registrants in compliance with the above procedures.

Lee Passell

ADMINISTRATIVE ACTIONS

Summary of Credit Union Regulatory Activity for May, 1973

Suspensions of Normal Operations

Name of Credit Union	Date
Lima S & W Employees Credit Union	5- 7-73
AFSCME Credit Union	5- 9-73
Canton Packers Credit Union	5-15-73
Olivet Credit Union	5-15-73
Spanish-American Credit Union	5-15-73
Prince Hall Masonic Temple Credit Union	5-18-73
Community Businessmen Credit Union	5-29-73
Pantorium Employees Credit Union	5-31-73

Vacations of Suspension Orders

Circle Credit Union	5- 3-73
Ralston-Purina Employees Credit Union	5-10-73
Local 7 Credit Union	5-29-73
Good Samaritan Employees Credit Union	5-29-73
Shaker Heights Teachers Credit Union	5-10-73
Trio Employees Credit Union	5-30-73

Liquidations Ordered

Stark Credit Union	5- 7-73

Mergers Approved

Local 7 Credit Union with Cincinnati Central Credit Union	5- 7-73

Hearings Held Pursuant to §1707.04

In re American Bancorporation (Morristown Bank)

In re American Bancorporation (American Bank of Central Ohio)

In re American Bancorporation (Kingston Building & Loan)

In re United Ohio Bancorporation (rehearing)

Hearings Held Pursuant to §1321.04

Midland Guardian Corporation
Parma Heights, Ohio

Household Finance Corporation
Salem, Ohio

Note: 276 Examinations Made

STATISTICS

Securities Broker-Dealer Applications (Form 15) Received in May

James A. Gerspacher	5- 3-73
Shenandoah Oil Corporation	5- 3-73
F.S. Moseley, Estabrook, Inc.	5- 7-73
Jas. H. Oilphant & Co., Inc.	5- 8-73
Richard H. Brandt-Clifton Two Investors	5-11-73
Kirby Securities Corporation	5-14-73
Morrow Syndications, Inc.	5-15-73
J.P. Holland & Co., Inc.	5-23-73
Reliance Electric Company	5-30-73

Securities Salesmen's Applications Received in May - 292

Foreign Real-Estate Broker-Dealer Applications (Form 331A) Received in May

Brookridge, Inc.	5- 4-73
Scarlet & Gray Agency, Inc.	5-10-73
Royal Palm Beach Realty Inc.	5-17-73
Penn Landmark Corporation	5-18-73
Empire Properties, Inc.	5-18-73

Foreign Real-Estate Salesmen's Applications Received in May - 146

Security Salesmen's License Suspension in May

Louis McCoy, Jr.	5- -73

Foreign Real-Estate Broker-Dealer Suspension in May

MacKinnon Realty Company	5- -73

EDITOR'S CORNER

All correspondence concerning this Bulletin or other Division matters may be addressed to Nick Caraccilo, Ohio Commerce Department, Division of Securities, 366 East Broad Street, Columbus, Ohio 43215. We welcome your questions, comments and suggestions on all Division matters. Subscriptions are $25.00 per year. New subscribers should enclose payment with their subscription requests. Make checks payable to the Ohio Commerce Department.