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ohio securities bulletin

State of Ohio
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Department of Commerce
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Division of Securities
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COMMENTS OF THE COMMISSIONER

1. *Recent Lawsuits Directed Against State Administrators:* During the week of November 5, two lawsuits with damage claims totaling $164 million were filed against various employees of the Division of Securities and Department of Commerce, including myself, naming these individuals personally as well as in their official capacities as representatives of the State of Ohio. The filing of these two suits raises some interesting questions with respect to the administration of a regulatory agency and the roles of individuals whose jobs involve public protection.

Curiously, both lawsuits attack the individual defendants for enforcing the securities laws of Ohio, one claiming, in essence, that they acted too quickly to enforce the law, resulting in injury to the issuer of the securities, and the other claiming that they acted too slowly, resulting in injury to the investors. It is interesting to note that enforcement actions were being prepared simultaneously by the Division in these two cases (both of which were very sizeable and complex,) as well as in several others, and that in both instances the Division issued administrative orders (approximately one month apart) halting sales activities of the companies involved. One wonders what would have been the result if the Division had completed its preparations and taken action against these two companies in reverse order. Instead of being sued by the first company and by the shareholders of the second, would its employees have been sued by the second company and by the shareholders of the first? Conceivably, we could be sued by both companies and by the shareholders of both — everybody, all at once!

It should not be news to anyone that regulatory agencies have limited resources, and the Division of Securities is no exception (see Comments of the Commissioner, **Ohio Securities Bulletin,** September, 1973, page one.) The Division has managed this year to increase dramatically both the quantity and effectiveness of its enforcement activities and we intend to continue that increase during the months to come, but the Enforcement Section of the Division cannot devote its attention exclusively to each big case which it encounters. At this time, two or three simultaneous multi-million dollar enforcement actions severely tax the human and financial resources of the Division.

Does it make any sense, as the sponsors of these two lawsuits would have us believe, that the Division (or any other regulatory agency, for that matter) and its employees, personally, should be put into a position where they are damned if they do and damned if they don't, where they are the guarantors of the financial success of every public enterprise and of every investor in this state? How are Division personnel supposed to react to the threat of a personal attack of this sort? Should the Commissioner repeal the cursory review policy with respect to registrations in order to avoid possible personal liability for losses sustained in private placements or by sophisticated investors? Should registration examiners spend three or four times as long to review each file (and allow the registration backlog to build up again to the point where attorneys must allow 90 to 120 days to clear an offering in Ohio) in order to avoid suit? Should the Attorney-Inspector abandon her attempts to increase enforcement efficiency by limiting full investigation and case preparation to a manageable number of cases in order to avoid personal liability in connection with a complaint which would otherwise be considered of low

enough priority to warrant the advising of civil remedies to the complainant? Should the Department withhold Division orders and other public documents from the Press for fear that informing the public of its official determinations will bring suit by the objects of its enforcement activities? The answer to all of these questions is obviously "No." Therefore, one is compelled to question the sensibility of persons who initiate this kind of legal action.

We in the Division and the Department are not at all intimidated by being named as individual defendants in these actions. We have been investigated (and, I might add, vindicated) by the F.B.I., a Federal Grand Jury, the Governor's special investigator, and the Press in connection with the Realty National matter and we have at this point become accustomed to operating under aggravating circumstances. We realize that we are bound to encounter resistance as we step up the intensity of our enforcement activities, and we interpret the materialization of this resistance as a positive indicator of the success of our increased regulatory efforts. When we decided to stick our heads up we expected to be shot at. Our resolve is now being tested and we are determined to continue in the course which we have set for ourselves.

2. *Key Personnel Changes in Two Sections:* On Monday, October 29, important administrative changes were put into effect in the Broker/Dealer and Foreign Real Estate Sections of the Division. Gordon Stott was appointed Supervisor of the Broker/Dealer Section and Deputy Commissioner Bernard Boiston was appointed Acting Supervisor of the Foreign Real Estate Section, pending the selection of a new supervisor to take charge of the regulation of interstate land sales.

Both of these administrative changes are designed to further the implementation of a more aggressive regulatory posture for the Division at the section level. Priorities for both sections will include taking the initiative in the development of new policies and gearing operations toward ultimate enforcement objectives. Immediate steps which have been taken in the Foreign Real Estate Section include the limitation, beginning November 1, 1973, of the period of effectiveness of all land registrations to a maximum of one year, and the curtailment, one and for all, of both oral approvals and referrals of complaints for disposition by counsel for registrants. Additional steps contemplated for the near future include the prohibition of all giveaways, including free dinners, to induce prospects to submit to sales pitches, and the requirement for all purchase contracts of anti-forfeiture provisions, a ten day "cooling off period", and an immediate notification to the Division of Securities of the names of all parties to executed contracts.

3. *Amendments to Senate Bill 338:* On November 10, the Division submitted to Senator Howard Cook, Chairman of the Senate Commerce and Labor Committee, a summary of its proposals for the amendments of Senate Bill 338. Included among these proposals, which resulted from a series of meetings with participants in earlier Committee hearings on the Bill as well as from correspondence received from other interested persons and self-generated analysis by the Division, were the following: (1) a restructuring of rule-making provisions with respect to the financial responsibility of broker/dealers, including a refinement of the concept of "custody or control" of customers funds and securities; (2) the elimination of provisions relating to the registration and regulation of investment advisors, except for general anti-fraud provisions; (3) several modifications proposed earlier by the Corporation Law Committee of the Ohio State Bar Association, relating to rule-making and administrative review, designed to more finely tune the application of these two key functional elements of the new statute; and (4) the addition of amendments to Chapter 121 of the Ohio Revised Code to structurally define the authority and responsibility of the Division of Securities and of the Commissioner.

Suggestions for amendments rejected by the Division included: (1) a reduction of the general fee structure contained in the Bill; (2) the addition of a provision for registration by notification of certain widely distributed securities such as consumer finance company subordinated debentures; (3) the futher broadening of exemptions for the encouragement, generally, of new industry in Ohio; and (4) the transfer of the authority over regulation of securities offerings by insurance companies back to the Department of Insurance. Except for a limited number of additional amendment proposals still being studied by the Division, including the addition of an exemption for secondary market activities in securities of the same class as those registered for distribution by the issuer and the inclusion of a rescission damage remedy in connection with civil liability for violation of substantive fraud provisions, the proposals of November 10 for amendment of the Bill can be considered the final statement to the Committee of the Division's position on the substantive content of the proposed new Ohio Securities Act. We hope that the Committee will, with the assistance of the Legislative Service Commission, be able to complete its deliberations on this Bill by the end of the year.

4. *Bulletin Delay:* As the result of a number of circumstances, this month's issue of the **Bulletin** has been delayed by approximately three weeks beyond the intended publication date. The S.B. 338 amendment project has for the last two months diverted to a great extent the attention of Ken Royalty, Nelson Genshaft, and myself from the policy writing, which is the central focus of this publication. In addition, due to other demands upon the time of the Commissioner, it has become increasingly more difficult for me to personally review, edit, and revise every article submitted for publication and still maintain a strict production schedule.

We are determined to continue in the future to publish on a regular monthly basis an **Ohio Securities Bulletin** of the same scope and caliber of content that has characterized the first six issues of this publication, and in order to facilitate the realization of this objective, certain organizational changes have been instituted. For the remainder of this year, Ken Royalty will concentrate his attention primarily upon the new Securities Act and Nelson Genshaft will work almost exclusively upon policy development. Additional staff support for rulewriting will be added after the first of next year. Beginning with the November issue, editorial

responsibility for the Bulletin will be transferred to Alan Baden. We expect to have the November issue distributed by the end of this month and to be back on our original publication schedule with the December issue. Although the Division was criticized by New York commentators at the North American Securities Administrators Association meeting in San Antonio last month for publishing its new policies in monthly installments ("like a television soap opera – tune in tomorrow"), we believe this practice to be preferrable to the previous one of publishing no written policies at all, and we intend to continue distributing the results of our rulewriting efforts each month via the **Bulletin,** as they are completed.

William L. Case, III

POLICY DEVELOPMENTS

Amendments of Registrations by Description

Recent events have brought to light a fundamental misconception on the part of certain individuals of the proper procedure for amending registrations by description under the Ohio Securities Act. Certain issuers, in particular consumer finance companies selling subordinated debentures, have attempted to effectuate changes in the terms of their securities (such as increased interest rates) by merely sending a letter to the Division indicating their intention to begin selling their securities on terms at variance with those described in their registration application and certificate of acknowledgement. When notified that such sales will be in violation of the securities laws without reregistration, these issuers have replied that such amendment procedures had previously been accepted practice of the Division. In order that this misconception not be perpetuated, let us clarify further what would appear to be a relatively clear matter.

Section 1707.08 states that: *"In order to correct errors or omissions,* a registration by description may be amended by the person who originally filed it, by the filing, in the same manner as in the case of an original registration by description, of an amended registration by description, or of an amendment of the original registration by description . . . ". Division Regulation CO_5 (formerly R-8B) provides that: "A registration by description may be amended in order to correct errors or omissions in the statement describing the transaction to be engaged in or the securities to be sold . . . Purported amendments relating to matters which are not properly the subject of amendment, such as a change in the plan of sale or in the terms and conditions under which securities are to be sold, are not permitted by R.C. §1707.08 and are inoperative." If allowing substantive amendments by letter was previously accepted practice of the Division, such practice was obviously contrary to both the statute and the Regulations and therefore *ultra-vires.*

The Division considers a change in the terms of securities registered by description to be equivalent to the offering of new securities and will therefore, consistent with the requirements of the Ohio Securities Act, require the filing of a new registration. With respect to offerings by consumer finance companies, this distinction has more than procedural significance. Many existing registrations contain no limitation as to duration. All new registrations will remain in effect no longer than one year. In addition, the Division has this year adopted special disclosure requirements applicable to all new registrations of consumer finance company debt obligations which call for the distribution of offering circulars to all offerees of such securities. New registrations failing to comply with these requirements are being immediately suspended. The Division will not allow these requirements to be circumvented by recognizing an unlawful substantive amendment to an existing registration.

Fractional Undivided Working Interests in Oil and Gas Leases

Following the publication of new standards dealing with the registration of fractional undivided working interests in oil and gas leases (**Ohio Securities Bulletin,** July issue, page 7) the Division has received many valuable comments from interested parties. A special meeting with Bar and industry representatives was held on Wednesday, September 12, to discuss possible revisions in these standards. As a result of the comments which have been received, certain mechanical details have been worked out and other fundamental policy changes have been instituted in the form of **Written Policy Guidelines 1973-3,** set forth below in this issue of the **Bulletin.**

The Division has reconstructed the formula for determining the "fairness" of an offering with respect to promoter and affiliate compensation. This formula, applying the so-called "forty percent rule" sets the outer limits of revenue that may be fairly generated through public investment, based upon a multiple of actual drilling and completion costs which must conform to the fair market value of such costs in the particular area in which the well is located. In addition, important modifications have been made in the disclosure and in the record keeping and reporting provisions of these standards.

It should be clarified that the Division will apply to offerings governed by these guidelines the standards for Cursory Review outlined in Section II of **Statement of Policy 1973-2,** contained in the May issue of the **Bulletin** at page 11, and more fully explained in the August issue on page 25. **Written Policy Guidelines 1973-3** will be implemented by the Division effective December 1, 1973.

Debt Securities of Non-Profit Issuers

General Standards for the registration of debt securities of issuers organized and operated as corporations for profit have been developed and published in Section VII of **Written Policy Guidelines 1973-2,** which appeared in the July issue of the **Bulletin** on page 17. As stated in the guidelines, those standards do not apply to issuers which are organized for non-profit but exclusively for religious, educational, social, recreational, athletic, benevolent, fraternal, charitable, reformatory, or cooperative marketing purposes. Under Section 1707.01(I) of the Ohio Revised Code, securities evidencing membership in such non-profit organizations are exempted from the registration requirements of the Act, but the notes, bonds, debentures, and other obli-

gations of such organizations are not so exempted. In this issue of the **Bulletin**, the Division sets forth below as **Written Policy Guidelines 1973-4** a general policy for the evaluation of the debt securities of non-profit issuers, which will be implemented by the Division effective December 1, 1973.

Non-Specified Property Programs

Since its adoption in February of this year, the Division has been applying the Statement of Policy Regarding Real Estate Programs of the Midwest Securities Commissioners Association to real estate offerings filed for registration in Ohio. As stated in the **Policy Developments** section of the May issue of the **Bulletin**, the Division has been departing from the Midwest Statement Of Policy in certain respects and is currently in the process of preparing written standards which will supercede the inconsistent provisions of the Midwest Statement of Policy in those areas, including: non-specified property programs; fees, compensation, and expenses; voting rights of limited partners; suitability of the participant; and projections. The first of these standards, relating to non-specified property programs —more commonly known as "blind pools," will be published as Written Policy Guidelines of the Division in the November or December issues of the **Bulletin.** The Division has determined it necessary to depart from the Midwest Statement of Policy in this area in order to add restrictions designed to protect investors against the increased risks inherent in the absence of information concerning specific properties to be included in these programs. The following is a brief summary of the most salient features of this proposed new guideline:

Part I: The experience requirements of the principal general partners are increased to minimums of ten years in the real estate business, five years in each of the specific types of property involved in the program, five years in each of the specific types of services to be rendered to the program, and two years in the management of a publicly funded real estate program. The offering circular must summarize such partners business experience and the performance of other programs in which they have participated as general partners for the previous ten years.

Part II: Financial responsibility requirements are added to demonstrate sufficient economic interest and financial capacity on the part of the principal general partners to assure that they will continue with the program and seek optimum performance. The principal general partners, individual or corporate, must have a combined minimum net worth equal to 10% of the maximum aggregate offering price of the program (plus 10% of the aggregate capital contributions by all persons to all other programs in which they are currently general partners). In addition, they must make non-transferrable cash capital contributions to the partnership equal to the amount of the total maximum proceeds of the offering, multiplied by 10%, and multiplied further by one minus the percentage of specificity achieved by the program prior to registration. Both of these provisions are mandatory.

Part III: Detailed disclosure requirements are added relating to the number, type, and proportion of properties to be acquired, property selection criteria, the methods of financing and leveraging restrictions to be followed, the tax posture to be maintained regarding depreciation and other matters, criteria relative to sale or disposition of properties, and the character of temporary investments to be made pending the completion of property acquisition activities. A legend is required for the covering page of the offering circular pointing out the extent of discretion in the general partners as to the investment of proceeds of the offering and cautioning the prospective investor to carefully consider the suitability of such investment for his own personal circumstances.

Part IV: A requirement is added for the escrows of (at a minimum) the greater of 25% of the maximum aggregate offering price, or $1,000,000, and a diversification requirement limiting the expenditure on any one property to 40% of the proceeds of the offering. Proceeds not committed to construction, purchase, or improvement of specific properties within 18 months following registration must be returned to the limited partners pro-rata as a return of capital.

Part V: Increased minimum investment and suitability requirements are added, distinguishing between tax-motivated, developmental, or high-risk programs and income-producing, non-developmental programs. The minimum investment for both is $5,000. Suitability for the former requires $50,000 net worth and 50% marginal federal income tax bracket, and for the latter, $50,000 net worth or $30,000 gross income.

Part VI: An absolute prohibition against dealing with any of the general partners or their affiliates is added.

William L. Case, III

INTERPRETIVE OPINION
Condominium Projects as Securities

The purpose of this interpretive opinion is to state the Division's position as to the applicability of the Ohio Securities Act, Chapter 1707, to condominium offerings of real estate to Ohio investors. The reader should refer to the Foreign Real Estate Section article concerning the registration requirements of condominiums.

For further clarification of the Division's position, reference should be made to Release 33-5347 of the Securities and Exchange Commission, dated January 4, 1973. In this release the Securities and Exchange Commission states that "condominium offerings and the offer of real estate as such, without any collateral arrangements with the seller or others, does not involve the offer of a security. When the real estate is offered in conjunction with certain services, a security, in the form of an investment contract, may be present."

Reference is made to the classic case of S.E.C. vs. W. J. Howey, 328 U.S. 293 (1946), in which the court notes that

> "an investment contract may be present in situations where the investor is not wholly inactive, but even participates to a limited degree in the operations of the business. The "profits" that the purchaser is led to expect may consist of revenues received from rent on the unit; these revenues and any tax benefits resulting from the rental of the unit are the economic inducements held out to the purchaser."

The release points out two specific types of collateral agreements which give rise to a "security" in connection with the sale of condominium units. The first of these is a "rental pool," a device whereby the unit is rented on behalf of the actual owner during a period of time when the unit is not in use by the owner. The rents received as well as expenses incurred in the rental of the unit are combined with the rental of all units in a development. The individual owner receives a pro-rated share of the rental proceeds irrespective of whether his individual unit was rented. The second type of collateral agreement is the required use of an exclusive rental agent or limitations on the period of time when the owner may occupy the unit. The Commission notes that "such restrictions suggest that the purchaser is in fact investing in a business enterprise, the terms of which will be substantially dependent on the success of the managerial efforts of other persons." The Commission states that the key factor in determining the existence or non-existence of a security is whether or not the condominiums are "offered and sold through advertising, sales literature, promotional schemes, or oral representations which emphaize the economic benefits to the purchaser to be derived from the managerial efforts of the promoter, or a third party designated or arranged for by the promoter, in renting units."

This interpretive opinion is not intended as a final statement of the Division's position concerning the offer and sale of condominiums units in the State of Ohio. The Division believes, however, that the substance of Release 5347 by the S.E.C. is a more than adequate summary of the existing securities law concerning condominium units. It is therefore the Division's intention to regard Release 5347 as an appropriate interpretation of the securities law for the State of Ohio and that, unless exempted by either §1707.02 or 1707.03 of the Ohio Revised Code, offerings of condominium units involving any of the above described additional collateral factors must be registered with the Division.

Alan P. Baden

ILLUSTRATIVE RULING

Amendments to Registrations by Qualification

Facts: ABC Co., Ltd., an Ohio limited partnership, registers with the Division an offering of 100 limited partnership interests pursuant to Section 1707.09 of the Ohio Revised Code. After the offering is sold out, the general partners realize that some of the intended projects cannot be accomplished, but would prefer to modify the offering through an amendment rather than terminate the enterprise. The proceeds of the offering are, as yet, uncommitted as to use.

Question: Is an amendment possible at this point in the offering?

Answer: Yes, but only in a most restrictive manner. Section 1707.09(K) reads in relevant parts: "An application may be amended by the person filing it at any time prior to the Division's action on it either in registering the securities for qualification or in refusing to do so. Subsequent to any such action by the Division, the person who filed the application may *with the consent of the Division* file one or more amendments thereto which shall become effective upon the mailing by the Division of the findings (that the offering is not grossly unfair), the giving of notice of such findings to the applicant by the Division, and the payment by the applicant of such additional fee as would have been payable had the application as it previously became effective contained such amendment."

The Division is of the opinion that such an amendment can be made after the registration becomes effective, but only in a restricted manner. Certainly, such an amendment is not troublesome if the issuer experiences a change in circumstance after effectiveness, yet prior to the selling effort. But if the change comes during the selling effort, or at its conclusion, then the amendment will engender more considerable difficulties.

In the latter circumstances, the Division will request a convincing explanation as to why the subject matter of the proposed amendment could not have been forseen at the time of registration. A revised selling document must be recirculated to all who have purchased, with a right of rescission prominently noted. Further, the investor must have at least a ten-day "cooling off" period to evaluate his decision to rescind or remain in the program. Lastly, the revised selling document must be used for the remainder of the selling effort. Robert L. DeLambo

REGULATORY STANDARDS

WRITTEN POLICY GUIDELINES 1973-3

General Standards used in Determining whether a Proposed Offering of Oil or Gas Interests in Local Wells is being made on Grossly Unfair Terms.

I. Introduction

(A) *Applicability of General Standards:* These guidelines contain the general standards which are to be applied by the Ohio Division of Securities effective December 1, 1973, 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 representing oil or gas interests is to be made on grossly unfair terms. More specifically, the Guidelines are to apply to applications for the registration of proposed offerings of oil or gas interests that are

filed on the Division's Form 6(A)(3) OG and Form 9-OG. An offering of oil or gas interests covered by these Guidelines will be entitled to Cursory Review and will be treated in that way if the offering qualifies under the provisions outlined in Section II of **Statement of Policy 1973-a,** which was published by the Division in the May, 1973 issue of the **Ohio Securities Bulletin.**

The standards set forth in these Guidelines apply only to the registration and sale of securities representing interests in or under profit-sharing or participation agreements relating to oil or gas wells located in Ohio, or interests in or under oil or gas leases of real estate situated in Ohio, particularly those located in the Clinton Sandstone Formation and in the Medina Sandstone Formation area, and to similar interests relating to oil or gas wells or leases located in other states where oil or gas deposits are found in geological formations which have characteristics comparable to the Clinton-Medina Formation. These standards are also intended to apply only to oil and gas interests in a single, specified well or to units of interests in a limited drilling program which consists of no more than five (5) specific wells, and not to other, larger oil or gas drilling programs.

(B) *Definitions:* As used in these Guidelines, the following terms shall have the respective definitions set forth below:

1. **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.

2. **Underwriting Commissions and Compensation.** The term "underwriting commissions or other compensation" shall have the same meaning as that assigned to it in Section VI(A) of **Written Policy Guidelines 1973-2.**

3. **Division.** The term "Division" shall refer to the Ohio Division of Securities, Department of Commerce, State of Ohio.

4. **Promoter.** The term "promoter" means the owner of any oil or gas right, lease, working interest, or other participation interest in an oil or gas well who creates fractional undivided interests in such right, lease, or other interest for the purpose of offering such interests for sale to the public, or any other person who offers such interests for sale to the public, other than persons acting solely as an underwriter. The term also includes any operator of, or affiliated contractor who has agreed to perform services for a promoter on, the well or wells to be drilled on the specific tract or tracts which are the subject of the offering.

5. **Landowner's Royalty Interest.** The term "landowner's royalty interest" means the right of participation in the oil or gas, or in the proceeds from the sale of the oil or gas reserved by the landowner or fee owner upon the creation of an oil or gas well, lease, or limited drilling program which is not subject to any portion of the expense of development, completion, operation, or maintenance.

6. **Limited Drilling Program.** The term "limited drilling program" refers to a joint venture or partnership which proposes to offer for sale to the public fractional undivided interests or units of interests in oil or gas production of from one (1) to five (5) wells to be drilled on a specific tract or tracts of land. The term may also include a limited partnership which proposes to offer oil or gas interests where the structure of the offering indicates that the offering is similar to an offering of individual interests in specific oil or gas wells, leases, or limited drilling programs.

7. **Offering Circular.** The term "offering circular" refers to the disclosure document which complies with the requirements of Schedule D employed in connection with Regulation B offerings filed with the Securities and Exchange Commission pursuant to Section 3(b) of the Securities Act of 1933 and the rules and regulations thereunder, or to the form prescribed by the Division.

8. **Overriding Royalty Interest.** The term "overriding royalty interest" means the right of participation in the well, lease, or limited drilling program or in the proceeds from sale of the oil or gas produced from a specific tract or tracts, which right is limited in duration to the terms of an existing lease and is not subject to any portion of the expense of development, completion, operation, and maintenance.

9. **Participation Interests.** The term "participation interest" means the right of participation in the oil or gas, or in the proceeds from the sale of oil or gas, produced from a specific tract or tracts, which right is limited in duration to the terms of an existing lease and is subject to any portion of the expense of development, completion, operation, and maintenance. For purposes of these Guidelines, the term also includes any working interest as that term is defined below.

10. **Sponsor.** The term "sponsor" refers to any person directly or indirectly instrumental in organizing, wholly or in part, an oil or gas well, lease, or limited drilling program or any person who will manage or participate in the management of such program, and any affiliate of any such person, but does not include a person whose only relationship to the program is that of an independent property manager, and whose only compensation is for services performed as such.

11. **Working Interest.** The term "working interest" under an oil or gas well, lease, or limited drilling program refers to the right of a lessee or assignee under such oil or gas lease to operate a well to be drilled on a specific tract or tracts for the production of oil or gas. Such right is subject to a portion of the expense of development, completion, operation, and maintenance.

II. Compensation of Promoters, Sponsors, Underwriters and their Affiliates

(A) *General Standards:* A proposed public offering of securities representing participation interests in an oil and gas well, fractional undivided interests in an oil or gas lease, or units of interest in a limited drilling program (as that term is defined in these Guidelines) is considered to be grossly unfair to public investors unless both of the following conditions are met:

1. The total of all compensation to be paid to any promoter, sponsor of a limited drilling program, or underwriter and/or any of their affiliates, regardless of whether such compensation is received in the form of cash, retained interests, or any combination thereof, does not exceed forty per cent (40%) of the reasonable value of the aggregate interests in such well, lease, or limited drilling program (or, alternatively stated, 66.67% of the estimated drilling and completion costs to be incurred by the promoter or limited drilling program in drilling and completing the well or wells which are the subject of the offering, provided that such estimated drilling and completion costs do not exceed the fair market value of similar costs incurred by other non-affiliated issuers for comparable wells in the same county or related geographical area); and

2. The promoter or sponsor of a limited drilling program retains, as a part of his compensation, an interest in such well, lease, or limited drilling program which is at least equal to, or substantially the equivalent of, a 1/8th working interest in such well, lease, or program.

A promoter or sponsor (and/or any of their affiliates) may, as a part of his compensation, under Division II(A)(1) of these Guidelines, retain an interest in such well, lease, or limited drilling program which is substantially greater than a 1/8th working interest so long as such interest, together with the amount of any compensation to be paid to an underwriter, does not exceed forty per cent (40%) of the reasonable value of the aggregate interest in such well, lease, or program.

For purposes of this standard, the term "aggregate interests" means the total amount of all participation interests in a specific oil or gas well, or fractional undivided interests in a specific oil or gas lease, or units of interest in a limited drilling program owned by a promoter or sponsor prior to a public offering, exclusive of any landowner's royalty interest, and exclusive of any overriding royalty interest owned by a person who is not an affiliate of the promoter or sponsor, with the total amount of all such interests being measured by the proposed cash offering price of each participation interest, fractional undivided interest, or unit of interest to be offered for sale to the public, multiplied by the total number of interests or units owned by the promoter, sponsor, or any affiliates (including any overriding royalty interests owned by such person or persons) on the date the registration application is filed.

For purposes of this standard, the value of the aggregate interests in a well, lease, or limited drilling program is considered to be "reasonable" if it does not exceed 166.67% of the estimated drilling and completion costs to be incurred by the promoter or limited drilling program in drilling and completing the well or wells which are the subject of the offering, provided that such estimated drilling and completion costs do not exceed, either in the aggregate or on each individual cost item, the fair market value of similar costs incurred by other non-affiliated issuers for comparable wells in the same county or related geographical area.

(B) *Limitation on Total Compensation:* In the event that the estimated drilling and completion costs (to be incurred by a promoter or limited drilling program in drilling and completing the well or wells which are the subject of the offering) exceed the fair market value of similar costs incurred by other non-affiliated issuers for comparable wells in the same county or similar geographical area, then the proposed public offering will not be considered to be grossly unfair to purchasers under this standard if the total amount of all compensation to be paid to any promoter, sponsor, or underwriter, and/or to any of their affiliates, does not exceed sixty-six and two-thirds per cent (66.67%) of the fair market value of similar costs incurred by other non-affiliated issuers for comparable wells in the same county or related geographical area.

(C) *Limitation on Underwriter Compensation:* Notwithstanding the foregoing, in the case of an offering of interests in an oil or gas well, lease, or drilling program registered by qualification under Section 1707.09 (Form 9-OG), the total amount of all underwriting commissions and other compensation paid or to be paid by a promoter or limited drilling program to one or more underwriters shall not exceed fifteen per cent (15%) of the aggregate price at which all such interests are sold by or on behalf of the promoter, sponsor, or limited drilling program.

In the case of an offering to be registered by description under sections 1707.06(A)(3) and 1707.08 (Form 6(A)(3)) the total amount of selling expenses to be incurred by an issuer in connection with the offering shall not exceed one per cent (1%) of the total sales price of such securities. [See **Written Policy Guidelines 1973-2,** VI(A) for a definition of the term "total selling expenses."]

(D) *Drilling and Completion Costs:* For purposes of this standard, the term "drilling and completion costs" refers to all costs incurred in connection with the drilling and completion of a specific well for the production of oil or gas (other than those services rendered in connection with the initial selection of a geological prospect area or well site and services rendered with the acquisition of an oil or gas lease), which are directly allocated to a specific well and which would be incurred by the promoter or sponsor if he had drilled or completed the well at his own expense without offering interests therein for sale to the public, plus all reasonable costs incurred in registering the interests for sale to the public. Such term includes all costs incurred (1) for equipment, labor, fuel, repairs, hauling, and supplies which are used in drilling, treating and cleaning an oil or gas well, preparing the surface for drilling, and preparing the well for production, (2) in obtaining clear title to, and the right to drill in, the geological prospect area (e.g., lease costs, lease rental payments, survey, title opinion, permit fee, bond, insurance, etc.) and (3) in registering the interests for sale to the public (e.g., registration fees, attorneys' fees, etc.). Such term does not include, (i) any administrative and overhead expenses or selling expenses which are not directly allocable to a specific well and which would be incurred by the promoter or sponsor even though the well was not drilled (e.g., office, personnel, transportation expenses, etc.), or (ii) any underwriting expenses paid by the promoter or sponsor for selling the interests which are the subject of the offering.

For purposes of this standard, the term "estimated drilling and completion costs" refers to the budget estimate required to be submitted as Exhibit D either to Form 6(A)(3) OG or Form 9-OG indicating the estimated costs of a well on a dry hole basis and on a producing basis, and the term "actual drilling and completion costs" refers to the invoice costs for the drilling and completion of the well which are required to be submitted as part of the certified schedule to the post-drilling report. (See Division IV(B) of these Guidelines).

(E) *Refund of Proceeds in the Event of a Dry Hole or Excessive Budget Estimate:* A proposed public offering of securities to which these standards apply is considered to be grossly unfair to public investors unless the promoter or sponsor makes a commitment or undertaking, both in the offering circular and in the participation agreement, lease assignment, or similar document, to refund to purchasers any portion of the total proceeds of the offering which represents costs saved, particularly those in the following categories:

1. In the event that no oil or gas in commercial quantities is found in the geological prospect area, the promoter or sponsor shall refund to purchasers the portion of the proceeds which represent the unexpended costs which would have been incurred if the well had been completed, plus the percentage of the proceeds which represent the cash compensation which the promoter or sponsor would have received if the well had been completed; and/or

2. In the event that the budget estimate costs exceed the actual drilling and completion costs by more than 2%, the promoter or sponsor shall refund to purchasers the portion of the proceeds which represents the amount of such excess over the actual drilling and completion costs. To the extent that actual costs exceed the budget estimate the promoter or sponsor shall assume those actual drilling and completion costs without assessments on individual units of interest in such program.

III. Disclosure and Suitability Requirements

(A) *Synopsis Sheet – Offering Circular:* Any promoter or sponsor to whom those Guidelines apply shall file as part of his registration application the following documents:

1. A Synopsis sheet indicating the terms of the offering, including a brief description of the proposed project a summary of all compensation to be paid to the promoter, sponsor, underwriter, and/or any other affiliates, the estimated drilling and completion costs of each well covered by the registration application, and a list of the promoter's or sponsor's qualifications to operate the oil or gas well, lease or limited drilling program. A Synopsis Sheet which contains the information specified in the sample form, a copy of which is annexed as Appendix A, is deemed to be sufficient under these Guidelines; and

2. An offering circular which contains the information and documents required by Schedule D used in connection with Regulation B offerings filed with the SEC pursuant to section 3(b) of the Securities Act of 1933 and the rules and regulations thereunder (e.g., SEC Rules 310, 326, 328, 330, and 332) or conforms to the form prescribed by the Division.

As a condition to the approval of the registration application, in order to insure that the offering does not tend to defraud or deceive investors and that the purchasers of the securities to be sold to the public will be protected, the Division shall require the promoter or sponsor to distribute to offerees a Synopsis Sheet and offering circular at least forty-eight (48) hours prior to consumation of the sale or the receipt of cash for the purchase of any securities being offered to which these Guidelines apply.

(B) *Minimum Investment:* In order for a proposed public offering not to be considered to be made on grossly unfair terms and in order to insure that the sale of the securities is suitable for the persons to whom they will be offered, the initial minimum cash purchase which shall be permitted for securities subject to these Guidelines shall be $2,500 per investor, all of which must be paid within one (1) year of the date of sale.

Nothing contained in these Guidelines shall permit a promoter or sponsor to assess any interest in an oil or gas well, lease, or limited drilling program over and above the stated cash offering price per unit.

Subsequent transfers of such interests shall be limited to no less than a minimum unit equivalent to an initial minimum purchase, except for transfers by gifts, inheritance, intra-family transfers, family dissolutions, and transfers to affiliates:

(C) *Other Suitability Standards:* In order to insure that a proposed public offering will not be considered to be made on grossly unfair terms and in order to insure adequate protection of investors, the proposed offering shall be sold only to persons who are suitable for this particular investment. Such investor shall have sufficient resources and shall be in a federal income tax bracket which will permit him to realize a reasonable tax benefit irrespective of the success or failure of the drilling program. Only persons who have a tangible net worth of at least $20,000 (exclusive of home, furnishings, and automobiles) and who are in at least a forty per cent (40%) federal income tax bracket shall be considered to meet these suitability requirements.

As a condition to the approval of the registration application, the Division shall require the promoter or sponsor to obtain evidence from the investor which indicates that he meets these suitability standards. Adequate evidence shall consist of an investment letter signed by the investor in which the investor acknowledges the following, namely that:

1. He has received a Synopsis Sheet and offering circular at least forty-eight (48) hours prior to the consumation of the sale;

2. The tax consequences of the investment have been fully disclosed; and

3. He has a tangible net worth of at least $20,000 (exclusive of home, furnishings, and automobiles) and has a taxable net income placing him in at least a forty per cent (40%) federal income tax bracket.

IV. Record Keeping and Reporting Requirements
A proposed public offering of interests in an oil or gas well, lease, or limited drilling program is presumed to be grossly unfair to investors under these standards unless the promoter or sponsor makes a commitment or undertaking to the Division in the registration application to do the following:

(A) *Records:* Every such promoter or sponsor shall maintain a separate set of records for the offering in a manner which will allow determination of costs, expenses, revenue, and compensation to promoters, sponsors, and/or affiliates involved in the activity covered by the offering registered. In the case of a promoter or sponsor who does not have significant experience in the oil or gas business or who, in prior offerings registered with the Division, has demonstrated deficiencies in record keeping, the Division may require such person to maintain a separate checking account to make other special record keeping arrangements for the offering being registered.

(B) *Post-Drilling Report:* Every promoter or sponsor shall submit to the Division, within 120 days following either the completion or capping of each well covered by the registration application, a post-drilling report containing a certified schedule of all actual drilling and completion costs, incurred in connection with the drilling and completion or capping of each well, and all actual compensation paid or to be paid to the promoter or sponsor in the form of direct cash compensation and retained interests in the oil or gas well, lease, or limited drilling program.

APPENDIX A

SYNOPSIS SHEET

Offeror:

Location and Size of Drilling Unit:

Target Formation & Approximate Depth:

Minimum Size Unit to be Sold:

Price Per Minimum Unit:

Total Offering:

Underwriting Commission:

Size of Working Interest:

Existing Overriding Royalty Interests:

Does any person connected with the issuer or underwriter own the overriding royalty interests?

Estimated Costs of Drilling:

Estimated Costs of Completion:

Interests to be Retained by Issuer or Affiliate:

Is it contemplated that the issuer is to spend any of its own funds in drilling and completing the wells aside from funds received from the sale of interests?

Who will Operate the Well:

What compensation will the operator receive?

WRITTEN POLICY GUIDELINES 1973-4

General Standards used in Determining Whether a Proposed Offering of the Debt Securities of Non-Profit Issuers is Being Made On Grossly Unfair Terms

Applicability of General Standards
These Guidelines contain the general standards which are to be applied by the Ohio Division of Securities effective December 1, 1973, in making determinations under Section 1707.09 and 1707.13 of the Ohio Revised Code as to whether or not a proposed offering of the debt securities of non-profit issuers is to be made upon grossly unfair terms. The standards set forth in these Guidelines apply only to the registration and sale of debt securities issued by issuers which are organized and operated not for profit, but exclusively for religious, educational, social, recreational, athletic, benevolent, fraternal, charitable, reformatory or cooperative marketing purposes, as other securities issued by such non-profit organizations are exempted from the registration requirements of Chapter 1707. of the Ohio Revised Code.

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I. Cursory Review

(A) *Eligibility*
1. Small Offerings Limited to Members of Religious Organizations (Church Bonds)
An application to register by description or qualification the debt securities of an issuer organized and operated not for private profit, but primarily for religious purposes (i.e., church bonds) will be handled by the Division of Securities on the basis of a cursory review if the offering meets any one of the qualifications set forth in Section II of the Division's **Statement of Policy 1973-2** or if all of the following conditions are satisfied:

(a) the amount of debt securities to be offered, together with the principal amount of all other debt securities to be outstanding at the completion of the offering, will not exceed $100,000;

(b) the offering is limited exclusively to existing active members of the issuer;

(c) no portion of the proceeds of the offering is to be used to acquire the assets of, or to form, a business which is unrelated to the primary purposes (religious, educational, and/or charitable) for which such issuer was organized; and

(d) the issuer's contributions and other receipts exceeded its expenditures for the most recently completed fiscal year.

2. Limited Offerings of the Debt Securities of Non-Profit Issuers Organized and Operated Primarily for Other Than Religious Purposes

An application to register by description or qualification the debt securities of an issuer organized and operated not for private profit, but primarily for charitable, benevolent, educational, or social purposes or for other than religious purposes (e.g., hospital bonds) will be handled by the Division of Securities on the basis of a cursory review if the offering is limited in any one of the ways specified in Section II of the Division's **Statement of Policy 1973-2,** even though the offering may otherwise be exempted from federal registration under Section 3(a)(4) or 3(a)(5)(B) of the Securities Act of 1933.

(B) *Disclosure Requirements*

As a condition to the approval of the registration, the Division may require that the registrant distribute to offerees a short form disclosure document which points out specific risks or terms of the offering that the Division considers essential to an informed investment decision. The disclosures which may be required include the following:

(a) a statement regarding the amount of debt securities to be offered and the purposes for which the proceeds of the offering are to be used;

(b) a statement to the effect that the offering is limited exclusively, in the case of church bonds, to existing active members of the issuer, or in the case of other securities, to the class of persons specified in the request for cursory review;

(c) a statement to the effect that it is unlikely that the purchaser will ever be able to sell his securities except possibly, in the case of church bonds, to the issuer or another member of the issuer or, in the case of other securities, to the issuer or other holders of such securities;

(d) a balance sheet as of a date within ninety (90) days of the date of filing and a receipts and expenditures statement for the issuer's most recently completed fiscal year and for all subsequent quarters ending prior to the date of the balance sheet; and

(e) a statement to the effect that the Division of Securities of the Ohio Department of Commerce has performed a cursory review of the offering upon the representation by the issuer that the offering will be limited to the class of persons specified in the registration application, and that, because cursory review involves a less thorough examination than is applied by the Division to widespread public offerings, and because offerings subject to cursory review are not denied on the basis of characteristics which would otherwise be deemed grossly unfair by Division, the prospective investor is cautioned to evaluate the offering carefully, and to seek the advice of an attorney, accountant, investment advisor, or other person who has knowledge and experience in business and financial matters, with respect to its various terms, including the financial background and condition of the issuer and the ability of the issuer to pay the interest and to repay the principal on the securities hereby being offered.

(C) *Period of Review and Notification of Findings*

The Division will endeavor to notify the applicant within ten (10) days after it has received the application of its approval thereof or of its request that such application be modified or withdrawn.

II. General Standards for Determining Whether a Proposed Offering is Being Made Upon Grossly Unfair Terms — Established and Recently Organized Non-Profit Issuers

(A) *Established Non-Profit Issuers*

Applicability: The requirements and limitations with respect to the issuance and sale of debt securities by non-profit issuers apply to all proposed public offerings of debt securities to be made by an issuer which is, and for the three (3) year period preceding the date of filing, has been organized and operated not for private profit, but exclusively for religious, educational, social, recreational, athletic, benevolent, fraternal, charitable, reformatory, or cooperative marketing purposes.

General Standards: A proposed public offering of debt securities to which these standards apply is generally considered to be grossly unfair to public investors if:

(1) the issuer has not been in existence and engaged in the activities or performing the services for which it was organized for at least three (3) fiscal years;

(2) the issuer's liabilities exceeded its assets as of the end of the most recently completed quarter of the issuer's current fiscal year;

(3) the issuer's expenditures exceeded its contributions and other receipts during two (2) of the three (3) preceding fiscal years;

(4) (a) in the case of the debt securities of an issuer which is organized primarily for religious purposes (i.e., church bonds), the average annualized net cash flow of the issuer for the three (3) fiscal years preceding the date the registration application is filed is insufficient to cover the annual interest requirements on all such securities, plus the annual interest requirements on all other debt obligations and securities of prior or equal rank 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; and the issuer is unable to demonstrate that the future activities of the issuer will result in net cash flow sufficient to cover the foregoing requirements;

(b) in the case of the debt securities of any other non-profit issuer, the average annualized net cash flow of the issuer for the three (3) fiscal years preceding the date the registration application is filed is insufficient to cover the annual interest and principal amortization requirements on all such securities, plus the annual interest and principal amortization requirements on all other debt obligations and securities of prior or equal rank 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; and the issuer is unable to demonstrate that the future activities of the issuer will result in net cash flow sufficient to cover the foregoing requirements;

(5) in a case where all or a substantial portion of the proceeds of the offering are to be used to acquire specific property, to erect one or more structures thereon, or to acquire the assets of, or to form, a business which is unrelated to the primary purposes (religious, educational, and/or charitable) for which such issuer was organized, the issuer fails to provide for the depositing in escrow of the proceeds of sale with a bank or other escrow agent acceptable to the Division pursuant to a written escrow agreement which substantially complies with the requirements specified in Division V(2)(a) of **Written Policy Guidelines 1973-2)** until a sufficient amount of securities equal to the specified portion or percentage of the proceeds subject to escrow has been subscribed and paid for, and the proceeds are released therefrom with the approval of the Division; and, in such case, the specified portion or percentage of the proceeds which shall be subject to escrow shall be at least sixty-seven percent (67%) of the total gross proceeds plus such additional portion or percentage, up to and including one hundred per cent (100%) thereof, as the Division may in its discretion require in order to insure that a specific minimum amount of funds necessary to acquire such property or assets will be obtained;

(6) in a case where all or a substantial portion of the proceeds of the offering are to be used to acquire specific property or to erect or remodel one or more structures thereon, and where the fair market value of the improvements to be made to or on such property exceeds $250,000, the issuer fails to demonstrate to the satisfaction of the Division that it has or will obtain a performance bond to insure the satisfactory completion of such proposed improvements; or

(7) in a case where the maturity date of the debt securities to be offered is more than ten (10) years from the date of issuance, the issuer fails to provide for, and to undertake to comply with, the sinking fund requirements specified in Division VII(A)(3) of **Written Policy Guidelines 1973-2.**

Modification and Construction of Standards: The Division may in its discretion modify the foregoing requirements if the issuer or applicant demonstrates to the satisfaction of the Division that the financial condition, character of services, or other circumstances of the issuer warrant such modification.

Nothing contained in these standards shall be construed to prohibit an issuer to which these standards apply from soliciting charitable contributions and from giving a receipt therefor, so long as the receipt is properly identified as such, and so long as the soliciting agent does not promise to repay the contribution.

Disclosure Requirements: As a condition to the approval of the registration, the Division will normally require that the registrant distribute to offerees an offering circular or other disclosure document which substantially complies with the requirements for offering circulars employed in connection with Regulation A offerings filed with the SEC pursuant to Section 3(b) of the Securities Act of 1933 and the rules and regulations thereunder. [see SEC Rule 256(a)(1) and Schedule I to Form 1-A].

B. *Recently-Organized Non-Profit Issuers*
General Standards: Normally, a proposed public offering of the debt securities of a non-profit issuer which has been organized within the three (3) year period preceding the date a registration application is filed is considered to be grossly unfair to public investors, regardless of whether such issuer can demonstrate a substantial future cash flow capability. However, the Division may in its discretion modify this standard for any proposed offering of debt securities if the issuer or applicant demonstrates to the satisfaction of the Division that the financial backing, guarantees of repayment by a third party, character of services, or other circumstances of the issuer warrant such modification.

THE SECTIONS

REGISTRATION SECTION
Suitability

Although many consider "suitability" an onerous subject, the Registration Section is becoming increasingly aware of instances where broker/dealers have sold investments to those who were completely unsuited for them. The problem has been most acute with respect to the intrastate broker/dealers who generally are not compelled to follow NASD standards or the broker/dealer regulations promulgated under the Securities Exchange Act of 1934. For purposes of this article, I will restrict the discussion to suitability and the sales of interests in real estate limited partnerships.

A. *The Midwest Guidelines*
With respect to both intrastate and interstate limited partnership offerings, the Division will more aggressively seek compliance with the suitability standards of Section III of the Statement of Policy regarding real estate programs, published in 1 CCH Blue Sky Law Reporter, at p. 635. As of December 1, 1973, the Division will *require* an *undertaking,* as a condition for the approval of the registration application, from the sponsor that compliance with Section III will be effectuated.

B. *Some Federal Standards*
Although the Federal Reserve Board announced last year that installment sales of real estate limited partnership interests, which are registered pursuant to Section 5 of the Securities Act of 1933, are forbidden by Regulation T, the Board has thus far refused to offer a definitive ruling with respect to which sales of securities are exempt from Section 5. Indeed, members of the Board's legal staff have suggested that Regulation T is inapplicable to intrastate offerings. Therefore, the Division finds itself besieged with intrastate offerings of partnership interests sold on the installment basis.

Technically, we believe that Regulation T does apply to these offerings (see generally recent ruling, Regulation T, 24 Case Western Reserve Law Review 391, 1973), but we will not raise the issue in the absence of an affirmative Board ruling. However, we believe that other regulations, promulgated under the Securities Exchange Act of 1934, do apply, particularly Rule 15c2-5. Generally, this rule makes it unlawful for *any* broker/dealer to offer or sell any security to, or to attempt to induce the purchase of any security by, any person to whom such broker/dealer, directly or indirectly, offers to extend any credit or arrange any loan, or participates in arranging said loan unless, prior to such purchase, the broker/dealer: (1) Delivers to such person a written statement setting forth the obligations the person will occur, the risks and disadvantages of the entire transaction, and a review of all commissions, discounts and other remuneration to be received by the broker/dealer and any other participant in the transaction, and (2) Makes a *positive inquiry* into the offeree's financial situation to determine that the entire transaction is suitable for such person, and *delivers to such person a written* statement setting forth the basis upon which the broker/dealer made such determination.

Our contention regarding the application of Rule 15c2-5 has been confirmed by the Securities and Exchange Commission. Therefore, in the handling of intrastate installment sales of partnership interests, the Registration Section will deem an offering to be grossly unfair in the event of non-compliance with Rule 15c2-5. This is not meant to be an onerous burden, but rather an inquiry into broker/dealer compliance with an important regulation for which such persons are already responsible.

Robert L. DeLambo

ENFORCEMENT SECTION

Enforcement Activities Related to Foreign Real Estate Sales

During recent months the Enforcement Section has been making an intensive investigation into the area of Foreign Real Estate Sales. While this investigation is still underway, it has thus far resulted in the suspension of four major broker/dealers and the indictment of six salesmen on thirty-two criminal counts.

This type of enforcement activity has drawn comment from the major land developers in Florida and Arizona. The response has been favorable and the land developers have in recent months made every effort to closely monitor the activities of their broker/dealers and in turn, of their salesmen. One repetitive theme heard from land developers is that published guidelines are needed in the Foreign Real Estate area. The Division is currently considering several approaches to the development of policy in this area.

Without the able assistance of county prosecutors across the state, this effort to regulate Foreign Real Estate Sales would not have been as effective in curbing violations of Chapter 1707 as it has been. It is interesting to note that following the issuance of these indictments and suspension orders many State land boards and HUD have notified their correspondents of such actions.

Throughout this investigatory effort it has been evident that the largest abuses have resulted from the failure of broker/dealers to supervise their salesmen. All Foreign Real Estate salesmen are cautioned that they are responsible for verifying the fact that they are currently licensed by the Division. In many cases this may require a personal inspection to determine that the broker/dealer is physically holding a properly issued salesman's license.

In coming months, enforcement efforts will continue in specific areas of broker/dealer and salesman activities, particularly in those areas where the Division has received the most complaints.

Veronica M. Dever

BROKER-DEALER SECTION

Self-Regulation and Compliance Within the Industry (Continued from September Issue)

VII. *Design and Review of Papers for New Customer Accounts*

1. Review all forms to make sure they require sufficient information to know your customer.
2. Make sure all forms are completely filled out.
3. Make sure that a check has been made for a prior account.
4. Make sure that a credit check has been made where appropriate.
5. Make sure that additional inquiry is made when warranted.
6. Make sure account is for a real person or entity.

7. Make an effort to find out if anyone else has a beneficial interest in the account.
8. Make sure that sufficient information has been obtained to know your customer.
9. Make sure power of attorney is obtained when required.
10. Make sure that officials of public companies are properly identified as such.

VIII. Review Of Trading Data

1. Use computer runs wherever possible, EDP equipment should be made available on a priority basis.
2. Make sure runs show:
   a. trading by all customers, including the firm itself.
   b. purchases and sales of all securities, including OTC.
   c. customer, security, geographic and economic concentration.
3. Review geographic concentration in particular issues.
   a. by the firm as a whole.
   b. by various branch offices.
   c. by particular registered representatives.
   d. by individual customers.
4. Review economic concentration
   a. by market.
   b. by price.
   c. by issue.
5. Runs should be used to detect possible churning or over-trading.
6. Runs should show solicited purchases of securities not on firm's recommended list.
7. Look for switching and break-points in mutual funds.
8. Watch for trading in their own stock by corporate officials.
9. Print-outs should be available on a real time basis.
10. Trade should be reviewed on the same day or early on the following day.
11. Contact customers where warranted on routine or special basis.
12. Make sure necessary corrective action is taken.
13. Weekly and monthly cumulative runs may be used to spot intermittent or gradual activity.
14. Trading by discretionary accounts should be reviewed carefully.

IX. Procedures Concerning Purchase Recommendations to Customers

1. Solicitations for purchases should only be made from the firm's recommended list or after clearance by the research department if one exists, or with firm's top officials.
2. Orders should be marked "solicited" or "unsolicited" and shown as such on confirmations and monthly statements.
3. The firm must know the security being recommended (See standards in the Hanly case).
4. Firm must require salesmen to know that a recommendation is suitable for the customer.
5. Must make sure customer's financial situation is consistent with the total value of securities being purchased.
6. Securities should not be recommended where firm cannot obtain the shares in time for delivery.
7. Firm's salesmen must avoid making statements without an adequate and reasonable basis.
8. Firm's salesmen must avoid making price predictions.
9. Firm should have procedures for determining that statements being made by salesmen are proper.
10. Do not permit your firm to allow special inducements to be given to salesmen for recommending a security.
11. Require salesmen to disclose to the firm receipt or offer of any special inducements for recommending a security.
12. Establish procedures to prevent salesmen from using inside information.
13. Firm must cease making market recommendations with respect to securities which the firm is distributing.
14. With respect to transactions in the securities of shells or spin-offs see S.E.C. Release of July 2, 1969.
15. Recommended list must be constantly reviewed to make sure information is current.
16. Be sure that adequate information has been obtained before effecting any transactions in securities where there has been an injunction or suspension of trading.

17. Be alert to substantial activity in low priced and speculative issues.
18. Be alert to facts indicating that the firm may be participating in an unlawful distribution or other illegal activity.
19. Firm should be aware of float of security being recommended and be cautious if there is unusual activity in the security.
20. Periodic customer checks should be made where there is undue activity or concentration or other indications that problems may exist.

X. Procedures Concerning Sales of Securities for Customers.

1. Must know customer before accepting sale order.
2. Must ascertain that the seller is the beneficial owner of the securities involved.
3. Must be alert to sell orders being entered by a third person without proper authorization.
4. Should ascertain where else the seller has brokerage accounts and whether any sales of the same security are being made through proper authorization.
5. Where orders involve a substantial number of shares appropriate inquiry should be made to be sure firm is not participating in an unlawful distribution or other illegal activity.
6. Must make sure customer's financial situation is consistent with the total value of the securities to be sold.
7. Must attempt to ascertain any connection between the seller and the issuer.
8. Must make sure that the seller is not selling on the basis of material non-public information.
9. Should ascertain whether the shares are registered and were acquired in the open market.
10. Cannot sell shares solely on the basis that they have been put through transfer.
11. If shares were acquired other than in the open market, the circumstances surrounding their acquisition should be carefully reviewed to determine that an exemption from registration is available.
12. Should require immediate referral of proposed transactions claimed to be exempt under applicable Rules so that they can be carefully reviewed in advance.
13. Where there is any question as to saleability a written opinion of independent counsel should be obtained.
14. Cannot accept opinion letters which conclude shares are freely tradeable but do not set out facts.
15. Where circumstances warrant, consider consultation with regulatory staffs.
16. When making distribution care must be taken to assure compliance with 10b-6.
17. Must know the security to be sold and have sufficient information concerning the company's business and financial condition to be sure the firm is not acting in furtherance of illegal activity.
18. In appropriate circumstances securities should be checked to determine if they are stolen or forged.
19. Must obtain and review trading data concerning sales transactions, both by security and by account.

XI. Procedures Concerning Foreign Customers and Securities

1. Special care must be taken with respect to effecting transactions on behalf of foreign individuals and entities.
2. Particular care must be taken to be sure that the foreign customer is known and that the firm is not participating in an unlawful distribution, violation of the credit provisions, or other illegal activities.
3. Foreign secrecy laws cannot be permitted to prevent adequate inquiry in order to know your customer.
4. Must have the Securities and Exchange Commission's Foreign Restricted List available and make sure all salesmen check it when appropriate.

XII. Oversight of Research Department

1. Firm should have a recommended list which is kept current.
2. Firm should have a restricted list which is kept current.
3. Make sure research reports:
   a. Have a proper factual basis.
   b. Take into account the floating supply.
   c. Are in good taste.
   d. Are not subject to misinterpretation.
   e. Contain adequate disclosure of possible adverse interest on the part of the firm.
   f. Are consistent with the firm's own trading.
   g. Meet all applicable regulatory standards.

XIII. Oversight of Firm Trading and Market-Making Activities:

1. Firm should not recommend or make market in any securities without adequate inquiry.
2. Must make sure firm does not trade in shells or spin offs unless satisfied such trading is lawful (See Harwyn Publishing Case).
3. Must make sure firm complies with Exchange Act Rules 10b-6 and 10b-2 and the registration requirements of the Securities Act.
4. Make sure that a prospectus is used for the required period of time in trading transactions in new issues.
5. Must make sure firm does not trade against customers.
6. Make sure that firm is not involved in interpositioning.
7. Maintain surveillance over mark-ups.
8. Maintain surveillance over quotations.
9. Review situations where firm backed away from quotations.
10. Watch for parking of securities.
11. Make sure firm's prices are in line with independent market.
12. In integrated firms be on lookout for conflicts between customers and firm's trading.
13. Assure compliance with market makers exemption to Regulation T.
14. Be alert to problems of numbers trading.
15. Watch out for fictitious quotations.
16. Must take steps to learn the source of securities being sold so as to avoid participation in an unlawful distribution or other illegal activity.
17. Make sure new communications systems are not used for manipulative or other unlawful purposes.
    a. limiting the number of its transactions to the firm's capacity.
    b. restricting trading for the firm's own account.
    c. refraining from soliciting orders.
    d. curtailing the opening of new offices and the hiring of new salesmen.
    e. limiting the opening of new accounts.
    f. refraining from advertising.
18. Where the condition is serious and the firm is in violation of applicable rules make sure it gives proper notice to regulatory organizations and ceases doing business.

XV. Oversight of Financial Condition

1. Employ accountants to establish complete internal auditing procedures and be sure that technically qualified persons are employed to carry them out.
2. Make sure that all financial records are maintained on a current and accurate basis.
3. Make sure that bank accounts are being reconciled on a current basis.
4. Make sure that management can at all times determine capital ratio and financial condition.
5. Make sure that new capital is solicited properly and obtained in correct form.
6. Review legality of all subordinated loans and how they were obtained.
7. Review methods of obtaining subordination of customers' accounts.
8. Make sure that money due from customers is collected in accordance with all Rules and Regulations.
9. Make sure that there are proper internal controls to prevent kiting and theft.
10. Make sure that all rules relating to financial responsibility are complied with, including net capital, segregation, hypothecation, lending of securities, credit and reports required by self-regulatory organizations.
11. When financial difficulties are encountered consider what disclosure to customers is appropriate.
12. Where the condition is serious and the firm is in violation of applicable rules make sure it gives proper notice to appropriate regulatory organizations and ceases doing business.

XVI. Review and Disposition of Customer Complaint Letters

1. Enter all such letters in a log.
2. Review letters as to apparent seriousness of complaints.
3. Determine whether reply should be made by telephone.
4. Send interim reply if delay in response appears likely.

5. Assign routine letters to appropriate department for answer.
6. Give careful consideration to referrals from S.E.C. or self-regulatory agencies (frequently a follow-up to prior complaint).
7. Retain and handle letters indicating serious problems.
8. Review replies by other departments.
9. Make sure customer has been treated fairly.
10. Make all necessary inquiries.
11. Periodically review and analyze complaints to determine if there are problems in certain locations or concerning a specific security.
12. Correct promptly any indicated weaknesses in the firm.
13. Take all appropriate disciplinary action.

XVII. Inspection of Branch Offices

1. All offices should be visited periodically.
2. Make visits generally on an unannounced basis.
3. Review files, including complaints and computer runs, relating to that office prior to visit.
4. Physically inspect entire premises.
5. Have conversations as to problems with key employees.
6. Discuss problems indicated by files and visit.
7. Where appropriate customers of that office should be interviewed.
8. Give a compliance talk to all employees.
9. Prepare a report of the visit.
10. Take necessary corrective action.
11. Include in the inspection a review of the financial operations of that office.
12. Consider whether the inspection should be coordinated with a visit by the firm's internal auditors.

XVIII. Liaison and Cooperation with Regulatory Authorities

1. Coordinate or handle all requests from Securities and Exchange Commission and self-regulatory authorities.
2. Be familiar with all Commission disciplinary actions and releases.
3. Review all disciplinary actions taken by self-regulatory authorities.
4. Keep informal contact with other compliance officers.
5. Prepare reports of disciplinary actions and violations of the rules of regulatory organizations for submission to them.
6. Report promptly to the Securities and Exchange Commission indications or evidence of unlawful activity.
7. Review all other disciplinary actions against employees for consideration as to whether a report is required.

XIX. Initiation of Disciplinary Actions

1. Require employees to disclose promptly involvement in any inquiry being conducted by the S.E.C. or self-regulatory agencies.
2. Receive reports of conduct by any employees which may have involved violations of the federal or state securities laws or rules of the self-regulatory bodies.
3. Review such reports to determine if any disciplinary action is appropriate.
4. Make any additional inquiry if necessary.
5. Consult with the Commission or appropriate self-regulatory bodies when warranted.
6. Take appropriate disciplinary action.
7. File required reports.

XX. Review of Adverse Personnel Actions

1. Receive reports of all adverse personnel actions taken for any reason.
2. Review such reports for indications of conduct possibly violative of federal securities or state laws or the rules of self-regulatory organizations.
3. Make any necessary inquiry to determine whether such violative conduct did exist.
4. Where such conduct is found, follow the procedures set forth in XIX.

XXI. Coordination of Litigations

1. Review all court actions filed against the firm and its employees.
2. Recommend appropriate course of action to take.
3. Coordinate with outside counsel the handling of such litigation.
4. Consult with and make recommendations to such counsel.
5. Maintain liaison with such counsel during litigation.
6. Take appropriate action upon completion of litigation.
7. Review recommendations to initiate litigation.
8. Coordinate, as outlined above, as to litigation brought by the firm.

XXII. Oversight of Firm's Advertising

1. Make sure advertising does not misrepresent the firm of its available services.
2. Make sure advertising is not subject to misinterpretation.
3. Make sure advertising is in good taste.
4. Make sure advertising complies with all applicable standards and requirements.

XXIII. Review of Prospective Underwriting

1. Review any underwriting that the firm may be interested in doing.
2. Obtain credit reports and background information on the company and its officers.
3. Obtain any available public information from the Commission and self-regulatory organizations concerning the company and its officers.
4. Seek information from the issuer's customers and suppliers.
5. Make sure that all due-diligence requirements are met.

XXIV. Review of Outside Connections of Firm Personnel

1. Require advance approval of all outside connections.
2. Review all outside connections:
   a. for possible conflicts.
   b. for indication of payola.
   c. as to potential for leaks.
3. Keep records of all outside connections.
4. Update and review such reports periodically.
5. Watch for possible connections with officials of issuers whose securities are being recommended.
6. Obtain and review brokerage accounts maintained at other firms by employees of your firm.
7. Require outside connections to be modified or terminated when appropriate.

XXV. Consultation on Selection of New Offices

1. See that offices are located so that all aspects of their operation can be adequately supervised.
2. Check to see that the business that will probably be produced does not appear unduly likely to present problems.
3. Provide more supervision over offices where potential problems are greater.

Elbridge Lewis

FOREIGN REAL ESTATE SECTION

Procedures for Registration of Condominium Offerings

It has been stated in the "Interpretive Opinions" section of this Bulletin that some offerings of condominium units are registerable transactions under the Ohio Securities Act.

Condominium offerings can be divided into two basic types — the normal condominium offering with no collateral agreements and the condominium offering with a rental pool or some similar investment contract characteristic.

It is the Division's position that the first type of condominium offering will be registerable only if it constitutes real estate situated more than 25 miles outside of the boundaries of the State of Ohio. If the offering is of this type, registration procedures will be restricted to the Foreign Real Estate Section of the Division.

If the offering of condominiums located outside the State of Ohio is of the second type (and therefore involves a security as stated in the "Interpretive Opinion") the filing should be on a Form 33 but with some additional require-

ments. The Form 33 should include as exhibits the offering circular and other material that would be required for a Form 9 filing. The file will be passed upon by both the Registration Section and the Foreign Real Estate Section. The securities aspect, including the disclosure of material facts, the offering circular, and the "fairness" of the file, would be reviewed by an examiner in the Registration Section. Until approved by such examiner, the file will not proceed for examination in the Foreign Real Estate Section. Once a file has cleared the Registration Section, the Foreign Real Estate Section will then proceed with a normal examination consistent with its own procedures relating to the foreign land aspects of the filing. In the licensing of a broker/dealer for the sale of a condominium unit involving a security (as determined by the Securities and Exchange Commission in Release 5347) the requirements of §1707.331 of the Ohio Revised Code will apply.

As a final matter, should an offering of condominiums situated within the State of Ohio involve a rental pool or some other collateral arrangement constituting a "security", the offering must be registered on a Form 9 with the attendant offering circular and exhibits required by that type of registration. An individual who desires to sell the proposed offering must be licensed pursuant to §1707.14 of the Ohio Revised Code. Such offering would be treated solely as a security, and not as real estate.

Alan P. Baden

CONSUMER FINANCE SECTION

Financial Ratio Requirements in Consumer Finance Company Registrations

Junior debt ratios and net worth adjustments are used in establishing adequate solvency for Finance Companies issuing and selling notes under Section 1707.06(A)(1). Section 2911.04 of the Revised Code of Ohio defines the term, "insolvent" in reference to a person's financial condition as meaning "whenever the aggregate of his property, at a fair valuation, is not sufficient in amount to pay his debts."

Obviously, when a financial examination is made by the Consumer Finance Section, a "fair valuation" or appraisal of the issuer's assets must be made to arrive at an adjusted net worth. Following the format proposed by the American Institute of Certified Public Accountants and present Securities Act regulation DS-10, normal adjustments to asset accounts are made generally as follows:

A. *Adjustment of Retail Receivables.*

1. Reserve for loss and unearned discount are deducted from gross receivables to arrive at a net asset valuation.

2. Unearned discount is divided by gross receivables to obtain a percentage. This figure, based on the annual report of December 31, 1972, was 18.2% for Ohio pre-computer loans. Dissipation of unearned charges, whereby this percentage falls below 16%, will necessitate a proportionate negative adjustment between the lower percentage figure and the 16% figure.

3. Delinquency is scaled on the Robert Morris format schedule E (par. 1, 2 and 3) and projected losses based on 25% of the 60-89 day category, 50% of the 90-179 day category, 75% of the 180-269 day category and 100% of the 270 day and over category. Should the projected losses exceed the established reserve for loss, the excess amount becomes a negative adjustment.

B. *Asset Items to be Disallowed Per Regulation DS-10*

1. Furniture and fixtures

2. Prepaid items or expenses

3. Unsecured notes or accounts receivable from officers.

4. Other unsecured notes or accounts receivable (except retail loans).

C. *Asset Items to be Adjusted Per Regulation DS-10*

1. Securities owned and other investments shall be reduced or increased to market value.

2. Real Estate assets shall be reduced or increased as supported by appraisals made by competent, disinterested appraisers.

D. *Other General Asset Adjustments*

1. Goodwill assets are disallowed.

2. Acquisition costs and similar deferred assets are disallowed.

3. Investments in subsidiaries can be reduced or increased to book value of the investment when supported by an accepted financial statement and not reported on a consolidated basis.

Empirical data discloses that all well-capitalized issuers are able to withstand these net worth adjustments and still maintain very adequate ratios. In keeping with the trends in financial analysis of companies funded by public securities, great emphasis is being placed on liquid assets in a determination of the relative safety of the public investment. You will all notice significant changes in the auditing and certification of your financial statements by your CPAs after December 31, 1972. They will be following the new specialized format for this procedure adotped by the A.I.C.P.A.

The general thrust of our financial examination is to determine your compliance with the Ohio Securities Act and to determine your junior debt ratio by applying your liquid assets to the outstanding dollars of your registration(s) after deducting any indebtedness senior to the subordinated securities. Research of examinations applied to present and past issuers, national averages, and advice from financial analysts have all established that a desirable junior debt ratio is 1.25 in net liquid assets (after deducting senior indebtedness) to 1.00 in subordinated notes outstanding. A ratio of 1.25 to 1 or better is desirable. When the ratio falls below 1.20 to 1, the issuer is on a red-flag basis and should show an improving picture to qualify for registration.

The Consumer Finance Section will welcome all inquiries from issuers regarding these matters.

Robert P. Fickell

CREDIT UNION SECTION

Statutory Reserve for Losses

Section 1733.31, Ohio Revised Code, provides for the establishment and funding of a statutory reserve for losses until a maximum of 7% of personal loans has been placed in reserve.

This section is quite specific as to the purpose for the maintenance of this reserve fund. No provision is made for the reduction of the reserve fund, once established. The statute is clear in its statement that the fund shall not be distributed through dividends except in the event of dissolution or liquidation of the credit union.

Regulations of the Division currently in effect and those to be promulgated in the near future provide that all losses on uncollectable loans are to be charged to the statutory reserve. All other losses may be charged against undivided earnings or against other reserves. The procedure for charging losses to this reserve takes on added significance in view of the current short money supply, high interest rates on borrowed funds and the many real losses resulting from the necessary sale of investments undertaken by many credit unions.

Through its examination procedures, the Division has become aware of instances in which credit unions have charged investment losses to this statutory reserve. In each case, these credit unions have been instructed to restore to the reserve fund the amount of the improperly charged losses. We recognize that this order may result in the inability of the credit union to sustain the dividend payment schedule that had been maintained in the past. However, the protection of member share deposits, the ultimate objective of the statutory reserve provisions, is the primary concern of the Division.

The National Credit Union Administration, which offers its federally-chartered credit unions and participating state-chartered credit unions share deposit insurance up to a maximum of $20,000 per account, requires state-chartered credit unions to maintain an investment valuation reserve. This reserve is to be equal to the difference between the cost and the current market value of certain investments which state-chartered credit unions would not be permitted to make under the federal guidelines. This investment valuation reserve is to be funded at the close of each accounting period prior to the payment of any dividend to shareholders. Any losses suffered through the sale of investments at inopportune times are to be charged to this investment reserve.

Though the Division does not specifically require an investment reserve, the Supervisor at his discretion is authorized to require additional reserves from time to time to cover potential losses such as those resulting from investments. All state-chartered credit unions are encouraged to provide for losses which might result from their individual exposures and the vagaries of the current market conditions.

John Gouch

OTHER DEVELOPMENTS

Larry Carlini recently joined the Enforcement Section as an assistant Attorney-Inspector following graduation from Case-Western Reserve University Law School.

Larry, Jeff Ginther, Alan Baden, and Nelson Genshaft, all four of the Division's candidates for admission to the Bar, successfully passed the Bar examination and were admitted to the practice of law on Saturday, November 3.

On October 15 and 16, Professor John Slain of the Ohio State University College of Law visited the Division to address the attorneys and examiners of the Registration and Enforcement Sections on the subject of Federal Securities Law as a part of the Division's continuing education program. The Division is indebted to Professor Slain and to others who have donated their time to help Division personnel improve their understanding of regulatory concepts.

William L. Case, III

ADMINISTRATIVE ACTIONS

Summary of Credit Union Section Administrative Actions for September, 1973

Suspension of Normal Operations

Warren Metal Decorating Credit Union	9- 6-73
Ohio Color Photography Credit Union	9- 6-73
Carpenters Local 1438 Credit Union	9-19-73
Varsity House Credit Union, Inc.	9-28-73

Mergers Approved

Marion Division Ohio Edison Employees Credit Union — Akron Ohio Edison Employees Credit Union

Hartman Electrical Employees Credit Union — Ohio Central Credit Union

MM & T Credit Union — Ohio Federal Employees Credit Union

Summary of Consumer Finance Activity for September, 1973

	Issued	Cancelled
Small Loan Licenses	2	4
Second Mortgage Licenses	4	5
Premium Finance Licenses	0	0
Pawnbroker Licenses	0	1

Note: 331 Compliance Examinations Made
9 Financial Examinations Made

Enforcement Activities

Suspension Orders

Mutual Sales and Investment	9-19-73
Charles C. Busby	9-26-73
William O'Callaghan	9-26-73
National Finance Company	9-28-73
Welfare Finance Corporation	9-28-73
Louis McCoy	9-26-73

Denial Hearing

O'Neill Fishbaugh	9-21-73

Indictments Sought and Returned

Sales of Unregistered Foreign Real Estate by Unlicensed Salesmen – Geauga County Grand Jury – Martin Silverberg

STATISTICS

Registration	Certificates
3-0	313
6-A-1	91
6-A-1 With Offering Circular	4
6-A-2	34
6-A-3	17
6-A-4	7

	Applications Received	Orders
Interstate Corporate	9	5
Stock-Option & Purchase Plan	5	5
Intrastate Corporate	3	2
Investment Companies	14	8
R.E.I.T.	1	0
Real Estate Ltd. Partnerships	22	8
Oil & Gas Offerings	20	15
Cattle Funds	2	0
Other Non-Corporate	2	4
Form 39	10	14
5 A's	2	2
2 B's	21	18

Note: 25 Requests for Cursory Review
3 Withdrawals

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

ARA Services, Inc.	9- 4-73
Patrick Henry Financial Corporation	9- 4-73
Intermark, Inc.	9- 4-73
Rowe Price New Income Fund, Inc.	9- 5-73
Vas-Co Money Management Plans, Inc.	9- 6-73
SFC Securities Corporation	9-10-73
Manley, Bennett, McDonald & Co.	9-10-73
Hazlett, Burt & Walson, Inc.	9-12-73
Exchange Bankshares Corporation	9-12-73
Lawrence L. Verdekal, CPA	9-17-73
Croesus Industries, Inc.	9-24-73
Xenophon Zapis	9-24-73
Ralph E. Deems	9-25-73
CPC International Inc. (the "Company")	9-26-73
Kohr & Kohr Investment Company	9-27-73
Hexcel Corporation	9-27-73

Foreign Real Estate Broker/Dealer Applications (Form 331A) Received in September

Michael J. Young dba The Young Companies	9- 7-73
Paul Decker	9-12-73
Kincoa Springs, Incorporated	9-17-73
Queen Creek Land & Cattle Corporation	9-17-73
William E. Jackson dba William E. Jackson Realty Company	9-18-73
Fairfield Green Valley, Inc.	9-20-73
N.C.B. Executive Realty Corporation	9-25-73
Vista West Properties, Inc.	9-26-73
Colonial Penn Communities, Inc.	9-27-73

Salesmen Applications Received in September

Form 16 – Securities	216
Form 331B - Foreign Real Estate	94
Total Salesmen for September	310