OHIO SECURITIES BULLETIN

RICHARD F. CELESTE, GOVERNOR | KENNETH R. COX, DIRECTOR OF COMMERCE | MARK HOLDERMAN, ACTING COMMISSIONER OF SECURITIES

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ARTICLES

SIMPLIFYING SECURITIES LITIGATION THROUGH OHIO REVISED CODE § 1707.43—By John L. Campbell, Walker, Chatfield & Doan, 1900 Carew Tower, Cincinnati, Ohio 45202

When analyzing potential claims of a client who has lost money in a securities transaction in Ohio, counsel is faced with an extensive review of the facts as they may apply to federal and state securities laws, Ohio common law, federal and state civil racketeering laws and banking laws. Each of these laws provides different relief and requires differing proof. However, among all of these, initial attention should be given to a review of the facts of the claim in light of Ohio Revised Code section 1707.43. In this area of litigation which ordinarily brings the words "complex" and "protracted" to mind, the existence of certain undisputed facts may allow the Plaintiff to prevail on a motion for summary judgment for violation of Ohio Revised Code section 1707.43.

Section 1707.43 provides in pertinent part that:

> Every sale or contract for sale made in violation of Chapter 1707 . . . is voidable at the election of the purchaser upon tender to the seller . . . of the securities sold . . . for the full amount paid by such purchaser . . . unless the Court determines that the violation did not materially affect the protection contemplated by the violated provision.

This section of the Ohio securities laws (also referred to herein as the Ohio Blue Sky Laws) provides rescissionary relief to purchasers of securities sold to them in violation of those laws. In analyzing the possible uses of the above section, it is helpful to understand its purpose. Although the legislative history behind the statute was never articulated,[1] the history of its creation and the judicial application of the section indicate that its *primary* purpose and use is to enforce compliance with the Ohio Blue Sky Laws. The method of such enforcement is to provide a nonpunitive civil right of recovery to investors who purchase securities sold in violation of the Ohio Blue Sky Laws. The statute simply gives the purchaser the right to obtain restitution of the purchase price of the security in exchange for the security purchased. The investor is not given the right to recover additional losses.[2] The clearest statement of the fact that the statute was created for the protection of the Ohio Blue Sky regulatory scheme was set forth by the Ohio Court of Appeals for the Twelfth District in *Belle v. Le-Ge, Inc.*[3] The court, referring to the Ohio Supreme Court's decision in *Pencheff v. Adams*,[4] stated with regard to O.R.C. § 1707.43 that:

> The Supreme Court focused on the significance of "protection contemplated" by the statutory requirement, rather than the protection actually denied to the rescinding buyer.[5]

Further support for the position that the primary purpose of the O.R.C. § 1707.43 is the protection of the regulatory scheme can be found in the development of the Ohio Blue Sky Laws.

In 1929, the Ohio Legislature enacted sweeping Blue Sky securities legislation. To provide remedies for defrauded investors, the 1929 Act set out sections establishing civil liability for fraud upon a purchaser.[6] This section, currently O.R.C. § 1707.41, reads in pertinent part:

> In addition to the other liabilities imposed by law, any person who, by a written or printed circular, prospectus, or advertisement, offers any security for sale, or receives the profits accruing from such sale, is liable, to any person who purchased such security relying on such circular, prospectus, or advertisement, for the loss or damage sustained by such relying person by reason of the falsity of any material statement contained therein or for the omission therefrom of material facts, unless such offeror or person who receives the profits establishes that he had no knowledge of the publication thereof prior to the transaction complained of, or had just and reasonable grounds to believe such statement to be true or the omitted facts to be not material . . .. Lack of reasonable diligence in ascertaining the fact of such publication or the falsity of any statement contained in it or of the omission of such material fact shall be deemed knowledge of such publication and of the falsity of any untrue statement in it or of the omission of material facts.

The protection contemplated provides civil remedies to the investor who has relied, to his or her detriment, upon false or misleading statements contained in written materials used to promote the sale of a security. That same year, the Ohio Legislature also provided a second remedy to an investor who has been misled.[7] This section, currently O.R.C. § 1707.42, protects investors from persons such as commissioned securities broker dealers or sales representa-

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COMMISSIONER'S LETTER

Introduction

This is the third of our quarterly bulletins and we hope there will be more and thicker volumes to come. This issue marks the return of articles submitted by outside contributors as well as statutory interpretations by the Division. The intent of these inclusions is to provide both education and notice to the practicing bar of not only the statutory and case law, but of the Division's thinking also. It is hoped that the Bulletin will be a device that reduces controversy surrounding the Ohio Securities Act, and it is the intent of the staff to publish it with that objective in mind.

The following letter discusses the content and import of various elements of this bulletin, and concludes with several miscellaneous matters of general interest.

NASDAQ/NMS Stock Exemption

Pending before the Ohio Legislature for the past year is the most significant piece of securities legislation proposed in Ohio since the present securities act was passed in 1929. This legislation would exempt from registration, all companies that the National Association of Securities Dealers chose to list on the dealers "National Market System." For all practical purposes, this exemption would eliminate registration for all *initial public offerings* of more than $3 million dollars. Because the NASD changes its standards at will, within the next several years, registration at the state level could be eliminated entirely at the whim of the securities dealers' association.

Although we live in an age of sweeping deregulation, Americans must be far more careful to subject the already limited authority of their state governments to the same anti-government fervor they apply to the federal government. It must be remembered that the federal government, particularly the SEC, "fills the gaps" between state authorities, not vice versa. State law remains the authority of last resort.

Contrary to arguments of the securities dealers, the need for state review is even higher than it has been in the past. Popular conception has it that the SEC is a powerful and dynamic watchdog of the securities markets and guardian of the public interest; however, in 1985 the SEC reviewed only 60% of first time offerings and only 25% of repeat offerings. This year, the percentage reviewed has been even lower. The need for state enforcement is even more important.

The Division of Securities cannot fulfill its responsibilities—either equitable or criminal—without registration review of some kind, and yet this legislation would allow some of the riskiest offerings to sell in Ohio without even the simplest notice to the Division. Should this legislation pass, the cost to Ohio investors will be enormous.

But not only will Ohio investors be exposed to the sorts of questionable offerings previously only known in Denver, Utah, Nevada and Florida, Ohio businesses will also suffer. For seventy-five years, Ohio businesses have had the privilege of selling securities to trusting Ohio investors. Should this bill pass, Ohio businesses will have to compete for investment dollars with Denver penny stocks, Nevada gold mines, and Canadian shale oil companies.

It is no accident that high-tech, venture-capital and growing small companies dominate the economies of states with tough securities regulation, like Ohio, California, and Massachusetts. Promoters find that the most difficult task of raising capital—that of instilling public trust—has already been performed by the state.

As a wealthy special interest, the NASD wields a powerful influence wherever it goes, but the constituency of investor protection is invisible until a tragedy arises. In spite of the arguments in favor of state securities review no investor constituency is beating down the doors of the Ohio legislature. Home State depositors and Baldwin-United investors know what it means to lose their savings, but other Ohio investors are unaware of even the existence of this bill.

It would seem that the special knowledge of the Bar would cause the legislature to go to great lengths to seek its advice. Unfortunately, although no bar association has endorsed the legislation, it appears that conflicts of interest stand in the way of testimony by many members of the Bar acting in an independent capacity. The Division staff would therefore ask that members of the Bar contact their Representatives and ask them to oppose any such Bill.

Within the bulletin are included written statements presented to the Ohio House of Representatives, Financial Institutions Subcommittee by Joseph Long, the leading scholar of "blue sky" law, and myself.

Interpretations and Policy Statements

On a daily basis, the Division receives numerous requests for statutory interpretations and "no-action" letters. Arguments concerning the nature, character, and advisability of issuing such statements constitutes the significant bulk of administrative law journals. This is not the place to delve into all of those considerations. Let it suffice to say that the Division considers several key factors in developing and maintaining a policy regarding publications. Among those factors are:

1) staff resources;
2) notice to the bar;
3) education of the bar;
4) equal application of the law;
5) consistent application of the law;
6) legal accuracy;
7) realistic and beneficial policy.

It is with these competing considerations in mind that the Division is conservatively beginning a practice of the publication of formal and informal statutory interpretations to be published in the Bulletin.

Distinguished from Articles

The Division will publish articles in the Bulletin contributed by outside writers as well as staff. These articles are intended as education and enlightenment for the bar, but do not carry the complications of endorsement by the Division. It might be noted, however that articles contributed by the Division staff most likely represent the best thought available to the Division at the time of publication.

All Interpretations Published

Statutory interpretations by the Division will likely center upon specific cases and examples presented to the Division, although other general policy positions may appear when dealing with widespread phenomenon.

It has been brought to the attention of the staff that certain internicene competition for clientel may arise among the members of the bar each claiming to have the "inside track" to the Division in matters of policy, no-action letters, and statutory interpretations. To avoid even the appearance of favoritism, the Division will publish *all* of its statutory interpretations. The bar is hereby cautioned that "staff interpretations" not found in the Bulletin are of questionable validity.

No No-Action Letters

A no-action letter is a device whereby an enforcement agency provides non-binding comfort to a member of its constituency by taking a position of recommending no enforcement of the law with regard to some action that falls within a gray area of the law that is of little policy interest to that enforcement entity. It provides no interpretation of the law, no concession by the agency, no precedent, and is nonbinding. It provides the agency the luxury of taking no stance with regard to a matter of policy while being nice guys at the same time. For the following reasons the Division will continue its long-standing policy of not issuing "no-action" letters.

First, response to the numerous requests for no-action received by the Division would be impossible with the limited resources and staff presently available. Second, it is not clear what is the impact of a no-action letter by the Division of Securities when presented to the county prosecutor who seeks to enforce the law. Third, unlike the SEC, which issues no-action letters on a regular basis, state laws are the all inclusive backstop of securities and corporate regulation. The Division of Securities does not have the luxury of knowing that there is another authority available to oversee matters upon which it has deferred review, because requests for no action by the Division are typically coupled with federal exemptions.

More importantly, however, it is the position of the Division that the issuance of a no-action letter is an abdication of the responsibility of good government to clarify the law and apply it equally to all members of its constituency. The issuance of an no-action letter does nothing to clarify the law regarding the issue that is the subject of no action. Furthermore, a no-action letter is inherently discriminatory because it exempts one party from equal enforcement of the law. No-action letters can only lead to bickering among the bar, and every letter issued would in turn create requests for ten more.

It is therefore the position of the Division that the issuance of no-action letters are not advisable at this time. Issuers are advised to rely upon the opinion of counsel for guidance with regard to compliance with the Ohio Securities Act.

The Division will respond to requests for statutory interpretation in matters of such significant import that publication in the *Bulletin* would be useful to the bar. Such interpretations will issue from Division counsel after consultation with and discussion among the Division staff. Examples of such responses are found within this Bulletin regarding sections 1707.02(B) and 1707.01(B).

Articles

With this Bulletin, the Division reestablishes its custom of publishing articles written by outside contributors. These articles are intended to be a resource to readers of the Bulletin, but do not carry the endorsement of the Division of Securities. Our first article is by John Campbell of the Cincinnati bar, and discusses what we have found to be an area of intense interest and confusion within the bar, namely, the availability of useful civil remedies under the Ohio Securities Act.

The remaining articles have been written by members of the staff.

Enforcement
Attorney Inspector

The State of Ohio was recently faced with a severe and unexpected handicap in the enforcement of its securities laws when a common pleas judge refused to allow the Division representation at the prosecutor's table in a difficult criminal prosecution investigated and reported by the Division.

Contrary to custom, the judge denied a motion of the prosecutor to admit a Division staff attorney to the prosecutor's table. This staff attorney was primarily responsible for assembling the case before the court. The denial of participation implicitly placed a substantial handicap upon the prosecution.

This action highlights perennial legal and policy problems at the Division: 1) How much authority does the Division have to represent itself in a court of law? 2) How can the Division effectively enforce the criminal laws if it must rely solely upon county prosecutors that are inexperienced in securities litigation?

Revised Code section 1707.36 states:

> There is hereby created in the division of securities a position to be known as attorney-inspector, which shall be held only by an attorney at law. The duties of this position shall be to investigate and report upon all complaints and alleged violations of laws relating to the issue and sale of securities and *to represent the division in prosecutions arising from such complaints and alleged violations*. (Emphasis added.)

In 1929, the final report of the Ohio Bar Association recommended retaining this provision in the modern version of the securities act making provision for a "special attorney of the Division of Securities." It was then felt that the Division would be ineffective unless it had counsel of a comparable quality and salary to that representing the "highest type of dealers in securities." Such a rationale is as persuasive today as it was then.

Through the passage of years, however, the clear meaning of this provision seems to have been lost. Whether the statute can be strengthened by legislation or whether the Division will be required to test it by litigation remains to be seen. What is clear however, is that the Division cannot effectively administer a statute it does not have the clear power to enforce.

The Division staff would appreciate the counsel, advice and aid of the bar in this matter. ■

ARTICLES—*continued*

SIMPLIFYING SECURITIES LITIGATION THROUGH OHIO REVISED CODE § 1707.43—*continued*

tives who do not disclose a personal financial interest in the security sold. O.R.C. § 1707.42 reads:

> Whoever, with intent to secure financial gain to himself, advises and procures any person to purchase any security, and receives any commission or reward for such advice or services without disclosing to the purchaser the fact of his agency or his interest in such sales, shall be liable to such purchaser for the amount of such purchaser's damage thereby, upon tender of such security to, and suit brought against, such adviser, by such purchaser. No such suit shall be brought more than one year subsequent to such purchase.

Each of these sections, O.R.C. § 1707.41 and O.R.C. § 1701.42, permit a successful litigant to recover all "loss or damage sustained" as a result of the fraud.

In 1938, the Ohio Legislature added O.R.C. § 1707.43[8] as a new civil remedy, which unlike the earlier sections, provides for rescissionary relief in the purchase of a security sold in violation of *any* provision of the Ohio Blue Sky Laws. Unlike the broad remedies provided in the 1929 legislation (O.R.C. §§ 1707.41 and 1707.42), the 1938 legislation merely provides for recovery of the purchase price. The section is not intended to be punitive,[9] but requires the seller to take back the securities and return the purchase price to the purchaser.[10]

Since the primary purpose of O.R.C. § 1707.43 is to enhance and protect the regulatory scheme, Ohio courts have interpreted the section to provide a kind of "strict liability" for the sellers of securities. In *Bronaugh v. R & E Dredging Co.*,[11] the Ohio Supreme Court established that it is a violation of the protection contemplated by the regulatory scheme which gives rise to liability under O.R.C. § 1707.43:

Syllabus by the Court

> 1. Under section 1707.43, Revised Code, the purchaser of a security sold in violation of any provision in Chapter 1707, Revised Code (Ohio Securities Act), is entitled to restitution of his purchase price

> unless the violation is of such a trivial nature as not to materially affect the protection contemplated by the violated provision.[12]

Violations of O.R.C. § 1707.43 are particularly suited for summary judgment since the purchaser need *not* show that the violation was the proximate cause of his damage. The investor need *not* show that he would not have purchased the security if he had known of the violation. There are, therefore, no issues of fact as to the individual investor's relationship with the seller.[13] The purchaser need only show that there has been a sale in violation of the Ohio Blue Sky Laws. It is then up to the seller to show that the violation was of such a trivial nature as to be of no harm to the regulatory scheme. The facts and decisions in two recent Ohio cases highlight this point.

In *Roger v. Lehman*,[14] Judge Carl Rubin, Chief Judge of the United States District Court for the Southern District of Ohio (Western Division), held that Lehman Brothers' sale of unregistered securities listed on the Toronto Exchange and sold over-the-counter to an Ohio investor gave rise to a right of rescission under Revised Code section 1707.43. The Court rejected Lehman's argument that the sale was exempt from the registration requirements of the Ohio Blue Sky Laws pursuant to section 1707.03(M)(3). This section exempts from registration any security listed in "a recognized securities manual containing the names of the issuer's officers and directors, a balance sheet of the issuer as of a date within eighteen months, and a profit and loss statement for either the fiscal year preceding that date or the most recent year of operations."[15]

However, the exemption was unavailable to defendant Lehman. The manual listing upon which Lehman attempted to rely (the security in question was listed in Moody's Industrial Manual) failed to include a profit and loss statement as specifically required. Since the Moody's listing was deficient, Lehman could not rely upon it as the basis for an exemption from the registration requirements of the Ohio Blue Sky Laws. Summary judgment was granted Plaintiff with no requirement that he show that he ever reviewed the deficient Moody's listing or relied to his detriment upon it.[16]

In *Belle v. Le-Ge, Inc.*,[17] the Ohio Appellate Court reversed the trial court to hold that the failure to file a post-sale report constituted a material violation of O.R.C. § 1707.43 even though the security was potentially eligible for registration and potentially eligible for an exemption from the registration requirements. The Court granted the purchaser the right of rescission stating:

> In effect, the Supreme Court has ruled that all sales without actual registration or exemption "materially affect the protection contemplated by the violated provision."
>
> This limited form of strict liability construes R.C. 1707.43 as permitting rescission of such unlawful sales regardless of the buyer's reason to request that remedy. The Supreme Court focused on the significance of "protection contemplated" by the statutory requirement, rather than the protection actually denied to the rescinding buyer.[18]

Since the particular facts as they relate to the particular purchaser are of no significance in determining the availability of O.R.C. § 1707.43 (other than those pertaining to the statute of limitations provisions), the opportunity to simplify lengthy litigation by requesting summary judgment is manifest.

Certain fact scenarios give rise to increased opportunities for summary judgment. The following are facts which counsel should carefully investigate to determine if there has been a violation of the Ohio blue sky laws making summary judgment appropriate.

First, counsel should determine if the securities purchased were registered with the Ohio Division of Securities prior to sale. This can be done by contacting the file room at the Division[19] and inquiring into the status of the security. Copies of all filings are available upon request. The Division will certify the registration or nonregistration of a particular issue or issuer.

Second, if the securities were not registered, counsel should determine if a timely exemption from registration was filed with the Ohio Division of Securities. This information is also available through the file room at the Division.

Third, if the securities are not registered, counsel should discover whether or not the securities were listed on a stock exchange at the time of sale. Any security which at the time of sale was listed on one of the listed exchanges is exempt from the registration requirements of the Ohio blue sky laws pursuant to the "Exchange Exemption" set forth in Revised Code section 1707.02(E)(1).[20] It is particularly important to note that securities sold by the issuer over the counter do not qualify for the exemption and must be registered or sold pursuant to some other specific exemption from the registration requirements of the Ohio Blue Sky Laws.[21]

Fourth, counsel should ascertain whether the seller of the securities was licensed with the Ohio Division of Securities at the time of sale. Although there are specific exemptions from the licensing provisions, most of these exemptions are not available to a seller who receives a direct or indirect commission for the sale.[22] Because the payment of a commission may be an undisputed fact or a question of law, the fact that the seller is not licensed may be sufficient to prevail on a summary judgment motion.

Fifth, counsel should determine whether the seller had an undisclosed ownership interest in the security at the time of sale. Even though the security was registered and sold by a licensed broker-dealer, there may be undisputed facts as to the seller's ownership interest in the security, and his failure to disclose this interest to purchaser. An undisclosed ownership interest may constitute a violation of O.R.C. § 1707.42 which (even if the one year statute of limitations set forth in O.R.C. § 1707.42 has expired) may nonetheless give rise to rescissionary relief under O.R.C. § 1707.43.[23]

Finally, counsel should require the seller, through formal discovery or otherwise, to provide the specific exemption upon which it relied. In reviewing the seller's claimed exemption, counsel should keep in mind the requirement that a seller of unregistered securities comply with all requirements of any exemption from registration upon which seller intends to rely.[24]

Through these methods counsel may be able to establish undisputed facts which will allow for the recovery of the client's investment through a successful summary judgment motion. It is important to note, however, that because recovery under O.R.C. § 1707.43 is limited to rescissionary damages it is therefore limited to recovery of the initial purchase price upon tender of the securities purchased.[25] This may seem an insufficient recovery to an investor who has been promised a substantial return, has lost the use of the funds during the period of the investment, has paid substantial investment interest expenses, or has other losses resulting from the purchase, all of which may be recoverable under other federal or state claims. On the other hand, because O.R.C. § 1707.43 requires the refund of the full amount paid by such purchaser upon tender to the seller of the securities, the seller may be called upon to repay the full purchase price regardless of interest or dividends earned or tax benefits derived from the investment.[26] In addition, plaintiff's successful summary judgment recovery may serve as a springboard to the disposition of other claims. The recovery may thus be satisfactory when weighed with the benefits derived.[27]

Conclusion

In sum, Ohio Revised Code § 1707.43 in appropriate cases provides an opportunity to avoid complex and lengthy securities litigation. In those cases where the facts establish a failure to register the security, or a sale by an unlicensed salesman, the case may be ripe for summary judgment and the plaintiff entitled to rescissionary relief provided for by the statute.

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[1]The absence of legislative history behind the Ohio Securities Laws makes it difficult to discover the specific intention of the legislature. See, *Express and Implied Civil Liability Provisions In State Blue Sky Laws.* Western Reserve Law Review 17:1173 (1966). Legislative history is available for much of the code in 1:42 Ohio Bar (1/15/29) (Final Report of The Committees on Corporate Blue Sky Law). This report provides no help with regard to present civil remedies because the Bar Committee felt civil remedies were a bad idea. *Id.* at 10.

[2]In *Crane v. Courtright*, 2 Ohio App. 2d 125, 126; 31 Ohio Ops. 2d 202, 203, 206 N.E.2d 913, 915 (Franklin App. Ct. 1964) the Ohio Court of Appeals for the Seventh District in reference to O.R.C. § 1707.43 stated:

> Upon failure to register, the statute involved here simply grants the purchaser the right to a unilateral rescission of the transaction and provides for mutual rescission, *i.e.*, the security for the purchase price. The statute is not, therefore, a penalty provision in the usual sense. It is not even compensatory since the purchaser's right is to obtain restitution of the purchase price, but does not include the right to recover damages.

[3]Belle v. Le-Ge, Inc., 20 Ohio App. 3d 127, 20 O.B.R. 160, 485 N.E.2d 282 (Cuyahoga App. Ct. 1985).

[4]Pencheff v. Adams, 5 Ohio St. 3d 153, 5 O.B.R. 318, 449 N.E.2d 1277 (1983).

[5]20 Ohio App. 3d at 131, 20 OBR at 164.

[6]113 Ohio Law 242 (1929). See also 1:42 Ohio Bar (Jan. 15, 1929).

[7]113 Ohio Law 243 *supra* n. 1.

[8]117 Ohio Law 794 (1938). The statute was amended in 1978 to extend the statute of limitations. Also, in 1985, O.R.C. § 1707.31 was added (1984 S.B. 310) to narrow the applicability of O.R.C. § 1707.43 so as to exclude most attorneys, accountants and engineers as well as some investment bankers.

[9]See Crane v. Courtright, *supra* n. 2.

[10]For additional discussion of the legislative history of the Civil Remedies and the Ohio Blue Sky Laws see Comment Express and Implied Civil Liability Provisions in State Blue Sky Laws; 17 Western Reserve Law Review 1173 (1966).

[11]16 Ohio St. 2d 35, 242 N.E.2d 572 (1968).

[12]16 Ohio St. 2d at 35, 242 N.E.2d at 573.

[13]In order to establish liability, Plaintiff must show that defendant participated in the sale of the security. This article will not address the question of what constitutes the sale of a security for purposes of Ohio Blue Sky Laws. For an analysis of this issue, *see*, State v. Silberberg, 166 Ohio St. 101, 139 N.E.2d 342, (1956), Mazza v. Kozel, et al., 591 F. Supp. 432 (N.D. Ohio 1984); FSB Financial, Inc. v. Clevetrust Realty Investors, Inc., et al., [1978] Fed. Sec. L. Rep. (CCH) ¶ 96,341 (N.D. Ohio 1977), Harold J. St. Clair v. Structured Shelters, Inc., et. al., C § 850313 (Hamilton App. Ct. 1985); State v. George, 50 Ohio App. 2d 297, 4 Ohio Ops. 3d 259, 362 N.E.2d 1223 (Franklin App. Ct. 1975).

[14]621 F. Supp. 114, 25 O.B.R. 58 (S.D. Ohio 1985).

[15]O.R.C. § 1707.03(M).

[16]The writer, along with Timothy L. Bouscaren, James B. Helmer, Jr., Ann Lugbill and Virginia Conlan Whitman, served as co-counsel for plaintiff in this case.

[17]20 Ohio App. 3d 127, 20 O.B.R. 160 (Cuyahoga App. 1985).

[18]20 Ohio App. 3d at 131, 20 OBR at 164.

[19]The phone number is (614) 462-7447.

[20]The statute provides that the Ohio Division of Securities may approve other exchanges for this exemption, but the Division has approved no additional exchange at this time. O.R.C. § 1707.02(E)(1).

[21]For secondary sale exemption *see* Ohio Revised Code § 1707.03(B) and 1707.03(M).

[22]*See* O.R.C. § 1707.44(A). A violation of this code section gives the purchaser a cause of action under O.R.C. § 1707.43.

[23]Although research disclosed no cases to support this position, O.R.C. § 1707.43 by its language includes all violations of O.R.C. Chapter 1707. In support of this position, *see* Express and Implied Civil Liability Provisions in State Blue Sky Laws, *supra* n. 10, at 1187.

[24]*See* Bronaugh v. R & E Dredging Co., *supra* text at n. 12, 16 Ohio St. 2d at 35, 242 N.E. 2d at 573.

[25]Although tender would seem to imply the requirement that plaintiff still hold the stock, at least one Ohio case has held that a purchaser need not still hold the security in order to benefit from the rescissionary statute if in fact he has sold the security back to the defendant. Roger v. Lehman, *supra* n. 14.

[26]*See*, Martin v. Steubner, 485 F. Supp. 88, (S.D. Ohio 1979), where the court stated that:

> "Mr. Martin's legal responsibilities under the Internal Revenue Code upon rescission of the transaction do not concern us here. As to the issues of this case, I hold that Martin's acceptance of tax benefits by virtue of his partnership interest after his request for rescission and before rescission is effectuated does not estop Martin from resort to the statutory remedy accorded by R.C. 1707.43."
> 485 F. Supp. at 101.

[27]For a detailed discussion of Rescissonary Remedies, *see* Voidability Provisions Under State Blue Sky Laws, 17 Western Reserve Law Review 1148 (1966).

DIVISION'S PUBLICATION OF "SHOW CAUSE" ORDERS ALLEGING SECURITIES VIOLATIONS

Questions have arisen regarding the propriety of the Division of Securities making public the allegations of securities law violations contained in a Division Order giving Notice to Show Cause and Notice of Opportunity for Hearing.

It is the conclusion herein that: (1) A Division Show Cause Order can be disclosed upon the Division's own initiative for the protection of the investing public; (2) a Division Show Cause Order is a matter of public record and can, therefore, be disclosed upon request directed to the Division.

The Ohio Administrative Procedure Act[1] requires that all administrative orders be preceded by a notice to the affected party of his right to a hearing[2] held pursuant to the procedure of the Act,[3] for the purpose of presenting his arguments of fact, law, and policy in opposition to the order.[4] A number of years ago, the Division of Securities began calling these notices *show cause orders*.[5]

The use of the mechanism of an administrative order to provide notice was apparently pursuant to the idea that the Division only spoke officially by way of an order. However, these show-cause orders are not "orders" that are addressed by express language of the Ohio APA.

The Division issues far more show-cause orders than final orders. Often this is because the respondent succeeds in his attempt to "show cause." Often it is because the respondent returns neither phone calls nor mail until a final order is threatened. In any case, it has long been uncertain what the legal status was of a show-cause order prior to a response by a respondent or its entry as a final order.

The notion of publicizing a Division show-cause Order is met with hesitancy because these orders allege violations without a final administrative determination. A closer examination of the law regarding disclosure of government-collected information, however, dispels these concerns.

Revised Code section 1707.12 is the starting point for determining the status of various types of information in the Division's possession. This section provides that "all applications and other papers filed with the division of securities shall be open to inspection at all reasonable times, except for unreasonable purposes."[6] This section distinguishes certain information that, because of its investigatory nature, is subject to inspection only by persons having a direct economic interest and certain other information which, as confidential law enforcement records or Division trial preparation records, is available for inspection only by law enforcement agencies.[7] This is the general framework for determining what Division information can be inspected, however, no specific guidance is provided for an array of other "documents" associated with the Division's daily functions. Among this array is the show-cause order.

Seventy years of case law has established the concept of "protection of the investing public" as the general purpose and utmost concern of Ohio's securities laws.[8] Revised Code section 1707.23 provides an array of enforcement powers to that end, including filing of forms and other statements, examination of records, conduct of hearings before the Division, issuance of cease and desist orders, and initiation of criminal proceedings. It is with regard to these general enforcement powers of the Division that comparison to the Uniform Securities Act proves of interest.[9] The Uniform Securities Act at section 407 (Investigations and Subpoenas) provides in part:

> (a) The [Administrator] in his discretion (1) may make such public or private investigations ... to determine whether any person has violated or is about to violate any provisions of this act ..., (2) may require or permit any person to file a statement in writing, ... as to all the facts and circumstances, concerning the matter to be investigated, and (3) *may publish information concerning any violation of this act or any rule or order hereunder.* (Emphasis added).[10]

Thus, the Uniform Securities Act would appear to directly address the issue of publication of administrative orders, holding that *any* order (therefore, including a show-cause order) can be publicized.

No specific provision in the Ohio Securities Act parallels this item in the Uniform Act, but the goals of the Ohio Act can be inferred to control here. In *Emery v. So-Soft of Ohio, Inc.*,[11] the overriding aim of the Securities Act was discussed, with the court declaring that the laws should be administered so as to fully meet the purposes of their enactment. Similarly, the court in *State v. Abdulla*[12] commented on the Securities Act, stating that the law was intended:

> ... for the protection of the buyer of securities. It seeks to prevent fraud in the disposition of securities, and, to that end, the legislature established broad powers of administration. There can be no question that laws to prevent fraud in the sale of securities are necessary for the public and are a valid exercise of the police power.[13]

Within this type of framework, then, the publication of a show-cause order upon sufficient belief that the Ohio investing public has been or will be harmed would appear proper.

This conclusion as to the publication of a show-cause order to advance the goal of protection of the public is given further foundation when analyzed from the standpoint of the public's right of access to government records. The issue of free access to public records versus the privacy interest of the subject(s) of these records has been a matter of great concern in recent years. Specifically, two competing statutes must be reconciled in arriving at a conclusion.

The first is Revised Code section 149.43, commonly known as Ohio's public record statute. This law loosely defines a public record as "any record required to be kept" by any governmental unit. With certain exceptions for trial preparation records and confidential law enforcement investigatory records (as well as other exceptions irrelevant here), the statute calls for prompt disclosure of records to the general public. Section 1707.12 of the Securities Act provides for inspection of Division records in accordance with these guidelines of Ohio's public records statute.

The second statute is Revised Code Chapter 1347, the "Privacy Act." This law governs the maintenance of personal information systems by government agencies, and grants to the individual who is the subject of such information a right of inspection.

These two laws were discussed in an exhaustive opinion issued in 1980 by Attorney General William J. Brown.[14] In concluding that the Privacy Act does not restrict access to records that are public under Revised Code section 149.43, it was stated that Ohio law formally recognizes three separate classes of governmental records, as follows:

> One class, which is comprised of records pertaining to confidential law enforcement investigations, trial preparations, and adoptions, may be disclosed neither to the public at large, nor to the person who is the subject matter of the information ... The second class, which is comprised of records otherwise made confidential by law and the subject matter of R.C. Chapter 1347, the Privacy Act, may not be disclosed to the public at large, but must, upon request, be disclosed to the person who is the subject of the information. The third class, which is comprised of records that are public, must, upon request, be disclosed to any member of the public for any reason.

Those records that are labelled public, therefore requiring full disclosure, will be discussed first. The 1980 Attorney General opinion employed the test for determining what records are "required to be kept" (and thus, "public") as contained in *Dayton Newspapers, Inc. v. Dayton Daily News.*[15] In concluding that a city jail log was a public record, the Ohio Supreme Court stated in its syllabus: "A record is 'required to be kept' by a governmental unit within the meaning of R.C. 149.43, where the unit's keeping of such record is necessary to the unit's execution of its duties and responsibilities."[16] This definition was upheld as against the stricter interpretation that "required to be kept" meant "required by statute (or at least by the official policy of the unit of the government) to be kept."

It can certainly be said that the show-cause order which the Division of Securities issues in a given case is necessary to the execution of its duties and responsibilities. Indeed, the status of these orders as public records becomes even clearer upon consideration of the fact that the Division is required by law to employ the show-cause procedure. Revised Code section 119.06 provides in pertinent part: "No adjudication order shall be valid unless an opportunity for hearing is afforded in accordance with section 119.01 to 119.13 of the Revised Code." Thus, the Division not only uses the show-cause procedure to execute its duties, but is required by law to do so. Also note that section 119.01 defines "Hearing" to mean "a *public* hearing by any agency in compliance with procedural safeguards afforded by sections 119.01 to 119.13 of the Revised Code."[17] Agency administration under Chapter 119 is thus decidedly a "public" process—orders issued pursuant to such administration must therefore be treated as public.

The next consideration is whether Division show-cause orders can be exempt from disclosure as public records because of their status as trial preparation records or confidential law enforcement investigatory records. Subsequent to the Attorney General opinion discussed above, Attorney General William J. Brown was requested by Director of Commerce J. Gordon Peltier to opine upon the treatment of complaint forms received by the Division of Real Estate.[18]

After determining that complaint forms were records "required to be kept" by the Division of Real Estate, the opinion examined the exceptions to the Public Records Act. With regard to the "trial preparation records" exception, it was determined that, as a hearing did not *automatically* flow from the filing of a complaint (although as a practical matter, a complaint almost invariably led to a hearing), the complaints did not fall within the definition of Revised Code section 149.43(H)(4), as "any record that contains information that is specifically compiled in reasonable anticipation of ... a civil or criminal action or proceeding."[19]

With regard to the "confidential law enforcement investigatory records" exception, it was determined that the Division of Real Estate complaints had to be evaluated on an individual basis to determine whether the release of a particular complaint created one of the risks of disclosure enumerated in Revised Code section 149.43(A)(2) (identity of suspect not yet charged, information by source promised confidentiality, investigatory technique or work product, and information endangering the safety of personnel, victim, witness, or source).

Using the analysis in this Attorney General opinion,[20] Division of Securities show-cause orders can be distinguished from both "trial preparation records" and "confidential law enforcement investigatory records." First, although compiled specifically in anticipation of a hearing, show-cause orders are themselves procedural devices comporting with the standards set forth in the Ohio APA. That is, the orders are not so much "preparation" records as they are procedural devices for the accomplishment of administrative action. To include these in the class of records that may be disclosed to neither the public at large, nor to the person who is the subject thereof, would be an anomaly in itself. It simply would be frivolous to conclude that a show-cause order is trial preparation material exempted from disclosure—the order must be disclosed in order for it to serve its procedural purpose.

Second, the concern in the 1981 Attorney General opinion regarding the risk of disclosing certain information contained as law enforcement investigatory records is not present when considering show-cause orders. Whereas a complaint form may name a suspect to an alleged violation before he has been charged, the show-cause order is the charge itself. As far as the other risks enumerated in section 149.43(A)(2), evaluation of show-cause orders on a case by case basis can be undertaken. If confidentiality or safety of a witness or Division personnel is at risk, the show-cause order can be redrafted to avoid the problem. Again, the fact that show-cause orders are not merely preparatory or investigatory materials, but the actual initiation of administrative procedures according to the appropriate section of law, should control here. It follows, then, that these orders should be considered public records subject to disclosure.

N. Essey

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[1] Ohio Rev. Code Ann. Ch 119 (Baldwin 1985 Supp).

[2] *Id.* § 119.07.

[3] *Id.* § 119.06, .09.

[4] *Id.* § 119.09.

[5] The language of the order generally states that: "The respondent is hereby notified of his opportunity to show cause why an order should be issued against him".

[6] Ohio Rev. Code Ann. §§ 1707.12(A). (Baldwin 1984).

[7] *Id.* at §§ 1707.12(B) and (C).

[8] *See*, e.g., *Miller v. Griffith*, 28 Ohio Ops.2d 278, 196 N.E.2d 154 (C.P. Columbiana Co. 1961); *Appeal of Ohio Radio, Inc.*, 25 Ohio App.2d 84, 266 N.E.2d 575 (Ottawa Co. 1970).

[9]Uniform Securities Act (1956), 1 Blue Sky L. Rep. (CCH), ¶ 5501 *et seq.* (Current).

[10]*Id.* § 407(a) at ¶ 5547.

[11]30 Ohio Ops.2d 226, 199 N.E.2d 120 (Cuyahoga App. 1964).

[12]37 Ohio App.2d 82, 307 N.E.2d 28 (Summit App. 1973).

[13]37 Ohio App.2d at 90, 307 N.E.2d at 33.

[14]1980 Opp. Ohio Atty. Gen. 096.

[15]45 Ohio St.2d 107, 341 N.E.2d 576 (1976).

[16]*Id.*

[17]Ohio Rev. Code Ann. § 119.01(E) (emphasis added).

[18]*See*, 1981 Op. Atty. Gen., Ohio 014.

[19]*Id.*

[20]*See* note 14 and accompanying text *supra.*

1707.03(W), OHIO'S COUNTERPART TO RULE 505 OF REGULATION D

In an attempt to simplify the maze of exemptions from federal securities registration, the Securities and Exchange Commission promulgated regulation D—a set of rules that provides three separate safe harbors from federal registration.

These three "limited offering exemptions"—rules 504, 505, and 506—do not provide exemptions from state registration, however, Ohio has two exemptions from registration—Revised Code sections 1707.03(W) and 1707.03(Q)—that exist for perfect coordination with rules 505 and 506 respectively. "3(W)" and "3(Q)" are not the only Ohio exemptions available for small offerings or even regulation D offerings. Any Ohio exemption may be coupled with a federal exemption and practitioners should pay particular attention to Revised Code sections 1707.03(O), .03(P), .0(6), and rules promulgated pursuant to section 1707.03(V), in addition to the "blue chip" exemptions formed in section 1707.02(J) and .05—all of which can be coupled with federal regulations A, B, D, or other federal exemptions.

On April 11, 1985, section 1707.03(W) of the Ohio Revised Code became one more addition to the laundry list of exempt transactions found in section 1707.03. Section 1707.03(W) (hereinafter referred to as "3-W") provides an exemption from registration for any offer or sale of securities made in reliance upon rule 505 of regulation D of the Securities Act of 1933,[1] provided additional conditions enumerated in 3-W are satisfied. Because 3-W is a relatively recent addition to the Ohio Securities Act and there are no administrative rules to clarify 3-W, there may be some confusion regarding the process of filing for the 3-W exemption. The purpose of this article is to point out the salient features of a 3-W filing, and to distinguish 3-W from section 1707.03(Q) of the Ohio Revised Code (hereinafter referred to as "3-Q").

Claiming 3-W

To perfect a 3-W exemption, there are two steps involved. First, the issuer must show reliance on rule 505 of regulation D and, second, the issuer must satisfy the additional requirements of 3-W which include filing a Form 3-W with the Division.

Step #1—Reliance on Rule 505 of Regulation D of the Securities Act of 1933, a Federal Limited Offering Exemption

3-W is available for "any offer or sale of securities made in reliance on the exemption provided by rule 505 of regulation D made pursuant to the Securities Act of 1933 and the conditions and definitions provided by rules 501 to 503 thereunder . . ."[2] Rule 505, the successor to former rule 242, is a federal safe harbor from registration requirements that was promulgated under section 3(b) of the Securities Act of 1933.[3] More specifically, it is an exemption from the registration requirements of section 5 of the Securities Act of 1933 for offers or sales of securities where the aggregate offering price does not exceed $5,000,000.00. It can be used by any issuer with the exception of investment companies[4] and issuers disqualified by rule 252(c), (d), (e), or (f) of regulation A.[5] This means that rule 505 of regulation D is available to issuers selling limited partnerships, interests in oil and gas ventures or leases, as well as by corporate issuers selling securities.

To rely on the exemption provided by rule 505 of regulation D, there are several conditions of rule 505 with which an issuer must comply:

1. The aggregate offering price for securities sold cannot exceed $5,000,000.00.[6]
2. The manner of the offering must be limited in that the offering cannot be advertised to the general public.[7]
3. The securities sold pursuant to a 505 offering cannot be resold without registration or without an appropriate exemption from registration. The issuer must take certain steps to insure that the purchaser is not purchasing with a view to resell the security.[8]
4. The offering may be purchased by up to 35 non-accredited investors and by an unlimited number of accredited investors.[9]
5. The issuer must comply with the information requirements of rule 502 by providing unaccredited investors with specified types of information.[10]
6. The issuer must not be subject to a list of disqualifications described in Rule 252(c), (d), (e), and (f) of regulation A, as modified in rule 505.[11]

Furthermore, although a transaction may be exempt from the registration requirements of section 5 of the Securities Act of 1933, a regulation D offering is never exempt from anti-fraud provisions of the federal securities laws.[12] Likewise, an exempt transaction under 3-W is not exempt from the anti-fraud provisions of the Ohio Securities Act.

Step #2—Compliance with the Conditions of 1707.03(W)

To perfect a 3-W exemption, an issuer must also satisfy the conditions of 3-W and file a Form 3-W with the Division. Merely filing a federal Form D with the Division will not perfect a 3-W exemption in Ohio, although it may perfect a rule 505, regulation D exemption with the SEC. Careful attention must be paid to Ohio's 3-W conditions. The importance of complying with Ohio law, as well as rule

505, was underscored in Preliminary Note 2 to regulation D which states, "Nothing in these rules obviates the need to comply with any applicable state laws relating to the offer and sale of securities." The following are several of the conditions listed in 3-W that the issuer must satisfy.

1. 1707.03(W)(1) cautions that commissions, or other remuneration for solicitations in Ohio may only be paid to brokers and dealers licensed in Ohio. An unlicensed issuer may sell its own securities in reliance on 3-W only so long as no commission, discount, or other remuneration is received for the sale.[13]

2. 1707.03(W)(4) states that the aggregate commission, discount, or other remuneration for the offering may not exceed 12% of the initial offering price excluding legal, accounting, and printing fees. As mentioned earlier, there are no administrative rules explaining the meaning of 3-W, however, Administrative Code rule 1301:6-3-03(B) sets forth the basic formula used to figure percentages of offering price. The formula to use for purposes of 1707.03(W)(4) is, 12/100 of the number of securities sold, multiplied by the offering price of the securities sold.

3. 1707.03(W)(3) states the filing requirements necessary to perfect a 3-W exemption. In addition to a filing fee of $100.00, the issuer must file a Form 3-W with the Division. 3-W is a pre-filing exemption and must be filed no later than five (5) business days before "the earlier of the date on which the first use of an offering document or the first sale is made" in Ohio in reliance on 3-W.[14] As with 3-Q filings, the date of filing in the case of personal delivery, ordinary mail, or courier service will be the time stamped date upon receipt by the Division. Along with Form 3-W, there must also be filed with the Division, information as required by rule 502(b)(2) of regulation D. Rule 502(b)(2) sets forth information which must be furnished in lieu of a regulation D offering.

4. 1707.03(W)(2)(a) lists a series of bad boy disqualifications which may disqualify the issuer from using the 3-W exemption. The 3-W exemption will not be available for an issuer unless the issuer did not know and in the exercise of reasonable care, could not have known that any of the bad boy disqualifications apply to the issuer, any of its predecessors, affiliates, directors, past general partners, past or present 10% shareholders, any promoters presently connected with the issuer, or any underwriters of the securities to be offered. The bad boy disqualifications include, but are not limited to, administrative orders issued by state security administrators, temporary or permanent injunctions from engaging in the sale of securities, criminal convictions in connection with the offer or sale of securities, and felony convictions such as fraud and theft.

The commissioner can waive a disqualification upon a showing of good cause that a denial of the use of 3-W is not necessary under the facts and circumstances involved.[15] If the disqualification involves a broker-dealer, it can be waived if the broker-dealer continues to be licensed in Ohio after notifying the commissioner of the act causing the disqualification.[16]

Distinguishing 3-Q and 3-W

Section 1707.03(Q) of the Ohio Revised Code provides an exemption for securities transactions which meet the federal "private offering" exemption of section 4(2) of the Securities Act of 1933[17] or any rule promulgated thereunder.[18] When 3-Q was originally enacted, the "rule promulgated thereunder" was 146,[19] now it is rule 506 of regulation D.[20] If an offer or sale of securities satisfies the conditions of rule 506, the transaction will not be considered to involve a public offering within the meaning of section 4(2) of the Securities Act of 1933 and an exemption from section 5 of the '33 Act will result. On the Form 3-Q, the issuer will be asked to specify which federal exemption is the basis for the 3-Q. The issuer can indicate either section 4(2) or rule 506 of regulation D.[21]

To perfect a 3-Q exemption, in addition to meeting one of the above-mentioned federal "private offering" exemptions, the issuer must also comply with the conditions enumerated in the 3-Q. Finally, a Form 3-Q must be completed and filed with the Division no later than sixty (60) days after the date of sale.

Because 3-Q and 3-W are similar exemptions in some respects, the decision of which exemption to use will involve a careful look at their differences. The most obvious distinguishable factor between the two Ohio exemptions is that the basis for claiming 3-W is reliance on rule 505 of regulation D, while the basis for claiming 3-Q is compliance with section 4(2) of the Securities Act of 1933 or rule 506 of regulation D.

Rules 505 and 506 of regulation D are substantially identical exemptions except for a few important differences:

1. Rule 505 is limited to offerings of up to $5,000,000.00, while rule 506 is an exemption without regard to the dollar amount of the offering.

2. Rule 505 contains issuer disqualifications, while rule 506 does not.

3. Rule 506 contains an investor suitability requirement that is not found in rule 505. The investor suitability requirement in rule 506 requires that the issuer reasonably believe that non-accredited investors, alone or with their purchaser representative, have a certain level of knowledge of business and financial matters so that they can appreciate the risks involved in the investment.

There are two other important differences between 3-Q and 3-W. First, 3-Q has a ceiling on commissions, discounts, and other remunerations excluding legal, accounting, and printing fees of 10% of the initial offering price.[22] 3-W raises that ceiling to 12%.[23] More importantly, the time for filing the two exemptions drastically differs. 3-Q requires merely a post-sale filing, while 3-W requires a pre-sale filing. 3-Q may be filed with the Division up to sixty (60) calendar days after the sale of the security, whereas 3-W must be filed prior to the circulation of the offering circular to the public or the sale.[24]

It should be pointed out that a private offering which fits all the criteria of 3-Q and 3-W may also be a candidate for the exemption provided by section 1707.03(O) of the Ohio Revised Code or for registration by description under section 1707.06 of the Ohio Revised Code. Section 1707.06 is the least burdensome form of registration for the small issuer and may be preferred over the 3-W exemption. Section 1707.06, besides providing for a dealer exemption from licensing requirements, will not require an offering circular in most instances if the aggregate offering price does not exceed $250,000.00. Even when an offering circular is required, the financial statements of the issuer do not have to be certified by certified public accountants. Although a thorough discussion of Section 1707.06 is beyond the scope of this article, it should be remembered when deciding on the most reasonable method of compliance with Ohio law.

A Word about the Uniform Limited Offering Exemption

In conjunction with the promulgation of regulation D, the SEC collaborated with the North American Securities Administrators Association (NASAA) in the hopes of achieving some degree of federal-state exemption uniformity.[25] Once regulation D was adopted, it was hoped that the states would adopt counterparts to rules 505 and 506 which would require little more than filing a Form D along with payment of a filing fee to the states in which the offering was made.[26] This goal of uniformity was not realized. Many states adopted private offering exemptions which had different conditions and limitations than rules 505 and 506.

In order to foster state level uniformity, NASAA formally adopted a Uniform Limited Offering Exemption (ULOE) as an official policy guideline.[27] It exempts offers or sales of securities if made in compliance with rule 505 of regulation D and which satisfy additional conditions and limitations. The additional conditions and limitations of ULOE put ULOE at variance with a regulation D, rule 505 filing. One important difference between ULOE and rule 505 of regulation D is that ULOE has an investor suitability requirement similar to that of rule 506 of regulation D, while rule 505 has no investor suitability requirement. At this time over half the states have adopted some form of ULOE. Ohio is not a true ULOE state. Instead, Ohio's 3-W exemption coordinates with rule 505 of regulation D, while 3-Q coordinates with rule 506 of regulation D.

D. Malkoff

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[1]Regulation D, 17 C.F.R. §§ 230.501 to 230.506. Rule 505 is promulgated pursuant to the statutory authority granted to the Securities Exchange Commission by § 3(b) of the Securities Act of 1933, 15 USCA § 77(c)(c) (1981).

[2]*See* Ohio Rev. Code Ann. 1707.03(W) (Baldwin 1985).

[3]15 U.S.C. § 77c(b).

[4]17 C.F.R. § 230.505(a).

[5]Regulation A, 17 C.F.R. § 230.252(c)-(f).

[6]17 C.F.R. Section 230.505(b)(2)(i). Examples of the aggregate offering price computation can be found in rule 505 itself and in securities Act Release No. 33-6455 (March 3, 1983) questions 67 and 68.

[7]17 C.F.R. § 230.502(c).

[8]17 C.F.R. § 230.502(d).

[9]17 C.F.R. § 230.505(b)(2)(ii). For a definition of accredited investor, see 17 C.F.R. § 230.501(a).

[10]17 C.F.R. § 230.502(b)(1)(2).

[11]17 C.F.R. §§ 230.252(c), (d), (e), and (f) and 230.505(b)(2)(iii).

[12]Preliminary Note 1 to regulation D.

[13]Ohio Rev. Code Ann. § 1707.14(B)(1) (Baldwin 1985).

[14]The definition of "sale", O.R.C. § 1707.01(C) (Baldwin 1985).

[15]Ohio Rev. Code Ann. § 1707.03(W)(2)(b)(ii) (Baldwin 1985).

[16]Ohio Rev. Code Ann. § 1707.03(W)(2)(b)(i) (Baldwin 1985).

[17]15 U.S.C.A. § 77d(2) (1981).

[18]Ohio Rev. Code Ann. § 1707.03(Q) (Baldwin 1985).

[19]Former 17 C.F.R. 230.146.

[20]17 C.F.R. 230.506.

[21]Note that rules 504 and 505 of regulation D cannot be used as a basis for a 3-Q filing.

[22]Ohio Rev. Code Ann. § 1707.03(Q)(2) (Baldwin 1985).

[23]Ohio Rev. Code Ann. § 1707.03(W)(4) (Baldwin 1985).

[24]Ohio Rev. Code Ann. §§ 1707.03(Q)(4) and .03(W)(3) (Baldwin 1985).

[25]Securities Act Release No. 33-6389 (March 8, 1982) and No. 33-6339 (August 2, 1981).

[26]Bloomenthal, Securities Law Handbook, (1985-86 Ed.) at 1096.

[27]1 Blue Sky L. Rep. (CCH) ¶ 5294 (Current).

Ohio Limited Offering Exemptions

	ORC 1707.03(O) Equity securities	ORC 1707.03(Q) and relevant rule 506 requirements	ORC 1707.03(W) and relevant rule 505 requirements
Reliance on regulation D safe harbor	NA	Reliance on either §4(2) of the '33 act or reliance on Rule 506 of regulation D	Reliance on rule 505 of regulation D
Aggregate offering Priv Limitation	Unlimited in amount	Unlimited in amount see rule 506	Limited to $5,000,000 see rule 505(b)(2)(i)
Limitation on the number of purchasers	Limited to 10 in a 12 month period ending with the date of sale	Limited to 35 unaccredited, and an unlimited number of accredited. See rule 506(b)(2)(i)	Limited to 35 unaccredited, and an unlimited number of accredited. See rule 505(b)(2)(ii).
Investor Sophistication	NA	The issuer must reasonably believe that the unaccredited investor (alone or with his purchaser representative) is sophisticated enough to appreciate the risks of the investment see rule 506(b)(2)(ii)	NA
Issuer disqualifications	NA	NA	3-W is not available to an issuer subject to the bad boy disqualifications in 1707.03(W)(2)(a)(i-iv)
Limitation on the manner of the offering	No general advertising or general solicitation	No general advertising or general solicitation	No general advertising or general solicitation.
Restriction on resale	The issuer must reasonably believe after reasonable investigation that the investor is purchasing for investment. See OAC 1301:6-3-03(F).	Restricted by rule 502(d)	Restricted by rule 502(d)
Ceiling on commissions, discounts and other remuneration to sellers of securities	10% of initial offering price to licensed dealers or licensed salesman.	10% of initial offering price to licensed dealers or licensed salesman.	12% of initial offering price to licensed brokers or licensed dealers.
Ohio informational requirements for filing	Completion of form 3-O	Completion of form 3-Q and attach an offering circular if one is used in the offering.	Completion of form 3-W with additional information as required by rule 3-W and rule 502
Filing Fee	$25.00	$100.00 for first filing $50.00 for each subsequent filing	$100.00
Filing date	No later than 60 days after the date of sale	No later than 60 days after the date of sale	No later than 5 business days before the earlier of the circulation of the offering circular to the public or the sale.

OHIO REGISTRATION OF MUTUAL FUNDS

The following focuses on frequent inquiries regarding the registration of investment companies. Most comments received by the Division concern registration procedure. These will be addressed first while discussion of substantive inquiries will follow.

- Every offering filed with the Division is a separate registration. Consequently, each period of effectiveness has a different file number. Use of current file numbers expedites status checks and other forms of correspondence.

- Division policy requires submission of only one copy each of the prospectus and statement of additional information (part B of the prospectus). This policy applies to initial registrations, renewals, and registrations of unit investment trusts.

- The Division permits amendments to current registrations. However, amendments changing the aggregate amount of securities to be sold in Ohio are limited to two increases. Attempts to increase the aggregate amount of securities more than twice will be refused. Keeping accurate records of the separate amounts of securities registered during fractions of an effective period overly complicates record-keeping.

Should the issuer wish to increase its aggregate amount of securities in Ohio, a qualification fee of one-tenth of 1 percent of the amount of the increase is required. The maximum qualification fee for any registration period is $1,000. An additional filing fee of $100 is not required for amendments.

- By rule amendment, the Division has eliminated the requirement that post-effective sales literature be submitted.

- Should an investment company have individual prospectuses for each of multiple portfolios, the Division requires that the issuer must register the portfolios separately, or, that the issuer must have the name of the parent company on the cover of each prospectus in as large or larger type than the portfolio name.

While procedural questions dominant those inquiries received by the Division, questions relating to specific substantive restrictions also arise.

Diversification: Rule 9(G)(1)(g)

- Apparently some confusion exists among applicants as to the meaning and purpose of Ohio administrative rule 1301:6-3-09(G)(1)(g). Although thought by some applicants to be Ohio's "diversification" provision, the limitation applies primarily to "non-diversified" funds.

The Investment Company Act of 1940's definition of "diversification" states in part, that as to 75 percent of the funds total company assets, no more than 5 percent may be invested in the securities of any one issuer. Ohio administrative rule 1301:6-3-09(G)(1)(g) states, in part, that as to 50 percent of the company's total assets, no more than 5 percent may be invested in the securities of any one issuer, and as to the remaining 50 percent of total company assets, not more than 25 percent may be invested in the securities of any one issuer. Therefore, a company which is "diversified" under the Investment Company Act of 1940 meets the requirements of rule 1301:6-3-09(G)(1)(g).

On the other hand, a "non-diversified" company, as defined in the Investment Company Act of 1940, may invest the company's assets in as few as the securities of one issuer. Because the Division sees the risk of "non-diversified" funds as greater than the risk associated with "diversified funds," the provisions of rule 9(G)(1)(g) were promulgated to address this greater risk.

The Ohio rule essentially creates a permissive threshold for the risks inherent to "non-diversified" funds. If an investment company does not comply with the rule, registration may be sought under the alternative requirements of either paragraph (H) or (I) of rule 1301:6-3-09.

This alternative means of registration requires the issuer to prominently display on the front cover of the prospectus, that it is not in compliance with rule 9(G) and to explain what it will be doing instead. Registration under these alternate provisions requires delivery of a prospectus prior to consummation of sale.

- In conjunction with the above restriction is Ohio's limitation involving the purchase of voting securities. Ohio Administrative Code 1301:6-3-09(G)(1)(h). This limitation applies to 100 percent of the company's total assets. That is, the registering company may acquire no more than 10 percent of the voting securities of each issuer in which it invests.

- Rule 1301:6-3-09(G)(1)(l), in part, prohibits the investment of more than 10 percent of the company's total assets in the securities of issuers which are restricted as to disposition. Compliance with this rule requires "restricted securities" to be specifically noted. Alternatively, one may state that the company will not invest in securities which have not been registered under the Securities Act of 1933.

- Ohio has an investment limitation concerning the investment in the securities of other investment companies. OAC 1301:6-3-09(G)(1)(i). Ohio's limitation is a blanket prohibition of purchase with two major exceptions: 1) the purchase is in conjunction with a consolidation, merger, acquisition or reorganization; 2) 100 percent of the company's total assets may be invested in the securities of other investment companies when purchased on the open market. The open market purchase provision operates to eliminate anything other than the normal commission associated with a purchase. This restriction, rule 1301:6-3-09(G)(1)(i), applies uniformly to both open-end and closed-end investment companies.

Further inquires or comments regarding substantive limitations or procedures are welcomed by the Division.

D. Joyce

COMMON QUESTIONS REGARDING CLAIMS OF EXEMPTION

Questions have been raised recently regarding claims of exemption made pursuant to sections 1707.03(O), 1707.03(Q), and 1707.03(W) of the Ohio Revised Code.

Q: When is a Form 3(O) or Form 3(Q) considered "filed" with the Division pursuant to ORC Sections 1707.03(O) and 1707.03(Q)?

A: When it is *received* by the Division.

Q: If a Form 3(O) or Form 3(Q) is mailed by certified mail not later than sixty days after a sale, but is received by the Division more than sixty days after the sale, is it timely filed?

A: No, only ORC Section 1707.08 provides for filing by certified mail.

Q: Do the commission limitations in ORC Sections 1707.03(O), 1707.03(Q), and 1707.03(W) apply only to Ohio sales or to all sales made in an offering?

A: The limitations apply to all sales. For example, you cannot have an Ohio sale with a 10% commission and claim the ORC Section 1707.03(Q) exemption if the sales commission in the other states is 15%.

Q: Do the commission limitations limit all compensation to the seller of the securities exempted?

A: No. The limitations apply to sales-related activities only. However, the Division presumes all compensation going to the seller is commission, unless the seller can prove a portion of the compensation is for necessary non-sales activities (e.g. acting as a property manager) and the compensation received is reasonable.

Q: Are back-end fees permitted as sales commissions?

A: There is nothing in the statute which prevents back-end fees. However, the commission cannot exceed the statutory limit or the exemption is lost.

Example: A Form 3(Q) is filed. There is a $1,000,000 offering with an 8% commission ($80,000) up-front and a back-end commission of 25% of the general partner's profit from the sale of real estate. The maximum commission is $100,000. The Division presumes the commission limitation to be met if: 1) The back-end commission will not exceed $20,000 (the maximum commission of $100,000 minus the up-front commission of $80,000 actually taken), or, 2) The seller can show that $20,000 would buy a 25% in its back-end profit from the sale of the real estate (e.g. a limited partner buying a $20,000 unit would receive a similar back-end interest).

Remember that the Ohio Securities Act places the burden of proving an exemption on the person claiming the exemption. *State v. Frost*, 57 Ohio St.2d 121, 387 N.E.2d 235 (1979).

J. Hunt

DIVISION INTERPRETATIONS

INTERPRETATION 86:3/1

1. Introduction

This interpretation is in response to a request for an opinion concerning the applicability of the exemption from securities registration found in Revised Code section 1707.02(B), to a proposed offering of certificates of participation in a trust to lease real estate to the Ohio State University.

2. Description of Transaction

This transaction involves the sale of *Certificates of Participation in the Ohio State University Child Care Facility Project*. The certificates represent proportional interests in lease payments to be paid by Ohio State for the use of the "facility"—a child care building built on OSU property. The title to the underlying land—and therefore title to the facility also—will be held by OSU. OSU has provided a twenty year ground lease to the builder of the facility, with a reciprocal agreement by OSU to lease the completed facility from the builder in consideration of the rental payments.

Rental payments by OSU are conditioned upon biennial appropriations by the Ohio legislature for this facility. In the event that such appropriations are not made, the holder of the ground lease may find an alternate tenant.

In this offering, all rights of the builder are assigned to a trustee (BancOhio), who will fractionalize the rights of the builder into the certificates that are the subject of the offering. These certificates will therefore represent direct interest in the lease payments made by OSU under the reciprocal sublease.

The offering document states that neither the University nor the state is party to the certificates. The trustee, on the other hand has no responsibilities other than those of a ministerial nature, except in the case of default by the University. OSU will retain title, control, and responsibility for maintenance during the pendency of the sublease.

3. Requirements of .02(B)

Revised Code section 1707.02 exempts certain *securities* from the registration requirements of section 1707.09. Section 1707.02(B) goes even farther to offer a blanket exemption for *all* securities of specific *issuers*. The focus for any analysis of this exemption therefore, is not upon the character of the transaction or the security, but rather the character of the "issuer" of the securities. In order to determine whether the exemption applies, one must determine who is the "issuer" or "guarantor" and whether that entity meets the qualifications of the exemption.

The focus of this analysis will be upon three candidates for the exemption, the university, the bank, and the trust. If the exemption is to be satisfied, it must be satisfied by way of division 2(B)3, which requires that the requirements of the exemption must be met by a candidate that "issue[s] *or* guarantee[s], *and* recognize[s] as its valid obligation" the securities in question.

Having identified the entity, it is then necessary to determine whether that entity meets the requirements of the first paragraph of 2(B), namely that the issuer either:

1) has the power of taxation or assessment, *or*

2) is empowered to

a) issue securities,

b) payable out of revenues collected or administered.

This determination may be dependent upon how the issuer is defined for the purposes of division 2(B)3, namely, is the issuer a "public body, corporation, or agency?"

3.1 Division 2(B)(3)

There are two issues presented by division 2(B)3: 1) who is the issuer, and 2) is the issuer one of those enumerated in division 2(B)3?

3.1.1 Issuer defined

Ohio law defines an issuer as "every person who ... issues any security." Revised Code section 1707.01(G). This definition gives absolutely no insight into what one might consider to be an issuer except that the definition makes clear that there may be more than one.

Nevertheless, federal law and other state laws are more thorough on the point and Louis Loss suggests that "state and federal law are to some extent interchangeable in this area."[1] The two items of specific interest in this case are from the federal statutory definition of issuer.[2] The first item is that in an "investment trust" the issuer is deemed to be the trustee. The second item is an exception to the above stating that "with respect to equipment-trust certificates or like securities" the issuer "means the person by whom the equipment or property is or is to be used."

Note that this particular transaction is identical to an equipment trust sale-and-leaseback type transaction.[3] Although federal statutory law is not necessarily controlling, a quick review of the three candidates for the title of issuer will show that the federal approach is logically compelling.

3.1.1.1 The trust

A trust is not an entity. Like a general partnership, it does not sue in its own name.[4] As in a general partnership also, the issuer is determined to be the person who has actual and practical control. Thus, in a securities offering by a trust, the trust is never found to be an issuer, rather, the trustee is the party considered to be the issuer.

This analysis is analogous to the "investment contract" formula for determining the existence of a security.[5] A requirement for the finding of an investment contract is that the investor not have the right to exercise actual and practical control over the management of the enterprise. It might be said, conversely, that the issuer of a security is that party that in fact does exercise that actual and practical managerial control.

3.1.1.2 BancOhio/trustee

In an ordinary business trust, the trustee would be considered the issuer of trust certificates. This conclusion derives from the reasoning that a person exercising actual and practical control over an investment is an issuer.

In this particular case however, the trustee has no actual or practical control over the enterprise. The trustee will merely provide ministerial functions to enable the operation *of the contract* (not the enterprise) between the certificate holders and the university. The holders of the certificates will look solely to the university for repayment and maintenance of the property and the bankruptcy or failure of the trustee to perform will in no way impair the obligation of the university to pay the certificate holders.[6] Most importantly, however, the trustee has no obligation to make payments on behalf of the lease or on behalf of the University.

The caveat to this analysis, however, arises in the instance in which the university defaults or the state does not renew the appropriations for the coming term. In that situation, the trustee clearly assumes a role that one would associate with an issuer. It is problematical whether that contingency is such that this particular trustee would be found to be an issuer.

Here are two reasons why such a caveat could be ignored: First, federal and most state laws clearly hold that the trustee in a sale and leaseback transaction is not an issuer; Second, it is possible to have two issuers of a security.

Note, however, that were we to find that BancOhio was the issuer because it had a contingent obligation under the trust agreement, then this transaction would be exempt under section 1707.02(C). Specifically, BancOhio is a national bank, issuing securities, representing an obligation of itself. Looking at the transaction from this point of view, it is apparent that, in fact, we could never construe trustees to be "issuers" in this type of transaction.

3.1.1.3 Ohio State/lessor

The Ohio State University is the entity from whom the funds to pay the certificates will flow. The University holds possession of the property that is the subject of the trust. The investment of funds is for the benefit of the University. Even if the trustee goes bankrupt or flies to Argentina, the University will still be obligated to fulfill its obligations under the lease agreement.

Under either an investment contract-enterprise analysis or a sale-and-leaseback approach, the University is the issuer of these lease participation certificates. It enjoys the use of the investment funds, it has actual and practical control over the property and it is the sole entity to which the investors will look for their return.[8]

3.1.2 Guaranteed

Were it to be found that the trustee was an issuer and the sole issuer, it might be observed that the bankruptcy or other failure of the trustee would have no effect upon the payment of the rents and the profits of the investors. Black's Law Dictionary defines guarantee as:

> A promise to answer for payment of debt or performance of obligation if person liable in first instance fails to make payment or perform obligation.

If it were found that the trustee were the "person liable in the first instance," (or is, in other words, the issuer) the university would be a guarantor because of its obligation to "answer for . . . the performance of obligation."

Because this analysis finds that the university is the issuer it is superfluous that it is also a guarantor.

3.1.3 Valid obligation

Ohio State University does not have an absolute requirement to occupy this property and make lease payments, nevertheless, it has a contingent obligation, which contingencies are not within its control. It also suffers a burden for any default.[9] Either of these elements may be adequate for the finding of a contractual obligation within the meaning of section 1707.02(B).

3.1.4 Public body

Ohio Revised Code section 3345.011 states that: " 'State university' means a public institution of higher education which is a body politic and corporate." This satisfies the "public body" requirement of division 2(B)3.

3.2 The issuer . . . has the power of taxation or assessment

In order to qualify for the 2(B) exemption, an issuer must meet the provisions of one of the two clauses of the first paragraph.[10] The Ohio State University clearly does not meet the provisions of the first clause of the first paragraph of section 2(B). Revised Code section 3345.12 provides that:

> Notwithstanding any other provision of sections 3345.07, 3345.11, and this section of the Revised Code, the holders or owners of the obligations shall not be given the right and shall have no right to have excises or taxes levied by the general assembly for the payment of bond service charges thereon, and each such obligation shall bear on its face a state-

ment to that effect and to the effect that the right to such payment is limited to the available receipts and special funds pledged to such purpose under the bond proceedings.

In other words, state universities may not provide for the payment of obligations from taxes, and Ohio State University is therefore prohibited by law from meeting the test of the first clause of the first sentence of section 2(B).

3.3 Empowered to issue securities payable out of revenues collected or administered by such issuer

The Ohio State University is explicitly empowered by statute to:

> . . .acquire by purchase, lease, lease-purchase, lease with option to purchase, or otherwise, construct . . . and operate, and lease to or from others, auxiliary facilities, and may pay for the same out of available receipts of such state university or college to pay all or part of the costs of auxiliary facilities, and to refund obligations previously issued for such purpose, each state university or college may issue obligations in the manner provided by and subject to the applicable provisions of section 3345.12 of the Revised Code.[11]

This provision addresses the requirements of section 2(B). explicitly, directly, and with almost identical language. It seems conclusive, therefore that the Ohio State University meets the requirements of the second clause of the first sentence of section 2(B).[12]

4. Conclusion

Revised Code section 1707.2(B) is an exemption keyed to the ability of an issuer or guarantor of securities to meet certain requirements as an issuer or guarantor. It provides that when a "public body" of a state is specifically empowered to issue securities "payable . . . out of revenues collected or administered by such [public body]," then any securities issued or guaranteed by such public body are exempt from the requirements for registration found in Revised Code section 1707.09.

Ohio State University is defined as a public body by Ohio law. It is specifically empowered to issue securities payable out of funds it administers for the purpose of funding auxiliary facilities.

This specific transaction involves the sale-and-leaseback of auxiliary facilities by Ohio State through the sale of certificates of participation administered by a trustee. The certificates of participation are direct obligations of the University and are created by the University for its own benefit. Although the trustee engages in some ministerial functions and may be called upon to dispose of the property in the event of a default of the University, the trustee has neither any obligation to make lease payments, nor has the trustee actual or practical possession or control of the property.

It is therefore the position of the Division that the Ohio State University is an entity qualifying for exemption under Revised Code section 1707.02(B); that the Ohio State University is the issuer of the described certificates of participation; and that these certificates of participation are therefore exempt from registration under the Ohio Securities Act.

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[1]Loss, 1 *Securities Regulation* 456 (1961).

[2]Securities Act of 1933, section 2(4) (code not cited).

[3]Note that these securities are in fact titled "certificates of participation."

[4]Distinguish between an Ohio common law trust and a Massachusetts business trust.

[5]*SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *State v. Hawaii Market Center, Inc.*, 485 P.2d 105 (Haw, 1971); *State v. George*, 50 Ohio App. 2d (1975).

[6]*See*, Letter of the Securities and Exchange Commission, division of corporate finance, to Smith, Barney, Harris, Upham, & Co. (1/7/77) [1977 Trans. Bind.] CCH Fed. Sec. L. Rep. P.80,953.

[7]For example, what if this were an equipment leaseback or an oil and gas offering? Would the bank be the issuer? Who would have liability for false information—the bank or the person whose financials are the basis of the offering?

[8]It is quite compelling to look at the transaction from the enforcement view. Were the Division to bring an enforcement action for fraud or other securities violation there would be no doubt that the issuer/defendant would be the University—the party who enjoyed the use of the funds.

[9]The University would be forced to abandon the control and use of the building at its expense.

[10]The two alternate requirements of section 1707.02(B) are 1) "the issuer or guarantor has the power of taxation or assessment for the purpose of paying the obligation represented by the security," *or* 2) "is in specific terms empowered by the laws of the state of issuance to issue securities payable as to principal or interest, or both, out of revenues collected or administered by such issuer."

[11]Ohio Revised Code section 3345.11.

[12]This is true even though the *securities* issued do not meet the requirement that the obligations be payable out of revenues collected or administered by the issuer.

INTERPRETATION 86:3/1.1

Interpretation 86:3/1 is not dispositive of all transactions involving a claim of exemption from securities registration pursuant to Revised Code section 1707.02(B). When determining who is the issuer of certain unusual instruments, many elements and ideas may come into play. Among these may be the following:

1) Who has control;

2) Who has access to actual investment information;

3) Who is the original source of funds that will provide the return to the investor;

4) Who's bankruptcy would cause the loss of the investment;

5) Which person "gives birth" to the certificates representing the transaction;

6) Which person receives the benefits of the funds;

7) Who can fly with the money to Argentina?

Multiple tiers of transactional entities or nonsimultaneous transactions are the two most common complications arising with regard to claims for exemption involving sale and leaseback transactions.

The multiple tier situation occurs where the entity in which an interest purchased is far removed from the entity claiming the exemption. For instance, in the example provided in Interpretation 86:3/1, the investor purchases shares of beneficial interest in a trust that is to distribute the rental proceeds of the sale and leaseback. Were the investor to purchase common stock in a corporation that would distribute the rental proceeds, the exemption provided to the lessee would not attach to the transaction because the corporation would be an independent entity not entitled to the exemption. The distinction between a trust and a corporation is real enough in this context to affect the applicability of the 2(B) exemption.

The nonsimultaneous transaction situation occurs where the property of a sale and leaseback transaction is not available or construction is not complete at the time of the investment or at the time funds are transferred. In the example provided in Interpretation 86:3/1, the facility that was the subject of the transaction was complete and the investment funds would flow directly through the trust and the lessee to the developer in exchange for simultaneous delivery of the completed facilities. In some cases, however, the facilities have yet to be built. In these situations, the Division will make sharp distinctions between funds that are paid to the benefit and control of the exempted lessee and those funds that are paid to the benefit and control of the developer of the facility. The Division will deem the lessee to be the issuer of shares of beneficial interest in a sale and leaseback transaction only when that lessee restricts the payment of proceeds to the developer to those payments allocated to portions of a project that are severable and complete, and in addition the lessee assumes full obligation under the lease for that portion of the funds paid out.

INTERPRETATION 86:3/2

The following analysis is provided in response to a request for no action.

FACTS: The Company is an Indiana corporation. Its common and non-voting common shares have been continuously registered in Ohio for approximately forty years. The company would now like to be relieved of the obligation to continue registration.

Since its inception in 1945, the Company has conducted business as a cooperative buying association for the benefit of its members and currently has over 2,500 members doing business in 30 states. All of the holders of common stock of the Company are individuals, partnerships, or corporations who sell hardware at retail. Ownership of shares in the Company is expressly limited to such retailers. Each holder of common stock of the Company holds 20 or more shares of common stock having a par value of $50 per share. The common stock of the Company is sold only in units of 20 shares. Each holder has one equal vote, regardless of his patronage with the Company.

Sale of the common stock is an incident to membership in the company. Proceeds are used in the general operation of the Company and to help fund the purchase of inventories of goods and merchandise needed to supply the members.

The "securities" offered for sale are authorized but unissued shares of common stock and non-voting common stock of the Company having a par value of $50 per share.

The Company buys merchandise at jobber's and distributor's prices. This merchandise is sold to the member shareholders and to a few non-members at prices which are competitive.

The Company keeps a record of the purchases made by each member shareholder and notes the gross profit on the merchandise so sold. At the end of each fiscal year the Company is obligated to refund to its member shareholders the gross profit earned. Refunds are made to each member shareholder in the proportion which the gross profit on purchases made by that member bears to the total gross profit on all purchases by members.

The Articles of Incorporation of the Company provide that no dividends, as such, can be paid on its capital stock. Only patronage *rebates* are distributed to shareholders, but, based on patronage and not on share holdings. The Articles of Incorporation also provide that shares of capital stock of the Company are transferable only to the Company or a successor in interest or occupancy of the premises serviced by the Company. The Company is required to repurchase its shares of common and non-voting stock at the lesser of par or book value from any holder on demand.

The company has received "no-action" letters from the United States Securities and Exchange Commission and a number of other states approving the theory that the Company's shares are not securities.

Analysis of the Division of Securities: When analyzing a transaction to determine whether it involves a "security" within the meaning of various securities laws, it has become an almost reflexive response to *begin* the analysis by asking whether the transaction involves what is called an "investment contract." This investment contract analysis is derived from a line of cases following *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). In that case, the Supreme Court used the previously vague term "investment contract" to *extend* the definition of a security to a sale of real estate that was implicitly coupled with a management contract.

Subsequent to *Howey*, cases dealing with the definition of "security," so often made use of this "investment contract" analysis that the distinction between a "security" and an "investment contract" became blurred. Many practitioners began to believe that *only* investment contracts were securities.

This confusion was heightened by the holding in the decision of *United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975)*. In that case, prospective tenants in a low-income government-sponsored housing co-op were required to buy "shares of stock" as a precondition to leasing an apartment. The Supreme Court found that "in effect, their purchase is a recoverable deposit," and thus even though the interest was called "stock," it had none of the attributes of stock and was, therefore, not a security.

The practical impact of this decision was that many practitioners began to suggest that, not only were the federal securities laws limited in application to investment contracts only, but also, instruments normally thought of as securities were no longer securities if those instruments were used in a context that did not involve all of the elements of investment contract analysis. *See*, Arnold, *"When is a Car a Bicycle? and Other Riddles: The Definition of a Security Under the Federal Securities Laws*, 33 Cleve. St. L. Rev. 449 (1984-85).

The expansion of this style of analysis was stopped cold by the companion decisions of *Gould v. Ruefenacht*, Fed. Sec. L. Rep. (CCH), ¶92,048 (1985); and *Landreth v. Landreth Timber Co.*, ¶92,047 (1985). Saying that: "It is fair to say that our cases have not been entirely clear on the proper method of analysis for determining when an instrument is a security" *Landreth*, ¶92,047 at ¶91,215, the Supreme Court rejected the "interpretation" that "our cases require us in every instance to look to the economic substance of the transaction to determine whether the *Howey* test has been met." ¶92,047 at ¶91,215-16.

The court insisted instead that "the *Howey* economic reality test was designed to determine whether a particular instrument is an 'investment contract,' not whether it fits within *any* of the examples listed in the statutory definition of 'security.' " *Id.* The court quotes Professor Loss for the proposition that "*stock* ... is so quintessentially a security as to foreclose further analysis." L. Loss, Fundamentals of Securities Regulation 211-212 (1983).

It is implicit that the definition of a security under the Ohio Securities Act is different from that at federal law, nevertheless, on this particular issue, the rationale behind the *Landreth* and *Gould* decisions can be found in the recent Ohio case of *Carrousel North, Inc. v. Chelsea Moore Co.*, 9 Ohio App. 3d 344 (Ham. 1983). In that case, the Hamilton County appellate court rejected the argument that because the transaction was a simple sale of undivided land the transaction was outside the ambit of the Ohio Securities Act.

As the court stated in the *syllabus*:

> 1. The definition of "security" in R.C. 1707.01(B) does not exclude a sale of stock merely because it originated in a real estate transaction that was restructured into a sale of corporate stock.

The opinions of *Landreth* and *Carrousel North* confirm the proposition that shares of a corporation are securities in any case whatsoever.

In the hypothetical outlined above, the Company is selling shares in an Indiana corporation incident to membership and participation in a hardware wholesaling cooperative. Whether or not those shares embody all of the elements that are normally associated with "common stock," it is the position of the Division of Securities that stock is so quintessentially a security that the Division will not engage in further analysis.

It might be noted that this particular transaction seems to lend itself well to the simple and expedient registration by description pursuant to Revised Code section 1707.06(A)(1). Upon good cause shown, the Division will grant a two year effectiveness to such registrations pursuant to Administrative Code section 1301:6-3-08(B). ■

REGISTRATION

LIMITED PARTNERSHIPS

In order to provide uniformity to the review of interstate offerings of limited partnership units, the Division has determined that the NASAA Real Estate Limited Partnership Statements of Policy (hereinafter "the Guidelines") will be applied to all interstate limited partnership offerings, insofar as practical.

Non-real estate limited partnership ("non-RELP") offerings do not currently have separate guidelines for their review. In order to avoid inconsistent merit review of such offerings, the Guidelines will be applied by analogy by the Division. Particularly, a non-RELP offering will be expected to meet certain basic minimum standards applicable to any limited partnership. The Division views Sections II, III, V, and VII of the Guidelines as guidelines to be used in determining whether a limited partnership meets such basic minimum standards.

While other areas of the Guidelines will require modification as the standards are applied to non-RELP offerings, deviations from the Guidelines will require justification. In such instances, an explanation within a footnote to the Cross-Reference Sheet will assist the Division's review.

The Division requests that a NASAA Cross-Reference Sheet be submitted for non-RELP offerings. ■

ENFORCEMENT

William E. Meistel, Jr. has pled in Hamilton County, Ohio to Thirty Misdemeanor counts of attempted securities violation, and three felony counts of selling unregistered securities, selling securities without a license and securities fraud. He received 1½ year prison term, 5 year probation and was ordered to make restitution in the amount of $23,000. This case was investigated and referred by former acting Comm'r Phillip Lehmkuhl and Tina K. Manning, Staff Atty.

Raymond Ficele, an investment adviser, has pled in Summit County, Ohio to three felony counts of securities fraud, selling securities without a license and grand theft. He received a suspended jail term of 6 months and a 5-year probation term during which period he has been ordered to make full restitution. This case was investigated and referred by staff attorneys Tina K. Manning and Daniel Malkoff. ■