OHIO SECURITIES BULLETIN

A QUARTERLY PUBLICATION OF THE OHIO DIVISION OF SECURITIES

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Division Announces Guidelines for the Sale of Securities on Bank Premises

Introduction

By publication in *Ohio Securities Bulletin* 96:1 (April 1996), the Ohio Division of Securities (the "Division") officially promulgates the following as "Guidelines for the Sale of Securities on Bank Premises" (the "Guidelines"). Definitions contained in the Ohio Securities Act, R.C. 1707 (the "Act") and related administrative rules, O.A.C. 1301 (the "Rules") apply to the Guidelines and related commentary (notable is the definition of "bank" contained in R.C. 1707.01(O)). All other applicable provisions of the Act and Rules apply to the sale of securities on bank premises in addition to the Guidelines, which are intended to clarify certain applicable provisions of the Act and Rules.

Regulatory Background

In the late 1970s and early 1980s, the barriers between traditional retail banking and investment banking established by the venerable Glass-Steagall Act,[1] began to erode as banks sought to broaden and diversify the range of financial products available to their customers. In 1985, the Securities and Exchange Commission (the "SEC") attempted to regulate this burgeoning area by adopting Rule 3b-9[2] under the Securities and Exchange Act of 1934[3] (the "1934 Act"). Rule 3b-9 provided that banks which offered certain types of brokerage services would no longer be excluded from the definitions of "broker" and "dealer" in the 1934 Act. In effect, the rule required banks that pro-

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In re Columbus Skyline Securities: Incorporating Federal Law into Ohio's Anti-Fraud Standard

by Thomas E. Geyer, Esq.

As Ohio courts have noted, the complementary state and federal securities regulatory framework shares the mutual purpose of replacing the concept of *caveat emptor* in securities transactions in order to protect investors from "the virtually limitless scope of human ingenuity, especially in the creation of countless and variable schemes devised by those who seek to use the money of others on the promise of profits."[1] The Ohio Supreme Court recognized both the investor protection purpose and the complementary nature of state and federal securities laws in its recent decision in *In re Columbus Skyline Securities*,[2] where it upheld the constitutionality of applying federal standards to determine fraudulent conduct under the Ohio Securities Act (the "Securities Act").[3] This article will comment briefly on the development of the complementary state and federal regulatory system, examine the Ohio Supreme Court's reasoning in the *Columbus Skyline* case and discuss the significance of the decision.

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vided brokerage services to register with the SEC, with limited exceptions. However, in 1986, the D.C. Circuit Court of Appeals invalidated Rule 3b-9, holding that the rule contravened Congressional intent, as expressed in the 1934 Act, to exclude banks from SEC broker-dealer regulation.[4]

The SEC did not propose a new or amended rule after the D.C. Circuit Court struck down Rule 3b-9. Instead, between 1986 and 1993, the SEC issued a number of No-Action Letters which set out some parameters for the sale of securities on bank premises. During this same time, states began to regulate the sale of securities on bank premises as a part of blue sky regulatory schemes.[5]

With its No-Action Letter *Chubb Securities Corporation*[6] in November 1993 (the "*Chubb* letter"), the SEC announced that it would no longer respond to no-action inquiries regarding "networking" arrangements between banks and securities dealers. The *Chubb* letter reiterated certain basic principles distilled from previous No-Action Letters: that the networking agreements must be in writing and provide that transactions in securities be effected only by persons with proper securities licensure; that the bank must permit examinations by securities regulators; that unlicensed personnel perform only clerical and ministerial functions with respect to securities transactions; that the licensed securities salesperson must disclose that the securities purchased are neither guaranteed by the bank nor insured by the Federal Deposit Insurance Corporation ("FDIC"); that securities transactions must be undertaken in an area that is physically separate from the bank's regular business activities; and that any reference to the bank must not be prominent in literature advertising the securities services.

While SEC No-Action Letters addressed the securities side of the issue, bank regulators issued various policies, opinions and statements to address the bank side of the issue. These regulations were consolidated by the "Interagency Statement on Retail Sales of Nondeposit Investment Products" issued jointly by the FDIC, the Federal Reserve System, the Comptroller of the Currency and the Office of Thrift Supervision in February 1994 (the "Interagency Statement"). The Interagency Statement set forth general guidelines regarding: disclosure and advertising; setting and circumstances; qualifications and training; suitability and sales practices; compensation; compliance and supervision by bank regulators.

In addition, in December 1994, the National Association of Securities Dealers (the "NASD") proposed amendments to its Rules of Fair Practice to adopt rules governing "broker-dealer conduct on the premises of financial institutions."[7] The NASD received a substantial number of comments to the proposed rule and in response issued amended proposed rules which were, in December 1995, submitted to the SEC for publication in the Federal Register (the "NASD amended proposed rules"). The NASD amended proposed rules address the setting for securities transactions, the content of networking agreements, compensation, disclosures and communication with the public.

Need and Purpose

Without question, the sale of securities on bank premises is the sale of securities in a special context. Texas Securities Commissioner Denise Voigt Crawford has thoughtfully commented:

> What is significant [about the sale of securities on bank premises] is that banks are continuing to find ways to benefit from what may be the most important thing they still have going for them — trust. Surveys show that people continue to have more confidence in banks than other financial insti-

OHIO SECURITIES BULLETIN

Thomas E. Geyer, Esq., Editor

The *Ohio Securities Bulletin* is a quarterly publication of the Ohio Department of Commerce, Division of Securities. The primary purpose of the *Bulletin* is to (i) provide commentary on timely or timeless issues pertaining to securities law and regulation in Ohio, (ii) provide legislative updates, (iii) report the activities of the enforcement section, (iv) set forth registration and licensing statistics and (v) provide public notice of various proceedings.

The Division encourages members of the securities community to submit for publication articles on timely or timeless issues pertaining to securities law and regulation in Ohio. If you are interested in submitting an article, contact the Editor for editorial guidelines and publication deadlines. The Division reserves the right to edit articles submitted for publication.

Ohio Division of Securities

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> tutions. That trust, of course, is rooted in one basic fact: money placed with a bank comes with the federal government's guarantee that it will always be there, even if the bank fails. Although the government insurance does not extend to investment-related products sold on bank premises, that fact is so often downplayed or completely omitted that it is not surprising that consumers are confused.[8]

In January 1994, the National Association of State Securities Administrators ("NASAA") in conjunction with the American Association of Retired Persons ("AARP") released the results of a national survey regarding the sale of securities on bank premises.[9] Results of the NASAA/AARP survey included the following:

(1) The vast majority of bank customers are unaware that mutual funds, annuities and stock sold at their bank are not FDIC insured:

• only 14% of customers knew annuities were uninsured; only 18% knew mutual funds were uninsured; and only 25% knew stocks were uninsured; and

• alarmingly, about 40% of customers thought annuities and mutual funds sold at banks were FDIC insured, while 35% thought stocks sold at banks were insured.

(2) People who have actually purchased mutual funds or annuities at their banks are no better informed about the risks associated with such investments than are other bank customers:

• over half of the people who purchased a mutual fund (52%) or annuity (55%) at a bank thought that the purchase was FDIC-insured; and

• more than one third of the people who purchased a mutual fund (36%) or annuity (38%) at a bank said no one talked to them about the appropriateness, or "suitability" of their investment.

Consistent with the results of the NASAA/AARP survey are complaints received by the Division over the past several years. Most complaints arise when the value of the investment purchased at a bank falls below the amount invested. In at least one instance, the complainants alleged that they were sold a mutual fund investment in response to their request for an investment "as safe as a certificate of deposit."

Within the past eighteen months, the Division has reviewed networking agreements between banks and licensed dealers and investigated bank premises where brokerage services are offered pursuant to such agreements. With respect to the agreements, many provide for impermissible commission sharing between the dealer and the bank; many provide that unlicensed bank employees consummate the sale of securities; and most failed to address customer disclosure and physical setting issues. With respect to bank premises, the Division's investigation revealed that conditions promoted customer confusion through insufficient physical separation between banking and brokerage services, woefully inadequate disclosure regarding the lack of FDIC insurance for securities, and consummation of securities transactions by unlicensed bank employees.

In addition, over the past eighteen to twenty-four months, the Division has received numerous inquiries from both the banking and securities communities. While O.A.C. 1301:6-1-01 limits the advice that the Division may give, the Division has attempted to point out sections of the Act and Rules particularly relevant to the sale of securities on bank premises.

The purpose of the Guidelines is to set forth the Division's interpretations of certain provisions of the Act and Rules applicable to the sale of securities on bank premises. As stated in the Introduction, the Guidelines do not limit statutory and administrative provisions applicable to the sale of securities on bank premises. Instead, all pertinent provisions of the Act and Rules apply in addition to the Guidelines, which are intended to clarify certain applicable provisions of the Act and Rules.

By providing public notice of the Guidelines, the Division believes it is in a better position to take enforcement action based on its interpretations of the Act and Rules as set forth in the Guidelines. However, the Division encourages the banking and securities communities to consider the Guidelines prospectively in order to avoid possible enforcement action.

In compiling the Guidelines, the Division has reviewed SEC pronouncements, the Interagency Statement, the NASD's amended proposed rules and the various existing blue sky standards. The Division believes that the Guidelines are consistent with the regulation imposed by these sources. The Division further believes that the Guidelines impose no burdens in addition to those established by the SEC's standards, the Interagency Statement and the NASD amended proposed rules.

Guidelines

I. Compensation

O.A.C. 1301:6-3-19(A)(7) ("Rule 19(A)(7)") states:

> No dealer or salesman shall... Share any commission, discount, or other remuneration from the purchase or sale of a security with any person not licensed as a dealer or salesman in Ohio or in the jurisdiction where the purchase or sale of the security took place.

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A. Commission Sharing

Rule 19(A)(7) prohibits a dealer from sharing commissions with an unlicensed bank or unlicensed bank employee.

The Division rejects the argument that the Rule 19(A)(7) prohibition does not apply to banks because banks are conditionally exempt from the definition of dealer (as set out in R.C. 1707.01(E)(1)(e)), and thus not required to be licensed. The plain language of Rule 19(A)(7) establishes a flat prohibition on the sharing of commissions with any unlicensed person, without regard to whether the unlicensed person is exempt from the definition of dealer or otherwise not required to be licensed.[10]

The Division also rejects the argument that R.C. 1707.03(J) ("03(J)") permits banks to receive commissions. First, the predecessor to 03(J) was enacted in 1929, before the Glass-Steagall Act's prohibition on banks acting as securities dealers.[11] However, even as initially enacted, the predecessor to 03(J) expressly limited the two percent profit to only "where such bank or trust company is not a regular dealer in securities."[12] Second, by its current statutory location and designation, 03(J) merely creates an exempt transaction; it does not authorize commission sharing. Third, to the arguable extent that 03(J) permits a bank to receive compensation by using the word "profit," the context surrounding the use of that word clearly evidences the intent to permit banks to receive mark up type remuneration in purchasing and selling securities; there is no indication that, contrary to Rule 19(A)(7), commission sharing is permitted.

Note that Rule 19(A)(7) broadly prohibits the sharing of any "commission, discount, or other remuneration from the purchase or sale of a security." In other words, the sharing of any transaction-based compensation is prohibited, whether such compensation is on a fixed or percentage basis.[13]

Further, compensation to unlicensed persons in the form of a referral fee, or remuneration for a referral, is prohibited, even if it is a fixed amount paid regardless of whether a securities transaction is consummated. Under the broad definition of "sale" set out in R.C. 1707.01(C), a referral leads to a "sale" and compensation to the referror would be "remuneration from the purchase or sale of a security" prohibited by Rule 19(A)(7).

The policy behind Rule 19(A)(7) is to prevent unlicensed persons from giving investment advice or otherwise hyping the sale of securities by prohibiting them from having a remunerative motivation to do so. This policy could be easily flouted in the context of sale of securities on bank premises where a captive group of customers face decisions as to what to do with their money. If, for instance, an unlicensed bank employee, such as a teller, had a financial motivation to encourage a bank customer to purchase securities, the teller may be tempted to promote the sale of securities without contemplating suitability or other considerations necessary before recommending the purchase or sale of securities.

B. Lease Arrangements

The Division believes that a strict lease arrangement, with a fixed lease payment, is the best way to avoid violating Rule 19(A)(7). There is little reason why the total value of the leased premises cannot be computed and reflected in a fixed payment. However, the Division recognizes that the percentage or adjustable-type lease is a commercial reality. Subject to the following, the Division views an adjustable lease as acceptable.

First, the adjustment must not consist of a component of "commission, discount, or other remuneration from the purchase or sale of securities" prohibited by Rule 19(A)(7). However, an adjustment consisting of reimbursement for expenses actually incurred, such as secretarial and related overhead-type costs, is permitted.

Second, the more often the lease payment is adjusted, the more it appears that the lease payment is an attempt to circumvent the Rule 19(A)(7) prohibition. A lease that is adjusted on a semi-annual or annual basis is more likely to withstand Division scrutiny than a lease that is adjusted on a monthly or even bi-monthly basis.

Third, the Division reserves the right to examine the facts and circumstances surrounding an adjustable lease to determine whether the adjustable lease is intended to circumvent the Rule 19(A)(7) prohibition. The Division draws supporting authority from a 1988 Opinion of the Attorney General, O.A.G. 88-056, which addresses the analogous situation of lease payments from an insurance agency to a bank. Ohio insurance laws have a similar prohibition on sharing commissions with unlicensed persons. In considering the lease arrangement against the backdrop of the prohibition on commission sharing, the Attorney General held:

> [L]ease payments by an insurance agency to a bank ... for lobby space that are based on a percentage ... may be deemed payments of commissions if it is established that such payments are intended to compensate the lessor for the lessor's negotiating, or otherwise procuring, placing, or transmitting contracts of insurance for the agency in question, notwithstanding that such payments also serve as consideration for the fair market value

of the agency's leasehold interest.[14]

II. Conduct

O.A.C. 1301:6-3-19(B)(9) ("Rule 19(B)(9)") states:

> No dealer shall ...
> Fail to reasonably supervise salesmen or other persons associated with the dealer or to establish reasonable procedures designed to avoid violations of Chapter 1707 of the Revised Code or of Chapter 1301:6-3 of the Administrative Code by salesmen or other persons associated with the dealer.

A. "Clerical and Ministerial" Functions

The Division interprets the dealer's obligation to "reasonably supervise... other persons associated with the dealer" to include ensuring that unlicensed personnel perform only "clerical and ministerial" functions in connection with the sale of securities.

The phrase "clerical and ministerial" first appeared in the ill-fated Rule 3b-9. Subsequently, the phrase was used by twelve of the seventeen states that regulate the sale of securities on bank premises to articulate what an unlicensed person could do in connection with the sale of securities. The SEC also recognized the "clerical and ministerial" standard in the *Chubb* letter.

Without limitation, the Division considers "clerical and ministerial" functions to include:

(1) referring interested persons to the licensed dealer or licensed salesman;

(2) disseminating literature regarding the licensed dealer;

(3) delivering blank forms, and instructions, for use in opening a new account with the licensed dealer;

(4) providing a mailer to send materials to the licensed dealer;

(5) providing secretarial services, including taking telephone messages, for licensed salesmen; or

(6) assisting a bank customer in accessing funds on deposit with the bank, including causing appropriate debit or credit to a customer's bank account.

Without limitation, the Division considers "clerical and ministerial" functions not to include:

(1) soliciting or undertaking a sale of securities;

(2) opening new securities accounts, including assistance in completing new account forms;

(3) giving investment advice or discussing the merits of any security or type of security;

(4) determining suitability or describing or answering questions about investment vehicles;

(5) accepting customer orders or transmitting customer orders;

(6) providing verbal or written confirmation of a sale of securities; or

(7) handling customer funds or securities.

Banks should note that they also have an interest in ensuring that unlicensed personnel perform only "clerical and ministerial" functions. A bank's exemption from the definition of dealer in the Act (set out in R.C. 1707.01(E)(1)(e)) is expressly conditioned on the proviso that "all transactions are consummated by or through a person licensed pursuant to section 1707.14 of the Revised Code." Thus, to the extent that unlicensed bank personnel engage in conduct that is not merely "clerical and ministerial" in nature, the securities transaction may be "consummated" by that unlicensed person and the conditional exemption would no longer apply, causing the bank to no longer be exempt from the definition of dealer and consequently no longer exempt from the licensing and other dealer requirements of the Act and Rules.

B. Supervision

The Division interprets the dealer's obligation to "establish reasonable procedures designed to avoid violations of Chapter 1707 of the Revised Code or of Chapter 1301:6-3 of the Administrative Code by licensed salesmen or other persons associated with the dealer" to include the following:

(1) providing instruction to unlicensed personnel that limits their conduct to "clerical and ministerial" functions;

(2) conducting periodic reviews on bank premises to ensure that unlicensed personnel limit their conduct to "clerical and ministerial" functions;

(3) providing compliance manuals to licensed salesmen located on bank premises; and

(4) monitoring and enforcing the policies and procedures set forth in the compliance manual.

Obviously, if a licensed salesman is located on bank premises, the site is a branch office subject to the relevant provisions of the Act and Rules.

C. Disclosure

The Division interprets the dealer's supervisory responsibilities to include requiring that the licensed salesman, at the time a new securities account is opened, present a verbal disclosure, and obtain a separate written acknowledgment signed by the customer, that the securities sold on bank premises:

(1) are not insured by the FDIC;

(2) are not deposits or other obligations of the bank and are not guaranteed by the bank; and

(3) are subject to investment risks, including possible loss of principal invested.

The licensed salesman must also verbally repeat these disclosures in connection with each sale of securities.

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D. Setting (Physical Location)

The Division interprets the dealer's supervisory responsibilities to include conducting the sale of securities on bank premises only in a physical location (i) distinct from the area where the bank's retail deposits are taken, and distinct from where other FDIC insured products are sold, and (ii) identified in a manner that clearly segregates and distinguishes the sale of securities from the FDIC insured activities of the bank.

E. Advertising

The Division interprets the dealer's supervisory responsibility to include ensuring that all advertising and promotional materials regarding the sale of securities on bank premises:

(1) clearly and prominently set out the disclosures required under the "Disclosure" section of these Guidelines;

(2) clearly and prominently identifies the licensed dealer; and

(3) clearly and prominently discloses that the bank and licensed dealer are separate persons.

Conclusion

To reiterate, all other applicable provisions of the Act and Rules apply to the sale of securities on bank premises in addition to the Guidelines which are intended to clarify certain applicable provisions.

The Division recognizes that the sale of securities on bank premises is an exciting development in capital formation: it permits banks to offer a wider array of investment products and it permits investors easy access to capital markets. However, the Division must also consider the investor protection purposes and the remedial nature of the Act, which was drafted "to protect the investing public from its own imprudence as well as the chicanery of unscrupulous securities dealers."[15] The Division has promulgated the Guidelines in order to strike the appropriate balance.

The Division welcomes comments on the Guidelines. Comments should be addressed to Thomas Geyer, Staff Attorney, Enforcement Section, at the offices of the Division. Extra copies of the Guidelines may be obtained from the Division.

Endnotes

[1] Banking Act of 1933, 12 U.S.C. *passim*.

[2] 17 C.F.R. §240.3b-9 (1985).

[3] 15 U.S.C. §§ 78a-78kk (1981).

[4] *American Bankers Association v. Securities and Exchange Commission*, 804 F.2d 739 (D.C. Cir. 1986).

[5] At least 17 other states have addressed the sale of securities on bank premises by statute, administrative rule, no-action letter, opinion or otherwise: Colorado, Connecticut, Idaho, Iowa, Kansas, Maine, Minnesota, Missouri, Nebraska, New Mexico, New York, North Dakota, Pennsylvania, South Dakota, Vermont, Virginia and Wisconsin.

[6] [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶76,829 (Nov. 11, 1993); *See also* NASD Notice to Members 94-47 (June 1994).

[7] NASD Notice to Members 94-94 (December 1994).

[8] Statement of Denise Voigt Crawford on Behalf of the North American Securities Administrators Association Before the Oversight and Investigation Committee on Energy and Commerce, U.S. House of Representatives, *reprinted in* NASAA Reports (CCH) ¶17,006 (1994). Ms. Crawford delivered her statement on March 2, 1994. In addition to being the Texas Securities Commissioner, Ms. Crawford serves as Chair of NASAA's Securities Activities of Banks Committee and is a member of NASAA's Board of Directors.

[9] *Id.*

[10] During its investigation, the Division discovered one state chartered bank that is licensed by the Division. Consequently, the Rule 19(A)(7) prohibition does not apply and that bank is permitted to share in commissions. However, that bank is also subject to the additional regulation of the Division.

[11] *See* Friedman, Ohio Securities Law and Practice § 9.11 (1993).

[12] The Securities Law of Ohio § 6373-2.3.c. (1929).

[13] Similarly, the NASD amended proposed rules prohibit a dealer from providing compensation to unlicensed persons. *See* subsection (C)(3) and related commentary.

[14] O.A.G. 88-056 (1988), syllabus ¶6.

[15] *In re Columbus Skyline Securities*, 74 Ohio St.3d 495, 498 (1996); *see also Bronaugh v. R. & E. Dredging Co.*, 16 Ohio St.2d 34, 45 (1968).

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A security transaction is one whose characteristics distinguish it from the generality of transactions so as to create a need for special fraud procedures, protections and remedies provided by the securities laws.[4] Early in this century, state legislatures recognized the need for such special protections and remedies and enacted state securities regulation or "blue sky laws." The Ohio General Assembly enacted the first Ohio blue sky law in 1913,[5] and the United States Supreme Court upheld the statute against constitutional challenge in 1917.[6] After the stock market crash in 1929, the federal government recognized the need for such special protections and remedies and enacted six related but separate statutes,[7] including the Securities Act of 1933 (the "1933 Act")[8] and the Securities Exchange Act of 1934 (the "1934 Act").[9]

The federal legislation was the first "uniform" treatment of securities regulation. Because of differences in both the substance and enforcement of early state securities laws, promoters and salesmen were able to operate interstate schemes beyond the reach of state authorities.[10] State regulators advised Congress that supplemental federal regulation was needed to fill the jurisdictional gaps.[11] Stemming from the same policy as state regulation, that of investor protection, the federal acts, by regulating interstate transactions, provided the necessary complement to the limited jurisdiction of state securities laws. Federal regulation further complemented the merit regulation of state securities laws by imposing strict disclosure requirements, regulating secondary trading and establishing regular reporting requirements. Because of the common goals and complementary nature of state and federal securities regulation, Professor Louis Loss, the principal draftsman of the Uniform Securities Act, has written that he hoped for "interchangeability" between state and federal precedent.[12]

In *Columbus Skyline*, the Ohio Supreme Court not only recognized interchangeability between state and federal precedent, but also noted the "goal of unifying securities law."[13]

Columbus Skyline Securities, Inc. ("Skyline"), was a Columbus-based intrastate securities dealer that dealt primarily in penny stocks. In September 1992, the Division revoked Skyline's Ohio Securities Dealer License for fraudulent conduct in the form of continued sale of securities at a price that was an unconscionable variation from the existing market.[14] The Division supported the revocation with evidence that Skyline sold shares of FiberCorp International, Inc. ("FiberCorp"), to retail customers at nondisclosed markups ranging from 300 to 567% above the current market price ("CMP").

In calculating the CMP and the markup, the Division used two methods gleaned from federal and Securities and Exchange Commission ("SEC") case law.[15] First, the Division presented evidence that Skyline had purchased FiberCorp shares from another dealer for $0.15 to $0.20 per share, and during the same time sold FiberCorp shares to retail customers for $1.00 per share, resulting in markups of 400 to 567%. Second, the Division presented evidence that Skyline sold FiberCorp shares to another dealer for $0.25 per share, while at the same time selling FiberCorp shares to retail customers at $1.00 per share, resulting in a markup of 300%.

Skyline appealed the revocation to the Franklin County Court of Common Pleas. In April 1993, the Common Pleas court affirmed the revocation.[16] The court considered the analogous federal and SEC case law[17] and the National Association of Securities Dealers' ("NASD") 5% markup guideline[18] and noted that although Skyline was not a member of the NASD, "a comparison of the 5% guideline to [Skyline's] markup of 300% or more should suggest to [Skyline] that its markup was subject to challenge."[19]

Skyline appealed the decision to the Tenth District Court of Appeals. The appellate court reversed the trial court, concluding that the Division's reliance on federal markup standards failed to give Skyline adequate notice of what markup standards applied and, therefore, violated Skyline's substantive due process rights.[20] Specifically, the appellate court held that the definition of fraud contained in the Securities Act, set out in R.C. 1707.01(J), was unconstitutionally void for vagueness. R.C. 1707.01(J) states:

> **"Fraud," "fraudulent acts," "fraudulent practices" or "fraudulent transactions" means anything recognized on or after July 22, 1929, as such in courts of law or equity; any device, scheme, or artifice to defraud or to obtain money or property by means of any false pretense, representation, or promise; and fictitious or pretended purchase or sale of securities; and any act, practice, transaction, or course of business relating to the sale of securities which is fraudulent or which has operated or would operate as a fraud upon the purchaser.**

The Division appealed to the Ohio Supreme Court, challenging the appellate court's finding of unconstitutionally. The Supreme Court framed the issue as "whether R.C. 1707.01(J) gives...adequate notice that federal case law may be applied...to determine if the conduct of a dealer is fraudulent".[21] More importantly, the Court stated "we answer that question in the affirmative."[22]

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Not surprisingly, the high court began its analysis by stating that "[i]t is well established that all legislative enactments enjoy a strong presumption of constitutionality," and "in order to prove that a statute is unconstitutionally vague, the challenger must show that upon examining the statute, an individual of ordinary intelligence would not understand what he is required to do under the law."[23] The court also noted the specific investor protection purposes of the statutes constituting the Securities Act, and commented "the enacted statutes are remedial in nature, and have been drafted broadly to protect the investing public from its own imprudence as well as the chicanery of unscrupulous securities dealers."[24] The court concluded "[i]n order to further the intended purposes of the Act, the securities anti-fraud provisions must be liberally construed."[25]

The Supreme Court next examined the plain language of R.C. 1707.01(J), emphasizing that it defines fraud, in part, as "anything recognized...as such in courts of law or equity."[26] This examination led the court to comment:

> The General Assembly did not limit the source of the definition solely to courts of Ohio, or even to state courts generally, as it easily could have done. Rather, the legislation broadly drafted R.C. 1707.01(J) to draw from *all* securities case law defining fraudulent conduct in both state and federal courts. Interpreting R.C. 1707.01(J) as not including federal securities law as a defining source for "fraud" would require us to modify the statute by inserting the word "Ohio" or "state" before the phrase "courts of law or equity." We refuse to do so, for when construing a statute, "it is the duty of this court to give effect to the words used, not to delete words or to insert words not used."[27]

The court did recognize Skyline's argument, stating "[w]e acknowledge that R.C. 1707.01(J) does not state the precise method used to calculate current market price of securities sold in Ohio."[28] However, the court, noting the remedial purposes of the Securities Act, remarked:

> Recognizing the creativity of unscrupulous securities dealers intent on defrauding Ohio investors, the General Assembly chose not to create a specific formula for calculating CMP and determining fraudulent conduct. Instead the General Assembly drafted R.C. 1707.01(J) so that securities case law, both state and federal, provides the appropriate standard.[29]

The court explored two specific reasons that supported this "sagacious"[30] drafting of R.C. 1707.01(J). First, the court observed that securities markets are constantly evolving, and by incorporating into the Securities Act a larger body of law by which to define fraudulent conduct, the legislature provided for changes in the markets that might otherwise require a redrafting of the statute. The court concluded that "[t]his has the desirable effect of preventing Ohio securities law from developing in a vacuum, and furthers the goal of unifying securities law."[31] Second, the court noted that the federal standards for determining CMP are more well developed than state standards and provide a more extensive body of law to draw from in defining fraud. This led the court to its holding in the case, that R.C. 1707.01(J) provides constitutionally adequate notice that federal law may be applied for the purpose of determining fraudulent conduct.[32]

The court concluded its analysis by rejecting the claim that R.C. 1707.01(J) sets forth a standard that is "impossible" to discern by stating "[m]any federal securities cases exist that provide a clear and workable method of calculating CMP, and set the standard for what constitutes an excessive price markup amounting to fraudulent conduct."[33]

The *Columbus Skyline* decision is significant because it truly recognizes the "interchangeability" of securities laws by actually incorporating federal standards into the Ohio anti-fraud standard. As the *Columbus Skyline* court noted, this incorporation is supported by the remedial nature of securities laws, the goal of unifying securities laws and "the central objective of all securities legislation of providing protection for those unfamiliar with market conditions from the dishonesty of those who do."[34] Further, it is logical to incorporate federal standards on the "anti-fraud side" of the Securities Act since federal standards are incorporated in numerous places on the "registration side" of the Securities Act.[35]

Of further significance is the fact that the *Columbus Skyline* decision is consistent with several other recent decisions that incorporate federal standards into state securities law. A strikingly similar case is the decision of the Arkansas Supreme Court in *Selig v Novak*.[36] Novak was a licensed securities agent who had his license permanently revoked by the Arkansas Securities Commissioner for excessive markups, unethical practices and falsifying applications. Specifically, the evidence showed that Novak sold to banks certain bonds at a markup of 10 to 27%. On appeal, Novak argued that there was no Arkansas statutory provision defining "fraudulently excessive markup." However, the court recognized a number of federal cases "wherein it was held to constitute fraud if an excessive markup was exacted."[37] The court concluded:

> We agree with [Novak] that some of the violations (for example, "markups") cannot be found spelled out in the statutes. However, those charges which cannot specifically be found in the statutes are covered by general language (which we have quoted) and reinforced by case law which has been developed over the years to protect the public from unethical conduct. We have discussed a number of those cases.[38]

Another example of such judicial incorporation is *Brewster v. Maryland Securities Commissioner.*[39] Brewster was a licensed securities salesperson who was suspended and fined by the Maryland Securities Commissioner for committing "dishonest and unethical practices" in violation of section 11-412(a)(7) of the Maryland Securities Act[40] by recommending unsuitable securities and then encouraging the customer to falsify the amount of his net worth to complete the transaction. Brewster's primary argument on appeal was that section 11-412(a)(7) was unconstitutionally vague because the standard set forth in that section, "dishonest and unethical practices" was not defined in the Maryland Securities Act.

In considering Brewster's constitutional challenge, the Maryland Court of Appeals recognized that Article III, Section 2 of the NASD Rules of Fair Practice required a securities salesperson to determine whether a particular security is suitable for a customer.[41] The court noted that Section 15 of the 1934 Act "provides for the creation and promulgation of NASD rules,"[42] and that "those standards embody the ethical guidelines for the securities industry."[43] The court also discussed the federal cases construing the NASD rule.[44] From there, the court reached its holding:

> The absence from the Maryland Act of a definition of the phrase "dishonest and unethical practices" does not, as Brewster suggests, preclude punishment for her conduct. Section 11-412(a)(7) does not stand as an independent, isolated proviso, free and clear of all other provisions of the securities law...The term "dishonest and unethical" has a meaning referent in business practice and usage.

A final example of incorporating federal standards into substantive state law is the 1991 SEC No-Action Letter *Edward A. Schrag, Jr.*[45] The letter of inquiry asked the SEC staff to confirm that sections 15(c) and (g) of the 1934 Act, and the rules promulgated thereunder, applied to broker/dealers that were exempt from registering with the SEC under the "intrastate" exemption set out in section 15(a)(1) of the 1934 Act. The staff confirmed this position, noting that:

> The intrastate exemption, however, merely exempts intrastate broker-dealers from the registration requirements of the [1934 Act], not other provisions that apply to persons acting as broker-dealers, whether or not they are registered with the [SEC].[46]

This No-Action position clearly incorporates federal standards, sections 15(c) and (g) of the 1934 Act and the rules promulgated thereunder, into state law.

To be effective, securities regulation must keep pace with the "virtually limitless scope of human ingenuity." The *Columbus Skyline* court, by properly interpreting the plain language of R.C. 1707.01(J), recognized that the General Assembly intended Ohio securities law to keep pace by defining fraud as "anything recognized...as such in courts of law or equity." As discussed, the *Columbus Skyline* decision is consistent with other recent decisions that recognize the complementary nature of the state and federal regulatory system. Incorporation of federal standards into state securities laws is supported by the remedial nature of securities laws, the goal of unifying securities laws and "the central objective of all securities legislation of providing protection for those unfamiliar with market conditions from the dishonesty of those who do." Such incorporation permits maximum enforcement, uniform application and the establishment of an appropriate balance between investor protection and capital formation.

Endnotes

[1] *State v. Taubman,* 78 Ohio App. 3d 834, 844 (Montgomery Cty. 1992)(internal quotation marks and citation omitted).

[2] 74 Ohio St. 3d 495 (1996).

[3] Ohio Revised Code Chapter 1707.

[4] Coffey, *The Economic Realities of a "Security:" Is There a More Meaningful Formulae?*, 18 W. Res. L. Rev. 367, 412 (1967); *see also Mazza v. Kozel,* 591 F. Supp. 432, 436 (N.D. Ohio 1984).

[5] 103 Laws of Ohio 743.

[6] *Hall v. Geiger-Jones Co.,* 242 U.S. 539 (1917)

[7] The Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940 and the Investment Advisers Act of 1940. A seventh related but separate statute was passed in 1970, the Securities Investor Protection Act of 1970. *See*

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Skyline

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generally L. Loss, Fundamentals of Securities Regulation 35-39 (1988).

[8] 15 U.S.C. §§77a-77aa (1981).

[9] 15 U.S.C. §§78a-78kk (1981).

[10] Warren, *Reflections on Dual Regulation of Securities: A Case Against Preemption,* 25 B.C.L. Rev. 495, 496-497 (1984) (citations omitted).

[11] *Id.* (citations omitted).

[12] L. Loss, Commentary on the Uniform Securities Act 147 (1976).

[13] *Columbus Skyline, supra* note 2, 74 Ohio St. 3d at 499.

[14] Division Order No. 92-051 (Sept. 8, 1992).

[15] CMP is not defined in the Securities Act or by Ohio case law.

[16] *Columbus Skyline Securities, Inc. v. Mark V. Holderman as Commissioner of Securities,* No. 92 CVF9-7516 (Franklin Cty. C.P. April 28, 1993).

[17] *Charles Hughes and Co. v. SEC,* 139 F.2d 434 (2nd Cir. 1943); *Barnett v. U.S.,* 319 F.2d 340 (8th Cir. 1963); *Associated Securities Corp. v. SEC,* 293 F.2d 738 (10th Cir. 1961).

[18] NASD Rules of Fair Practice Art. III, Sec. 4; Interpretation of the Board of Governors, NASD Mark-Up Policy, NASD Manual (CCH) ¶ 2154.

[19] *Columbus Skyline, supra* note 16, slip op. at 5.

[20] *In the Matter of Columbus Skyline Securities, Inc., et al.,* No. 93AP-790 (Franklin Cty. Ct. App. May 19, 1994).

[21] *Columbus Skyline, supra* note 2, 74 Ohio St. 3d at 497.

[22] *Id.* The case was successfully argued before the Ohio Supreme Court by Daniel A. Malkoff, Esq., currently an Assistant Attorney General and formerly a Division Staff Attorney.

[23] *Id.* at 498 (citation omitted).

[24] *Id.* (citation omitted).

[25] *Id.*

[26] *Id.*

[27] *Id.* (emphasis in original; citation omitted).

[28] *Id.*

[29] *Id.* at 499.

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] *Id.* at 500.

[35] *See, e.g.,* R.C. 1707.091 and 1707.03(Q).

[36] 506 S.W. 2d 825 (Ark. 1974).

[37] *Id.* (citing *Hughes v. SEC,* 139 F.2d 434 (2d Cir. 1943); *Otis & Co. v. SEC,* 106 F.2d 579 (6th Cir. 1939); *Associated Sec. Corp. v. SEC,* 293 F.2d 738 (10th Cir. 1961); *Handley Inv. Co. v. SEC,* 354 F.2d 64 (10th Cir. 1965); and *Merritt, Vickers, Inc. v. SEC,* 353 F.2d 293 (2d Cir. 1965)).

[38] *Novak, supra* note 36, 506 S.W. 2d at 830.

[39] 548 A.2d 157 (Md. Ct. App. 1988).

[40] Section 11-412(a) provides in pertinent part:

The Commissioner by order may deny, suspend, or revoke any registration if he finds that the order is in the public interest and that the applicant or registrant...

(7) has engaged in dishonest or unethical practices.

[41] The rule states:

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

[42] *Brewster,* note 39, 548 A.2d at 159 (citation omitted).

[43] *Id.* (citation omitted).

[44] *Id.* at 160 (citation omitted).

[45] *Id.*

[46] [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,041 (Sept. 3, 1991).

[47] *Id.* at p. 78,968-9.

Mr. Geyer is a Staff Attorney in the Enforcement Section and Editor of the Ohio Securities Bulletin. Portions of this article appeared previously in Mr. Geyer's article "Weaving the Cloth of State Securities Regulation on the Loom of Federal Securities Regulation" published in the 1995 NASAA Enforcement Law Reporter.

Summaries of the Advisory Committee Meetings held at the 1995 Ohio Securities Conference

Registration and Exemption Advisory Committee

by Mark Heuerman, Esq.

The Registration and Exemption Advisory Committee held its meeting directly after the 1995 Ohio Securities Conference. Warren Udisky, co-chairperson, called the meeting to order. Mark Heuerman agreed to act as co-chairperson in the absence of Michael Miglets.

The first issue for discussion was Securities Act Release No. 7185, June 27, 1995. The Division is interested in receiving comments as to whether Ohio should adopt a similar exemption from registration by qualification as the exemption under California Corporations Code §25102(n). The Securities Act Release would provide an exemption from registration under Section 3(b) of the Securities Act of 1933, proposed rule 1001, if issuers meet the California exemption. The California exemption is available for any business entity organized in that state provided certain conditions are satisfied. Non-California organized businesses must have at least 50% of property, payroll, sales and voting securities within the state. The offering may not exceed $5 million. The exemption would be available for sales to qualified purchasers who purchase for investment and not redistribution i.e. restricted securities. Qualified purchasers most notably includes any purchaser who is purchasing $150,000 or more of the securities and natural persons whose net worth exceeds $500,000 or exceeds $250,000 if such persons annual income exceeds $100,000. Additionally, the total purchase may not exceed 10% of the purchaser's net worth and the purchaser must be able to protect his or her own interests. Issuers are required to provide a disclosure document five days prior to any sale. The offering permits a general announcement which may be widely published and circulated provided the announcements meets the "test the waters" concept as in Regulation A. A notice filing is required to be made before the general announcement and at the completion of the offering. The Division requests comments to be sent to the Division as to whether a similar exemption should be adopted in Ohio. Details of the Securities and Exchange Commission's proposal may be reviewed in the release.

The Committee noted that a rules hearing was scheduled for December 12, 1995, at 10:00 a.m. The Division noted that it had not received any comments opposing the proposed rule changes, and the Committee then discussed the general nature of the amendments. Rule 1301:6-3-03(D)(6) of the Ohio Administrative Code was amended to delete the requirement of a licensed dealer. The provision, which exempts warrants and options to purchase securities listed on a designated exchange, is somewhat inconsistent with section 1707.02(E)(1) of the Revised Code which exempts the securities listed on a designated exchange. Prior to the amendment, the rule required the security to be sold by a licensed dealer although section 1707.02(E)(1) does not require the sale to be made by a licensed dealer. The investment company rules will be changed which will provide more consistency with other states. The proposal to the provision concerning illiquid securities pursuant to rule 1301:6-3-09(E)(12) of the Ohio Administrative Code was changed to exclude rule 144A securities that have been determined to be liquid by the board of directors and commercial paper rated investment grade. A new rule proposed by the Division, rule 1301:6-3-03(D)(8) of the O.A.C., exempts credit enhancements sold in conjunction with a security that is exempt under section 1707.02(B) of the Revised Code. Numerous inquires to the Division have been made questioning whether the Ohio Securities Act treats such guarantee or credit enhancement as a separate security and whether such security is exempt. The provision should relieve counsel that if such credit enhancement is deemed to be a separate security that it is exempt. Contrary conclusions could require registration of a credit enhancement regardless of the exempt status of the underlying security. The Division does not want issuers of these securities to avoid selling in Ohio or dropping credit enhancements because of the questionable status of an exemption.

The Division commented that it intends to adopt the North American Securities Administrators Association Guidelines for the Registration of Asset-Backed Securities. The proposed Guidelines were adopted by NASAA at its annual conference in October 1995. The guidelines will apply to public offerings. The Division has informally applied the Guidelines to asset-backed offerings which would not meet the current policy statement requiring earnings to fixed charges for at least 3 years. Many requirements will not apply to investment grade offerings. The Division will be publishing an article in an upcoming issue of the *Ohio Securities Bulletin* announcing the adoption of the Guidelines and describing their significant aspects.

Commissioner Holderman presented brief remarks on the Fields Bill. NASAA and industry representatives believe that action on the bill is not likely until later in 1996. The original bill, H.R. 2131, would preempt state regulation of most registration filings and elimates pro-

Committee Meetings

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spectus delivery unless requested by the investor.

The Committee then discussed several unresolved issues regarding the confidentiality of disclosure documents. Counsel for private placement issuers have requested that all or portions of confidential information be sealed or not available for public inspection. Section 1707.12 of the Revised Code states that these documents are public records. The Division requires the offering memorandum. While a merit review is not conducted for the private placement issuers, the Division requires the offering memorandum for the records to check remuneration and commissions and for fraud upon further examination by field staff or the enforcement section. Another issue raised has been whether the private placement status of an offering has been lost due to the filing becoming public records. The Division is not aware of a Form 3-Q or 3-W filing that has lost the corresponding federal exemption due to the filings becoming public records.

Another suggestion to the Division was to make available to the public examples of model disclosure documents to filers. The Division and investors benefit from a higher quality of disclosure document. Currently, the Division does not volunteer disclosure documents of particular issuers. Many issuers, as stated earlier, wish to keep their filings confidential. A suggestion was made to allow issuers to volunteer their disclosure documents for public reference.

The Division noted that it is still considering adoption of some form of Uniform Limited Offering Exemption. The Division believes that a statutory change would be required for the exemption in Ohio. Additionally, the Division requests suggestions on whether the "commission and other remuneration" limitation should contain the 10% standard under section 1707.03(Q) of the Revised Code or 12% standard under section 1707.03(W) of the Revised Code. The commission standard has been the subject of many lost exemptions or rescission offers. Many private placements refrain from offering in Ohio. The Division currently requests filers to satisfy their burden of proof under section 1707.45 of the Revised Code that the commission or other remuneration standard has been satisfied by the issuer.

The final topic of discussion was the Division's concern with offerings over the Internet. Many offerings, not registered or exempt, are being offered over the Internet. It was requested that the Division actively review the Internet for fraudulent offerings. Offerings being sold by issuers that do not intend to consummate the sale of the securities within Ohio may still run afoul of the Ohio Securities Act. Sale is broadly defined under section 1707.01(C)(1) and may encompass such an offering. Those offerings that have a licensed dealer may be excluded from the definition of sale under section 1707.01(C)(4) of the Revised Code.

Licensing Advisory Committee

by Joyce Cleary

The Licensing Advisory Committee first discussed a proposal to amend the Division's regulation of the non-delivery of securities.

Thomas Geyer, a Staff Attorney in the Division's Enforcement Section, presented for discussion the following proposed amended administrative rule:

O.A.C. 1301:6-3-19(A) - No dealer or salesman shall:

(1)(a) Fail to deliver proceeds from a sell transaction to a customer or a customer's account within thirty (30) calendar days of the trade date.

(b) Fail to either (i) deliver securities to the customer's account, or (ii) take steps necessary to effect physical delivery of the stock certificate, within thirty (30) calendar days of receipt of the customer's funds or the close of escrow.

(c) If the time period for compliance with section (a) or (b) has not been met, the dealer or salesman shall deliver written notice to the customer and the Division within seven (7) calendar days of the date required for compliance with section (a) or (b). Such written notice shall indicate the steps taken towards compliance and the reasons for noncompliance. Any failure to provide written notice under this section (c) shall be an additional violation of this rule.

Mr. Geyer stated that one purpose of the amended rule was to clarify the existing rule, which states:

(A) No dealer or salesman shall:

(1) Engage in any pattern of unreasonable or unjustified delay in the delivery of securities sold.

Mr. Geyer noted that the problem of non-delivery of securities was not limited to penny stock dealers. He noted that several other states set a time limit on the delivery of stock certificates and proceeds. As examples, Mr. Geyer cited Minnesota's 20 day requirement, Idaho's 60 day requirement and the "willful delay" provisions of Nebraska and Wisconsin.

Committee members expressed serious concerns about the proposal and discussed examples of where a 30 day turnaround may not be possible, such as the resale of restricted or "Rule 144" securities. Committee members also noted that a dealer will not pay out until the transaction is cleared through the transfer agent. The Committee suggested that the language, "take steps necessary" be used with both delivery of proceeds and delivery of securities.

A number of Committee members stated that the amended rule was unnecessary. They believed non-delivery to be a penny stock problem and now believed to be gone. According to some, the Division has the authority to take steps against this already.

A vote was taken from the industry members only. One felt the rule could be changed by using "take steps necessary" and not imposing a time limit or filing a written notice. The remainder felt the rule did not need to be changed.

The next item for discussion was the Fields Bill. Dale Jewell reported that the bill was getting mixed reviews.

The final item on the agenda was a discussion of the proposed record keeping requirements put out by NASAA. The proposal will be discussed at the NASAA Spring Conference. Mr. Jewell asked that comments be submitted to the Division.

The SIA comment letter to the record keeping proposal was discussed. Mr. Jewell will send a copy of that draft to all members of the Committee.

Particular issues discussed included the proposals regarding investment objectives, record keeping of oral complaints and the requirement that new account forms be sent to the customer for signature and returned to the dealer.

Enforcement Advisory Committee

by Lynne Greenler

William H. Jackson, Jr., Co-Chairman of the Enforcement Advisory Committee called the meeting to order. Also presiding was Co-Chairman Caryn A. Francis.

The Co-Chairmen stated that new business would be the first item on the agenda since several committee members were attending the first part of the Licensing Advisory Committee meeting. The Co-Chairmen opened the discussion with NASAA's proposed legislation regarding Record-Keeping Requirements for Broker-Dealers. The Committee raised a few concerns. Co-Chairman Francis pointed out that there are many steps to be taken before a proposed regulation would be considered for adoption as a rule and, of course, there is always a public hearing prior to the adoption of any new rule.

The second issue for discussion pertained to proposed legislation permitting continued jurisdiction following a license withdrawal. Discussion took place regarding the various states and their similar rules. Two committee members felt the legislation to be a good idea if it would, for example, weed out the problem salesmen for dealers. Several concerns however were raised. One concern being that this proposal, if adopted as a rule, may conflict with Ohio Revised Code chapter 119. Co-Chairman Francis pointed out that no time frame had been set for this legislation. The Division's purpose for raising this issue was to receive feed back from the Committee. Such legislation would need industry support; more research would need to be completed; a third party would need to get involved; and legislative hearings would need to be held.

Old business was the next topic on the agenda. At the 1993 Enforcement Advisory Committee meeting, a subcommittee was formed to address the proposal of statutorily granting fining authority to the Division. The subcommittee consisted of Phil Lehmkuhl, Greg Seeley, Alan Blue, Jamie Zitsman and Daniel Malkoff. For the benefit of the new committee members, Mr. Lehmkuhl gave background information on how this proposed rule originated. The proposed rule went through some changes in 1994 and most of those affected 1707.371 (i.e. how the money could be used). The subcommittee suggested a few changes to the 1995 redrafted proposed rule. After discussion by the Committee, Co-Chairman Jackson made a motion to present the proposed legislation to the Commissioner of Securities. The motion was seconded with no objections.

The last topic for discussion was on the proposed amendment to O.A.C. 1301:6-3-19(A). After returning from the Licensing Advisory Committee meeting, Thomas Geyer reported that the Licensing Committee strongly objected, not only in theory, but to the additional filing requirement imposed by the proposed rule. The Licensing Committee felt that there is currently enough control on the federal level and that the few complaints received do not justify a rule at this point. A discussion regarding the proposed rule took place after Mr. Geyer's report. Several questions and concerns were raised. Co-Chairman Francis thanked the members of the Committee for all of their input and reminded them that should any rule be proposed, there would be additional opportunities for comment at the required public hearing.

The meeting closed with the nomination of the 1996 Enforcement Advisory Committee Co-Chairman. Mr. Robert Rapp was nominated and the Committee unanimously agreed.

Takeover Advisory Committee

by William Leber, Esq.

The Takeover Advisory Committee met briefly to consider the revisions to the rules of the Division and the relative lack of takeover activity. During 1995, only one Control Bid, Form 041, was filed with the Ohio Division of Securities.

Administrative Orders

Midwest Video Wholesalers Limited Partnership; Midwest Video Wholesalers, Inc.; Andrew Spry

On January 12, 1996, the Division issued a final Cease and Desist Order, Division Order 96-003 to Midwest Video Wholesalers Limited Partnership, Midwest Video Wholesalers, Inc., and Andrew Spry (collectively, "Respondents"). Midwest Video Wholesalers Limited Partnership is an Ohio limited partnership; Midwest Video Wholesalers, Inc. is an Ohio corporation; and Andrew Spry is the president, director and shareholder of Midwest Video Wholesalers, Inc. and a resident of Columbus, Ohio.

On May 19, 1995, the Division had issued to Respondents Division Order 95-024, a Notice of Opportunity for Hearing, alleging the sale of unregistered, non-exempt securities in Ohio, in violation of R.C. section 1707.44(C)(1). In response to the Notice, counsel for Respondents requested that an administrative hearing be held on the matter. An administrative hearing was held on August 17, 1995, at the offices of the Division. However, neither Respondents nor counsel for Respondents appeared at the hearing. The hearing proceeded with the Division presenting evidence and then the Hearing Officer closed the record.

On October 2, 1995, the Hearing Officer issued her Report and Recommendation, recommending an order to Cease and Desist be issued. The Final Order approves the recommendation of the Hearing Officer and orders that the Respondents cease and desist from future violations of the Securities Act.

Kinlaw Securities Corporation

On January 24, 1996, the Division issued Division Order 96-014, a Final Order of Revocation of the Ohio Securities Dealers License of Kinlaw Securities Corporation of Dallas, Texas. The Division found that Kinlaw Securities was not of "good business repute" and revoked its license under the authority of R.C. section 1707.19.

O.A.C. Rule 1301:6-3-19(D)(2) provides that in determining "good business repute" the Division shall consider whether the dealer "has been the subject of any cease and desist order, permanent or temporary injunction, or consent order." In addition, O.A.C. Rule 1301:6-3-19(D)(7) provides that in determining "good business repute," the Division shall consider whether the dealer has "been the subject of any suspension, expulsion, revocation, censure or other disciplinary action by any professional association granting disciplinary or regulatory authority by state or federal law, any association of securities salesmen or dealers, any recognized securities exchange or any state or federal agency."

The Division found that on or about August 2, 1995, Kinlaw entered into a consent agreement with the Securities and Exchange Commission ("SEC") pursuant to which the SEC obtained a permanent injunction against Kinlaw and revoked Kinlaw's broker/dealer registration. The action was based on evidence that in connection with the offer, purchase and sale of securities involving interests in oil and gas drilling ventures, Kinlaw operated a boiler room sales operation in which material misrepresentations and omissions of material facts were made. In addition, between August and November in 1995, the states of California, Nevada, Arkansas, Maryland, Iowa, Illinois and the NASD, all revoked Kinlaw's licensure.

On December 21, 1995, the Division issued and mailed to Kinlaw, Division Order No. 95-098, an order captioned "Suspension of Ohio Securities Dealer License/Notice of Intent to Revoke." The suspension order was properly served upon Respondent by certified mail; however, Kinlaw failed to request an administrative hearing on the matter. Consequently, the Division issued the final order revoking Kinlaw's Ohio securities dealer license.

Ruth M. Cohn

On March 26, 1996, the Division issued Division Order No. 96-045, a Final Order to Deny the Application for an Ohio Securities Salesman's License of Ruth M. Cohn of Chicago, Illinois.

R.C. 1707.19 permits the Division to refuse an application for a securities salesman's license if the applicant is not of "good business repute." On December 7, 1995, the Division had issued to Cohn Division Order No. 95-094, a Notice of Opportunity for Hearing, which set for the Division's allegations that Cohn was not of "good business repute." Specifically, the Division alleged that Cohn failed to meet the good business repute standards set out in O.A.C. 1301:6-3-19(D)(7) and (9),based on, among other things, an NASD fine and censure and the fact that in 1980 Cohn pleaded guilty to conspiacy to commit murder and was sentenced to six years incarceration by an Illinois state court.

The notice order was properly served on Cohn, but she did not request an administrative hearing on the matter as permitted by the notice order and R.C. Chapter 119. Consequently, the Division issued the final order, which denied her application for an Ohio securities salesman's license.

Danos S. Tiano

On March 27, 1996, the Division issued Division Order No. 96-050, a Final Order to Cease and Desist to Danos S. Tiano of Dublin, Ohio. In connection with the Cease and Desist order, the Division and Tiano entered into a Consent Agreement, in which Tiano consented, stipulated and agreed to the issuance of the final Cease and Desist order.

Tiano was employed as a licensed securities salesman by Dublin Securities, Inc., from August 1988 to December 1992. In May 1992, Tiano sold to Ohio resident Miles L. Barrere 6,000 shares of Lifeline Shelter Systems at $3.50 per share. In selling the securities, Tiano did not provide Barrere with disclosure documents and made representations about Lifeline's potential growth and ability to be listed on the NASDAQ exchange within 12 months. In addition, Tiano failed to disclose that only $1.00 of the per share purchase price went to Lifeline, while the rest was retained by Dublin Securities; that Lifeline had lost money throughout 1991; that Dublin Management, Inc., an affiliate of Dublin Securities, had purchased a large block of Lifeline shares at approximately $.01 per share; and that the Lifeline shares were speculative and involved a high degree of risk.

On May 25, 1995, the Division issued to Tiano Division Order No. 95-026, a Notice of Opportunity for Hearing, alleging that the foregoing misrepresentations and omissions constituted violations of R.C. 1707.44(B)(4) and (G). Tiano requested an administrative hearing on the matter, but entered into the Consent Agreement before the hearing was held. The Final Order found that Tiano had violated R.C. 1707.44(B)(4) and (G) and ordered Tiano to cease and desist from future violations of the Ohio Securities Act.

Victor E. Steinfels, III

On March 29, 1996, the Division issued Division Order No. 96-051, a Final Order to Cease and Desist to Victor E. Steinfels, III, of Dublin, Ohio. The Final Order followed an administrative hearing on the matter, which had been held on September 7, 1995.

At the administrative hearing, the Division presented evidence that Steinfels had violated R.C. 1707.44(B)(4) by making false representations of material facts in the sale of a limited partnership unit in Vesmont Partners Limited to Steven A. Miller, an Ohio resident. Steinfels presented evidence attempting to show that the representations made were not false and/or not material. However, the Hearing Officer recommended that an order to cease and desist should be issued against Steinfels.

Subsequent to the issuance of the Hearing Officer's report and recommendation, Steinfels filed objections thereto, as permitted by R.C. Chapter 119. Pursuant to R.C. 119.09, the Division considered the hearing officer's recommendation, the transcript of testimony, the evidence and the objections. Upon such consideration, the Division issued its Final Order, ordering that Steinfels cease and desist from the acts and practices described in the Hearing Officer's report and recommendation which violate the Ohio Securities Act.

Civil Cases

Owens, Director of Commerce v. International Mortgage Company, Inc., Liberty Bell Association, Inc., Theodore E. Mong and Larry Druggan

On March 19, 1996, Judge James O'Grady of the Franklin County Court of Common Pleas entered a permanent injunction in *Owens, Director of Commerce v. International Mortgage Company, Inc., Liberty Bell Association, Inc., Theodore E. Mong and Larry Druggan*, (No. 96 CVH02-1535 Franklin Cty. C.P. March 19, 1996). The entry enjoined defendant Mong, of Newark, from offering shares of defendant International Mortgage, an Ohio corporation with a Dublin address, to the holders of promissory notes issued through Liberty Bell, an Ohio corporation with a Newark address, in exchange for cancellation of the promissory notes. Defendant Druggan, of Dublin, is the president of International Mortgage. Judge O'Grady had issued a temporary restraining order on February 28, 1996.

As reported in *Bulletin* 95:4, on October 12, 1995, the Division issued to Mong and Liberty Bell Division Order No. 95-081, a final order confirming the Suspension of the Right to Sell Securities in the State of Ohio pursuant to R.C. section 1707.13. The final order permanently suspended the unlicensed sale of unregistered promissory notes by Mong.

Subsequent to the final suspension order, Mong sent letters to the holders of the promissory notes proposing the distribution of shares of International Mortgage in exchange for the cancellation of the promissory notes. It appeared to the Division that the proposed exchange was an attempt to eliminate the $1,400,000 debt Mong and Liberty Bell owe to the promissory note holders. Upon examination, the Division determined that the proposed transaction violated the Securities Act because: (i) no registration or exemption filing had been made, and no self-executing exemption was available; (ii) no disclosures regarding International Mortgage had been made to the promissory note holders; and (iii) the promissory note holders were not informed about the consequences of

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Danaher Corporation Files Form 041 for Control Bid for Shares of Cleveland-based Acme-Cleveland Corporation

On March 7, 1996, Danaher Corporation, a Delaware corporation with a principal place of business in Washington, D.C., filed with the Division a Form 041 to pursue a control bid, or tender offer, for shares of Acme-Cleveland Corporation, an Ohio corporation with a principal place of business in Pepper Pike, Ohio. Acme-Cleveland is in the business of telecommunications, electronics and precision products. For the fiscal year ending September 30, 1995, Acme-Cleveland had net earnings of $42,503,000 on net sales of $120,716,000. Danaher is in the business of tools and components, including the manufacture of Craftsman and Matco brand tools, as well as process/environmental controls. For the fiscal year ending December 31, 1994, Danaher had net income of $81,650,000 on net revenues of $1,288,684,000. Danaher formed a wholly-owned subsidiary corporation, WEC Acquisition Corporation, a Delaware corporation, to facilitate the takeover.

Danaher's surprise offer of $27 cash per share represented a premium of $7, or 35%, over Acme-Cleveland's March 6, 1996, NYSE closing price of $20 per share. However, the announcement caused Acme-Cleveland's per share price to rise to $30.125 at the close of the market on March 7, 1996. Acme-Cleveland shares have remained around the $30 per share level. Danaher's per share price, also listed on the NYSE, remained unchanged at $34.625 after announcement of the control bid.

The Ohio Control Bid Statute, R.C. 1707.041 *et seq.*, prohibits a "control bid" for any securities of a "subject company" without the filing with the Division of the information set out in R.C. 1707.041(A)(2). Because Acme-Cleveland is a "subject company" as defined in R.C. 1707.01(Y)(1), Danaher was required to comply with R.C. 1707.041. Consequently, Danaher filed with the Division the information required by 1707.041(A)(2) including copies of all documents disclosing the terms of the offer, the source and amount of funds to be used in acquiring securities, plans for changes to Acme-Cleveland, and a complete description of the offeror, including financial statements and recent filings with the SEC.

Upon the filing of the Form 041, R.C. 1707.041(A)(3) provides that the Division has three days to review the materials submitted to determine whether "the control bid materials provided to offerees...provide full disclosure...of all material information concerning the control bid." R.C. 1707.041(A)(3) also states that the Division may summarily suspend the control bid if the materials do not meet this standard. In this instance, the Division did not suspend the control bid.

As the plain language of R.C. 1707.041 makes clear, the purpose of the Division's review is not to determine whether the offer is a good deal, or even fair. The sole role of the Division is to determine whether there has been full disclosure of all material information concerning the control bid. Federal courts have recognized that this type of review is consistent with the Williams Act, which sets out the federal standard for takeovers. See *Cardiff Acquisitions, Inc. v. Hatch*, 751 F. 2d 906 (8th Cir. 1984).

In connection with the control bid, Danaher filed in the U.S. District Court for the Southern District of Ohio a complaint for restraining order, preliminary and permanent injunction and declaratory judgment, attacking the constitutionality of portions of both the Control Bid Statute and the Ohio Control Share Acquisition Act, R.C. 1701.831 *et seq.* At a status conference before Judge James L. Graham on March 7, 1996, counsel for Danaher acknowledged that the attack on the Control Bid Statute would be moot if the Division failed to suspend the control bid, which is what happened in this case. However, the attack on the Control Share Act remained.

R.C. 1701.831 provides that a "control share acquisition" of shares of an "issuing public company" may be made only with the prior authorization of the shareholders of the issuing public company at special meeting of the shareholders called for such purpose. The statute imposes a dual quorum requirement for the special meeting: both a majority of the shares entitled to vote in the election of directors and a majority of "non-interested" shares must be present in person or by proxy. The statute similarly imposes a dual voting requirement: the offer must be approved by a majority of the voting shares and by a majority of the voting non-"interested" shares.

Specifically, Danaher's complaint attacks the constitutionality of the definition of "interested shares" set out in R.C. 1701.01(CC)(2), which primarily encompasses shares acquired after the announcement of the control share acquisition. Danaher claimed that R.C. 1701.01(CC)(2) is preempted by the Williams Act. Danaher also argued that R.C. 1701.01(CC)(2) violates the commerce clause in that it prevents the consummation of certain interstate tender offers and imposes a burden on interstate commerce that is not justified by any purported local benefit. Danaher argued that the issue is controlled by the decision in *Luxottica Group S.p.A. v. United States Shoe Corp.*, No. C2-95-244

Danaher

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(March 16, 1995 S.D. Ohio), where Judge Graham held that R.C. 1701.01(CC)(2) was preempted by the Williams Act.

In response, the State argued that the *Luxottica* decision did not control and that the Control Share Act is not preempted because, among other reasons, Congress has not expressly indicated an intent to preempt, compliance with both the Williams Act and the Control Share Act is not impossible and the Control Share Act does not frustrate the purpose of the Williams Act. The State further argued that the Control Share Act does not offend the commerce clause because it does not discriminate against interstate commerce or subject activities to conflicting state regulations, and any incidental burden imposed is rationally related the Control Share Act's legitimate purpose.

A hearing on Danaher's complaint began on April 9, 1996, before Judge Graham in U.S. District Court.

Section Reports

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exchanging a debt instrument for an equity instrument.

The permanent injunction enjoins defendants from (i) offering, selling or otherwise transferring shares of International Mortgage in violation of the Securities Act; (ii) transferring to Mong and his affiliates any assets obtained through the sale of shares of International Mortgage; and (iii) destroying any documents pertaining to International Mortgage securities.

Criminal Cases

Dublin Securities, Inc.

In January and February 1996, fivecriminal defendants were sentenced in the Franklin County Court of Common Pleas for their respective roles in the Dublin Securities, Inc., securities fraud scheme.

On January 16, 1996, former Dublin Securities controller Anthony Kohl was sentenced by Judge Beverly Pfeiffer to two to fifteen years incarceration. Kohl had pleaded guilty to felony counts of aggravated theft, aiding and abetting aggravated theft and aiding and abetting the sale of unregistered securities in a plea arrangement reached with the special prosecutor before a Franklin County Grand Jury handed down a 1,350 count indictment in April 1994. On February 14, 1996, Kohl was granted shock probation after serving thirty days of his sentence.

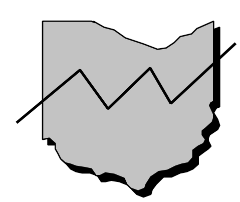
On February 9, 1996, former chief financial officer David Carmichael, who had pleaded guilty to four felony counts of false representations in the registration of securities and was found guilty of conspiracy to engage in a pattern of corrupt activity after pleading no contest, was sentenced by Judge William Ammer to five and one half to fifteen years in prison and fined $5,000. However, Judge Ammer suspended the jail term and granted Carmichael two years probation.

Also sentenced by Judge Ammer on February 9, 1996, were the three defendants who were convicted of multiple felonies after a five month jury trial: Dwight Hurd, Robert Hodge and XXX XXXXXX. Hurd, a Columbus attorney who served as legal counsel to Dublin Securities and was convicted on one count of engaging in a pattern of corrupt activity and three counts of false representations in the registration of securities, was sentenced to five and one half to twenty-five years incarceration and fined $17,500. Hodge, the former general sales manager of Dublin Securities who was convicted on 103 counts including engaging in a pattern of corrupt activity, grand theft and theft, was sentenced to five and one half to twenty-five years incarceration and fined $10,000. XXXXXX, who served as president of Dublin Securities and was convicted on 45 counts including engaging in a pattern of corrupt activity, grand theft, theft and selling unregistered securities, was sentenced to five and one half to twenty-five years incarceration and fined $10,000. However, Judge Ammer suspended the jail term and granted XXXXXX five years probation.

The sentencings concluded the trial court prosecution of the Dublin Securities principals. The only defendant not sentenced was Dublin Securities founder and initial president Clarence J. "Red" Eyerman, who had been indicted on 327 felony counts. Eyerman died in January 1995 after reaching a plea agreement with the special prosecutor in December 1994.

Descriptions of earlier stages of the Dublin Securities case appear in *Bulletins* 94:2, 94:4 and 95:4.

In addition, as reported in *Bulletin* 95:1, five former Dublin Securities salesmen were indicted in March 1995 and are scheduled for trial in the Franklin County Court of Common Pleas.



PUBLIC NOTICE

At 10:00 a.m. on June 3, 1996, the Ohio Division of Securities will hold a hearing regarding proposed changes to rules of the Division. The hearing will be held in the offices of the Ohio Division of Securities, 77 South High Street, 22nd Floor, Columbus, Ohio 43215.

The Division of Securities has proposed that the following rules be repealed:

Ohio Administrative Code rule **1301:6-1-02**, Forms.

Ohio Administrative Code rule **1301:6-1-04**, Inspection of Records.

The Division of Securities has also proposed that the following rule be amended:

Ohio Administrative Code rule **1301:6-3-09**, Registration by qualification; amended to revise the definition of liquidity for the purpose of determining permissible investments for Investment Companies.

Copies of the rules proposed for repeal and the amendment to rule 1301:6-3-09 may be obtained by contacting the Ohio Division of Securities, 77 South High Street, 22nd Floor, Columbus, Ohio 43215.

Comments to the Public Notice

The rules slated for repeal in accordance with the public notice are being eliminated pursuant to Governor Voinovich's mandate to reduce regulatory burdens imposed by state government. Because O.A.C. rule 1301:6-1-02 and O.A.C. rule 1301:6-1-04 appear to have been initially intended to reflect the statutory standards of the Division, they have been designated for repeal.

O.A.C. rule 1301:6-1-02, Forms, repeats a requirement that is stated throughout the Ohio Securities Act; specifically, that filings made under the Ohio Securities Act shall be made on forms designated by the Division. By repealing the rule, the Division intends to eliminate redundancy, but not to change the filing standard. Filings made with the Division must still be made on forms acceptable to the Division.

Similarly, the repeal of O.A.C. rule 1301:6-1-04, Inspection of Records, should not itself be seen as a change in the Division's policies regarding public records. The rule to be repealed had last been amended in 1976 and there have been substantial changes in records technology and case law in the intervening twenty years. Accordingly, the Ohio Securities Act, particularly R.C. section 1707.12, and Ohio case law should be the primary references for determining Division of Securities standards for inspection of records.

Registration Statistics

The table to the right sets out the number of registration filings received by the Division during the first quarter of 1996, compared to the number received during the first quarter of 1995, as well as the number of registration filings received by the Division in 1996 year to date, compared to the number received in 1995 year to date.

1707	*1Q'96*	*YTD '96*	*1Q'95*	*YTD '95*
.03(Q)	279	279	376	376
.03(W)	43	43	38	38
.04	0	0	0	0
.041	1	1	1	1
.06(A)(1)	27	27	35	35
.06(A)(2)	7	7	12	12
.06(A)(3)	7	7	5	5
.06(A)(4)	4	4	6	6
.09	122	122	136	136
.091	981	981	844	844
.39	7	7	13	13
.391/.09	1	1	0	0
.391/.091	6	6	9	9
.391/.03(O)	6	6	119	119
.391/.03(Q)	40	40	48	48
.391/.03(W)	1	1	0	0
.391/.06(A)(1)	0	0	0	0
.391/.06(A)(2)	0	0	0	0
.391/.06(A)(3)	0	0	0	0
.391/.06(A)(4)	0	0	0	0
Totals	1,532	1,532	1,642	1,642

Licensing Statistics

The table below sets out the number of Salesmen and Dealers licensed by the Division at the end of the first quarter of 1996, compared to the same quarter of 1995, as well as the number of Salesmen and Dealers licensed by the Division at the end of the second, third, and fourth quarters of 1995, compared to the same quarters of 1994.

	End of Q2 1995	End of Q2 1994	End of Q3 1995	End of Q3 1994	End of Q4 1995	End of Q4 1994	End of Q1 1996	End of Q1 1995
Number of Salesmen Licensed:	70,580	70,200	72,062	72,045	71,658	70,642	78,890	69,143
Number of Dealers Licensed:	1,873	1,842	1,891	1,894	1,863	1,759	1,928	1,837

Investor Education and Protection

Division Unveils Investor Education Video

On October 3, 1995, the Division of Securities held a press conference to introduce a new securities investor education video titled "What Every Investor Needs to Know." The 24-minute video and an accompanying color brochure explain how individual investors can recognize fraudulent practices. It also teaches investors how to prevent and resolve disputes with investment professionals.

The Division mailed approximately 200 copies of the video to cable television systems and main libraries throughout the state. The Division also sent color posters to the libraries to be posted to announce the availability of the video. The Investor Protection Trust, a non-profit organization providing customers with the facts they need to be informed investors, supplied the videos and brochures.

Division Establishes 1-800-788-1194 as Investor Protection Hotline

On March 4, 1996, Director of Commerce Donna Owens introduced the Division of Securities' Investor Protection Hotline. The toll-free number, 1-800-788-1194, is designed for use by investors to protect themselves from securities fraud. In general, the hotline permits investors to check the licensing status and disciplinary history of securities salespersons and securities dealers. An investor may also inquire as to whether a securities offering is in compliance with the appropriate registration or exemptive provisions of the Ohio Securities Act.

Specifically, the hotline's automated voice menu gives a caller four options. Under option 1, the caller receives information about the Division's complaint process and can request a formal complaint form. Under option 2, the caller can inquire as to the status of a complaint filed with the Division. Option 3 connects the caller to the Division's Licensing Section for inquiries as to the licensing status and disciplinary history of securities salespersons and securities dealers. Finally, option 4 connects the caller to the Division's Records Section to check whether a registration or exemptive filing has been made on a particular securities offering.

OHIO SECURITIES BULLETIN

Ohio Division of Securities
77 South High Street
22nd Floor
Columbus, Ohio 43266-0548

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