OHIO SECURITIES BULLETIN

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Bob Taft, Governor of Ohio | Gary C. Suhadolnik, Director of Commerce | Thomas E. Geyer, Commissioner of Securities

An Introduction to Am. Sub. H.B. 695

By Thomas E. Geyer

On December 17, 1998, Governor George V. Voinovich bolstered and updated the Ohio Securities Act (the "Act") by signing Am. Sub. H.B. 695 into law. The primary impact of the bill, sponsored by Representative Dennis Stapleton, is to establish state level oversight of certain investment advisers and investment adviser representatives operating in Ohio. This new oversight will be administered and enforced by the Ohio Division of Securities (the "Division"). In all, 37 sections and subsections of the Act were added or amended by Am. Sub. H.B. 695. Subject to certain "phase-in" provisions applicable to investment advisers and investment adviser representatives, the new statutory provisions take effect on March 18, 1999.

This issue of the *Ohio Securities Bulletin* is devoted to a discussion of the major issues that spring from Am. Sub. H.B. 695. The following articles address investment adviser aspects of the bill: "The Definitions of 'Investment Adviser' and 'Investment Adviser Representative;'" "IA and IAR Licensing and Notice Filing Obligations;" "The $25,000,000 Question For Ohio Investment Advisers;" and "Phase-In Provisions of Am. Sub. H.B. 695." The following articles address non-investment adviser aspects of the bill: "Rule 506 Amendments and Ohio's Model Accredited Investor Exemption;" and "Securities Notice Filings Under New R.C. 1707.092." The articles entitled "An Examination of the

Continued on page 2

Rule 506 Amendments and Ohio's Model Accredited Investor Exemption

By Michael P. Miglets

Am. Sub. H.B. 695 will create a new filing procedure for Rule 506 offerings in Ohio. Separately, the bill adds a new exemption permitting general solicitations during offerings limited to accredited investors.

New Companion Exemption for Rule 506 Offerings

Prior to the enactment of the National Securities Markets Improvement Act of 1996 ("NSMIA") on October 11, 1996, issuers relying on either section 4(2) of the Securities Act of 1933 ("section 4(2)") or Rule 506 of Regulation D ("Rule 506") were required to file sales reports within sixty days of each transaction on the Division's Form 3-Q pursuant to R.C. §1707.03(Q). The Division's administrative rules permitted all sales, within a sixty day period, to be reported on a single filing. Commissions, discounts and other remuneration were limited to an aggregate of 10% and could be paid only to licensed securities dealers.

In response to the uniformity mandate of NSMIA, the Division adopted an administrative rule in April 1997 permitting issuers relying on Rule 506 to file either: 1) the Form D, with sales information for Ohio transactions on the appendix, or 2) the Division's Form 3-Q. As NSMIA preempted state regulation of offerings of "covered securities" except for notice filing requirements and actions involving fraud, the 10% limit on commis-

Continued on page 3

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Table of Contents

An Introduction to Am. Sub. H.B. 695 1

Rule 506 Amendments and Ohio's Model Accredited Investor Exemption 1

Definitions of "Investment Adviser" and "Investment Adviser Representative" 4

Are You an Investment Adviser Under Ohio Law? 6

Are You an Investment Adviser Representative Under Ohio Law? 9

IA and IAR Licensing and Notice Filing Obligations 11

An Examination of the Changes to the Anti-Fraud Standards and Criminal Sanctions of Chapter 1707 in the Wake of Am. Sub. H.B. 695 14

New Laws to Impact Enforcement of Securities Provisions 18

Table of Contents continued on page 2

The Division of Securities is an Equal Opportunity Employer and Service Provider

Am. Sub. H.B. 695

Continued from page 1

Changes to the Anti-Fraud Standards and Criminal Sanctions of Chapter 1707 in the Wake of Am. Sub. H.B. 695" and "New Law to Impact Enforcement of Securities Provisions" discuss the new anti-fraud standards applicable to advisers, the increased criminal penalties for all violations of the Act and other enforcement aspects. Also, two charts are included: one lists the sections of the Act added or amended by Am. Sub. H.B. 695, and the other lists the Act's licensing fees. Finally, a letter from Lori Richards of the Office of Compliance, Inspections and Examinations of the Securities and Exchange Commission regarding the supervision of "independent contractors" is reprinted with the consent of the Commission.

Am. Sub. H.B. 695 is landmark legislation in the history of the Act and represents the Division's response to the National Securities Markets Improvement Act of 1996 ("NSMIA"). The investment adviser aspects of the bill are based primarily on the federal Investment Advisers Act of 1940, which governs the operation of all investment advisers operating in Ohio prior to March 18, 1999. This should provide for a smooth transition for those advisers who shift from federal to state oversight. The non-investment adviser portions of the bill, for the most part, bring the Act in line with the changes to the state-federal securities regulatory framework effected by NSMIA.

Several aspects of Am. Sub. H.B. 695 are not covered by separate articles in this issue of the *Bulletin*, but nonetheless deserve mention. First, new R.C. 1707.093 permits the Division to, by rule, provide for the electronic filing or submission of any form, document, material or information that is required or permitted to be filed with or submitted to the Division. Backed by this enabling provision, the Division expects to develop an "EDGAR"-type securities registration and exemption filing system during 1999.

Second, R.C. 1707.20, the Division's rule making authority, has been amended to allow the Division to consider the interests of "clients or prospective clients."

Third, the "bringing together" dealer licensing exception set out in R.C. 1707.431 has been amended to exclude investment advisers and investment adviser representatives.

Fourth, R.C. 1707.46 has been amended to extend the authority of the Commissioner of Securities to investment advisers and investment adviser representatives.

Finally, R.C. 1707.48 has been amended to give the Division rule making authority regarding certain record retention issues.

Am. Sub. H.B. 695 establishes important consumer protections and also serves to preserve and enhance the integrity of the Ohio securities marketplace. The Act now provides for oversight of those who sell advice regarding securities, in addition to those who sell securities. The Division is committed to efficient administration and diligent enforcement of the Act in order to promote an honest and vibrant securities market in Ohio.

Mr. Geyer is the Commissioner of Securities.

Table of Contents
(Continued)

The $25,000,000 Question for Ohio Investment Advisors 19

Securities Notice Filings Under New R.C. 1707.092 20

Phase-In Provisions of Am. Sub. H.B. 695 20

Sections of the Ohio Securities Act Added or Amended by Am. Sub. H.B. 695 22

Licensing Fees Under the Ohio Securities Act 23

Supervision of Independent Contractors 24

Investor Protection and Education 25

Capital Formation Statistics 26

Registration and Licensing Statistics 27

OHIO SECURITIES BULLETIN

Desiree T. Shannon, 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.

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Ohio Division of Securities

77 South High Street, 22nd Floor • Columbus, Ohio 43215

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Rule 506 Amendments

Continued from page 1

sions, discounts and other remuneration no longer applied to offerings under Rule 506. Filing procedures and the dealer compensation limit of 10% were not changed for offerings under section 4(2) of the Securities Act of 1933, as NSMIA did not include offerings under section 4(2) as a "covered security." As R.C. §1707.03(Q) set forth statutory requirements for the filing requirements and fees for sales reports in Ohio, the Division was not authorized to amend the timing of filings or the required fees for Rule 506 offerings by administrative rule.

Am. Sub. H.B. 695 will make the filing requirements in Ohio for issuers relying on Rule 506 consistent with the timing of filings under Regulation D. The reference to rules enacted under section 4(2) in R.C. §1707.03(Q) will be deleted. The exemption under R.C. §1707.03(Q) will be available only to issuers relying on section 4(2). The sixty-day post-sale filing requirement, the 10% limit on dealer compensation and the Division's administrative rules will all remain unchanged under Am. Sub. H.B. 695. Issuers relying on section 4(2) must continue to file sales reports on the Division's Form 3-Q.

A new notice filing provision for offerings exempt under Rule 506 will be added in R.C. §1707.03(X). This provision will require issuers relying on Rule 506 to file a Form D within fifteen days of the first sale with a consent to service, if required under R.C. §1707.11, and a $100.00 filing fee. While the time to submit filings has been reduced to fifteen days from sixty days after the first sale, additional sales reports will no longer be required for offerings under Rule 506. Once the $100.00 filing fee is received, issuers will be permitted to file amendments to the Form D without additional fees. There is no limit on commission, discounts, or other remuneration paid in connection with offerings under Rule 506, but persons receiving compensation must be licensed with the Division under R.C. §1707.14 or the sale must qualify as a de minimus transaction by an associated person under section 15 of the Securities Exchange Act of 1934. Issuers will still be able to make sales in Ohio through officers, directors, partners, managers, members and trustees under R.C. §§1707.01(E)(1)(a) and 1707.14 provided that no commissions or other compensation are paid for sales.

Model Accredited Investor Exemption

A new exemption for sales to accredited investors as defined under Rule 501 of Regulation D will be added under Am. Sub. H.B. 695. Unlike Rules 505 and 506 of Regulation D, the exemption under R.C. §1707.03(Y) will permit general solicitations after a filing with the Division. The exemption is similar to Section 25102(M) of the California Corporation Code and the NASAA Model Accredited Investor Exemption. There is no dollar limitation set on the size of the offering under R.C. §1707.03(Y), but Rule 504 of Regulation D or Rule 1001 of the Securities and Exchange Commission may impose a $1,000,000.00 or $5,000,000.00 limit on the size of the offering. The general solicitations permitted under this exemption may allow issuers to use ACE-NET or other Internet connections for sales in Ohio.

To qualify for the exemption, an issuer must make a pre-sale filing on the Division's Form 3-Y with a consent to service, if required under R.C. §1707.11, and pay a $100.00 filing fee. Copies of all offering materials and notices must be submitted with the Form 3-Y. All offering materials must clearly indicate that the offering is limited solely to accredited investors. Telephone solicitations are permitted, but the issuer or dealer must have a reasonable belief that the prospective investor is an accredited investor. Securities sold pursuant to this exemption will be restricted securities, and may be resold only to other accredited investors or after registration of the securities by the Division. As with Rule 505 offerings, issuers or dealers that have been the subject of sanctions for past securities law violations may be disqualified from relying on the exemption. The Division may waive the disqualification upon a showing of good cause. There is no statutory limit on the amount of commissions or other compensation which may be paid for sales under this exemption, but R.C. 1707.14(A)(1) requires that any person receiving compensation be licensed by the Division. Issuers may also offer and sell securities directly through officers, directors, employees, partners, managers and members provided compensation is not paid for the sale of securities.

Amendments to R.C. §1707.391 in Am. Sub. H.B. 695 will permit "excusable neglect" filings for issuers relying on the exemptions under R.C. §1707.03(X) and R.C. §1707.03(Y). Issuers making an "excusable neglect" filing for an offering solely to accredited investors, must file a Form 391 and the Form 3-Y with required exhibits. The filing fee will include the $100.00 filing fee under R.C. §1707.03(Y), unless previously submitted, and the $100.00 fee under R.C. §1707.391. The affidavits required under Ohio Administrative Code 1301:6-3-391(D) also must be filed. For sales under the accredited investor exemption, "excusable neglect" will be presumed if the Form 391/Form 3-Y filing is made within six months of the earliest sale. For Rule 506 offerings, only the Form D, the consent to service, if required under R.C. §1707.11, the $100.00 filing fee and the $100.00 fee under R.C. §1707.391 must be filed to make a corrective filing. There is no time limit set forth in the Division's Administrative Rules defining "excusable neglect" for Rule 506 offerings, but NSMIA indicates that delays in the payments of fees or the underpayment of fees should be promptly submitted.

Mr. Miglets serves as the Division's Control Bid Attorney and also reviews registration and exemption filings.

Definitions of "Investment Adviser" and "Investment Adviser Representative"

By Thomas E. Geyer

The starting points for the adviser analysis are the definitions of "investment adviser" and "investment adviser representative." The definitions of these terms under Ohio law are virtually identical to the definitions of the terms under federal law.

Definition of "Investment Adviser"

The definition of "investment adviser" is contained in R.C. 1707.01(X), as amended by Am. Sub. H.B. 695, which states:

> (X)(1) "Investment adviser" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as a part of regular business, issues or promulgates analyses or reports concerning securities.
>
> (2) "Investment adviser" does not mean any of the following:
>
> (a) Any attorney, accountant, engineer, or teacher, whose performance or investment advisory services described in division (X)(1) of this section is solely incidental to the practice of the attorney's, accountant's, engineer's, or teacher's profession;
>
> (b) A publisher of any bona fide newspaper, news magazine, or business or financial publication of general and regular circulation;
>
> (c) a person who acts solely as an investment adviser representative;
>
> (d) a bank holding company, as defined in the "Bank Holding Company Act of 1956," 70 Stat. 133, 12 U.S.C. 1841, that is not an investment company;
>
> (e) a bank, or any receiver, conservator, or other liquidating agent of a bank;
>
> (f) any licensed dealer or licensed salesperson whose performance of investment advisory services described in division (X)(1) of this section is solely incidental to the conduct of the dealer's or salesperson's business as a licensed dealer or licensed salesperson and who receives no special compensation for the services;
>
> (g) any person, the advice, analyses, or reports of which do not relate to securities other than securities that are direct obligations of, or obligations guaranteed as to principal or interest by, the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest, and that have been designated by the secretary of the treasury as exempt securities as defined in the "Securities Exchange Act of 1934," 48 Stat. 881,15 U.S.C 78c;
>
> (h) any person that is excluded from the definition of investment adviser pursuant to section 202(a)(11)(A) to (E) of the "Investment Advisers Act of 1940," 15 U.S.C. 80b-2(a)(11), or that has received an order from the securities and exchange commission under section 202(a)(11)(F) of the Investment Adviser Act of 1940," 15 U.S.C. 80b-2(a)(11)(F), declaring that the person is not within the intent of section 202(a)(11) of the Investment Advisers Act of 1940.
>
> (i) any other person that the division designates by rule, if the division finds that the designation is necessary or appropriate in the public interest or for the protection of investors or clients and consistent with the purposes fairly intended by the policy and provisions of this chapter.

Use the flow chart on pages 6 and 7 (and accompanying notes) to walk through the elements of this definition.

Definition of "Investment Adviser Representative"

The definition of "investment adviser representative" is contained in new R.C. 1707.01(II), which states:

(II)(1) "Investment adviser representative" means a supervised person of an investment adviser, provided that the supervised person has more than five clients who are natural persons other than excepted persons defined in division (KK) of this section, and that more than ten per cent of the supervised person's clients are natural persons other than excepted persons defined in division (KK) of this section. "Investment adviser representative" does not mean any of the following:

(a) a supervised person that does not on a regular basis solicit, meet with, or otherwise communicate with clients of the investment adviser;

(b) a supervised person that provides only investment advisory services described in division (X)(1) of this section by means of written materials or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts;

(c) any other person that the division designates by rule, if the division finds that the designation is necessary or appropriate in the public interest or for the protection of investors or clients and is consistent with the provisions fairly intended by the policy and provisions of this chapter.

(2) For the purpose of the calculation of clients in division (II)(1) of this section, a natural person and the following persons are deemed a single client: any minor child of the natural person; any relative, spouse, or relative of the spouse of the natural person who has the same principal residence as the natural person; all accounts of which the natural person or the persons referred to in division (II)(2) of this section are the only primary beneficiaries; and all trusts of which the natural person or persons referred to in division (II)(2) of this section are the only primary beneficiaries. Persons who are not residents of the United States need not be included in the calculation of clients under division (II)(1) of this section.

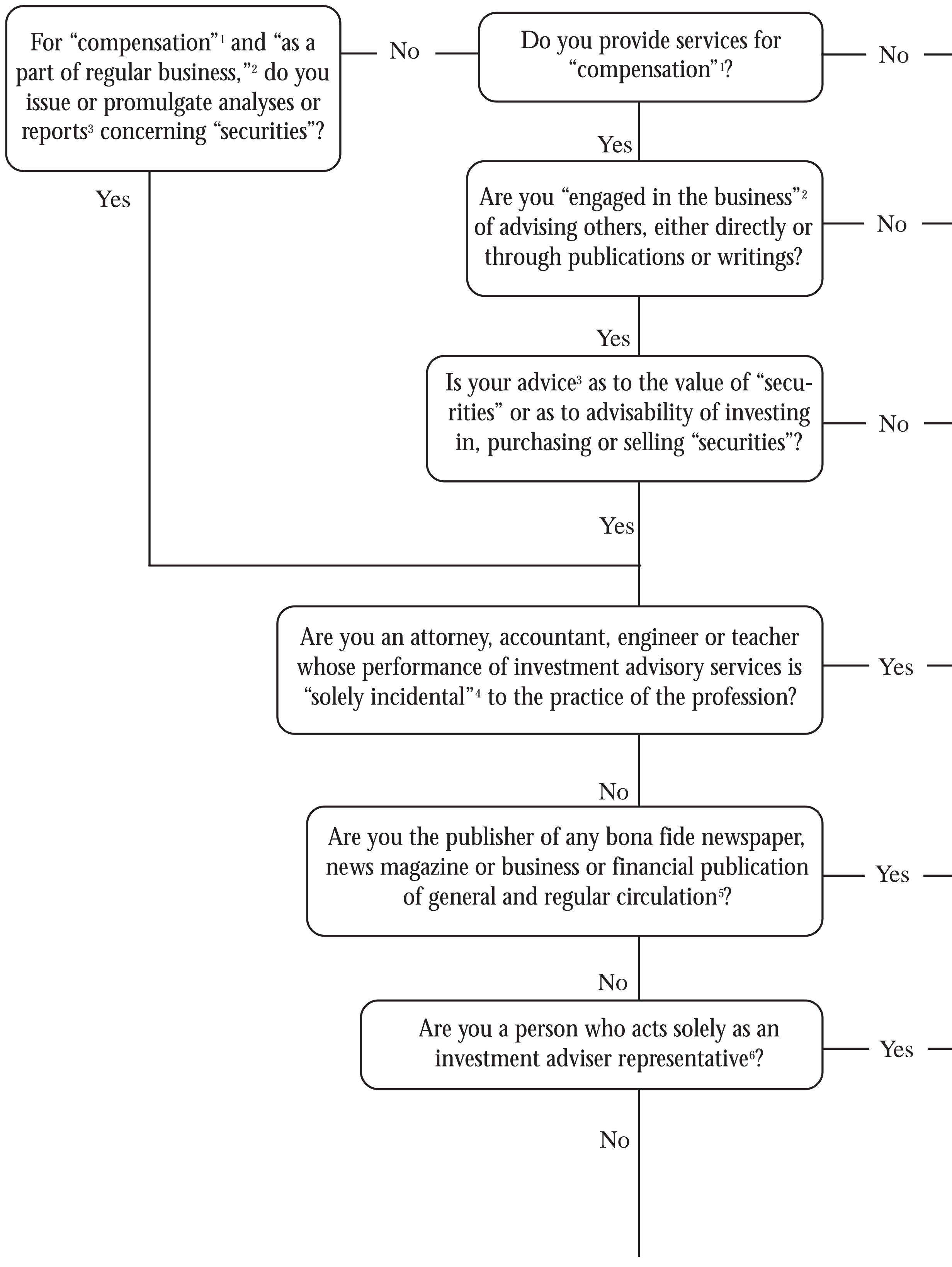
(3) If subsequent to the effective date of this amendment, amendments are enacted or adopted defining "investment adviser representative" for purposes of the Investment Advisers Act of 1940 or additional rules or regulations are promulgated by the Securities and Exchange Commission regarding the definition of "investment adviser representative" for purposes of the Investment Advisers Act of 1940, the division of securities shall, by rule, adopt the substance of the amendments, rules, or regulations, unless the division finds that the amendments, rules, or regulations are not necessary for the protection of investors or in the public interest.

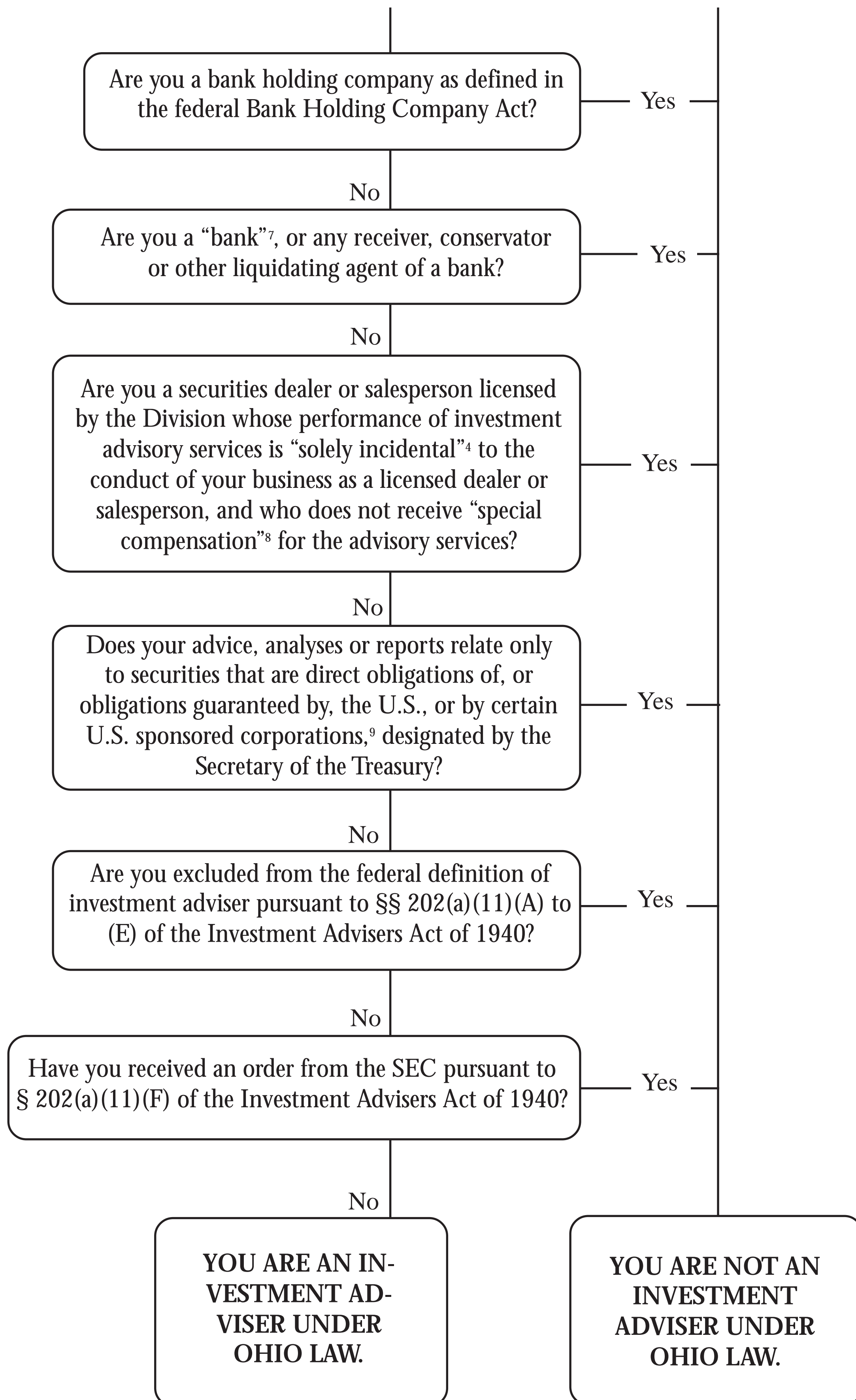
Use the flow chart on page 9 (and accompanying notes) to walk through the elements of this definition.

ARE YOU AN INVESTMENT ADVISER UNDER OHIO LAW?

(R.C. 1707.01(X))

(The accompanying notes are an integral part of this flowchart.)




Are you a bank holding company as defined in the federal Bank Holding Company Act?
Yes
No
Are you a "bank"[7], or any receiver, conservator or other liquidating agent of a bank?
Yes
No
Are you a securities dealer or salesperson licensed by the Division whose performance of investment advisory services is "solely incidental"[4] to the conduct of your business as a licensed dealer or salesperson, and who does not receive "special compensation"[8] for the advisory services?
Yes
No
Does your advice, analyses or reports relate only to securities that are direct obligations of, or obligations guaranteed by, the U.S., or by certain U.S. sponsored corporations,[9] designated by the Secretary of the Treasury?
Yes
No
Are you excluded from the federal definition of investment adviser pursuant to §§ 202(a)(11)(A) to (E) of the Investment Advisers Act of 1940?
Yes
No
Have you received an order from the SEC pursuant to § 202(a)(11)(F) of the Investment Advisers Act of 1940?
Yes
No
YOU ARE AN INVESTMENT ADVISER UNDER OHIO LAW.
YOU ARE NOT AN INVESTMENT ADVISER UNDER OHIO LAW.

NOTES TO "ARE YOU AN INVESTMENT ADVISER UNDER OHIO LAW?"

1. "Compensation" is construed broadly and means the receipt of any economic benefit, whether in the form of an advisory fee or some other fee relating to the total services rendered, commissions, or some combination of the foregoing. It is not necessary that an adviser's compensation be paid directly by the person receiving investment advisory services, but only that the investment adviser receive compensation from some source for the services. See SEC Release No. IA-1092, § II.A.3. (October 8, 1987).

2. "As a part of regular business" and "engages in the business" both require a "business" element and are to be construed in the same manner. The determination to be made is whether the degree of the person's advisory activities constitutes being "in the business." Whether a person giving advice about securities for compensation would be "in the business" depends upon all relevant facts and circumstances. In general, a person is considered to be "in the business" if the person (i) holds himself or herself out as an investment adviser or as one who provides investment advice; or (ii) receives any separate or additional compensation that represents a clearly definable charge for providing advice about securities; or (iii) on anything other than rare, isolated and non-periodic instances, provides specific investment advice. See SEC Release No. IA-1092, § II.A.2. (October 8, 1987).

3. The advice, report or analyses need not be with respect to particular securities. Rather, for example, advice concerning the relative advantages and disadvantages of investing in securities in general as compared to other investments would be "advice" for purposes of this prong of the definition. See SEC Release No. IA-1092, § II.A.1. (October 8, 1987).

4. Whether an exclusion from the definition of investment adviser is applicable depends on the relevant facts and circumstances. For example, an attorney or accountant who holds himself or herself out to the public as providing financial planning or advisory services would not appear to fall within this "solely incidental" exclusion. See SEC Release No. IA-1092, § II.B. (October 8, 1987). In general, three factors are relevant to the determination of whether the "solely incidental" exclusion is available: (i) whether the person holds himself or herself out to the public as an investment adviser, financial planner or other provider of advisory services; (ii) whether the advisory services are rendered in connection with and reasonably related to the professional services; (iii) whether the fee charged for advisory services is based on the same factors as those used to determine the fee for the professional services. See, e.g., Hauk, Soule & Fasani, P.C., SEC No-Action Letter (April 2, 1986); Milton O. Brown, P.C., SEC No-Action Letter (August 28, 1983).

5. This exclusion does not include bulletins that are issued from time to time in response to episodic market activity, advertisements that "tout" particular issues, advertised lists of stocks "that are sure to go up" that are sold to individual purchasers or publications distributed as an incident to personalized investment service. Lowe v. SEC 472 U.S. 181 (1985). The Lowe court did hold that this exclusion was applicable to a newsletter that was "completely disinterested" and "offered to the general public on a regular schedule." Id. at 206. The definition of "investment adviser" encompasses publishers as well as authors. See SEC Release No. IA-563 (January 10, 1977). This exclusion, if it is available, would extend to authors.

6. A person may act as both an investment adviser and an investment adviser representative. See R.C. 1707.161(B)(2). However, a person who acts solely as an investment adviser representative is excluded from the definition of investment adviser. "Investment adviser representative" is defined in R.C. 1707.01(II).

7. "Bank" is defined in R.C. 1707.01(O). This exclusion extends to an employee of a bank to the extent that the employee is acting in his or her capacity as an employee. See, e.g., Harbor Springs State Bank, SEC No-Action Letter (March 3, 1986). This exclusion does not extend to a bank employee acting in his or her individual capacity. Id.

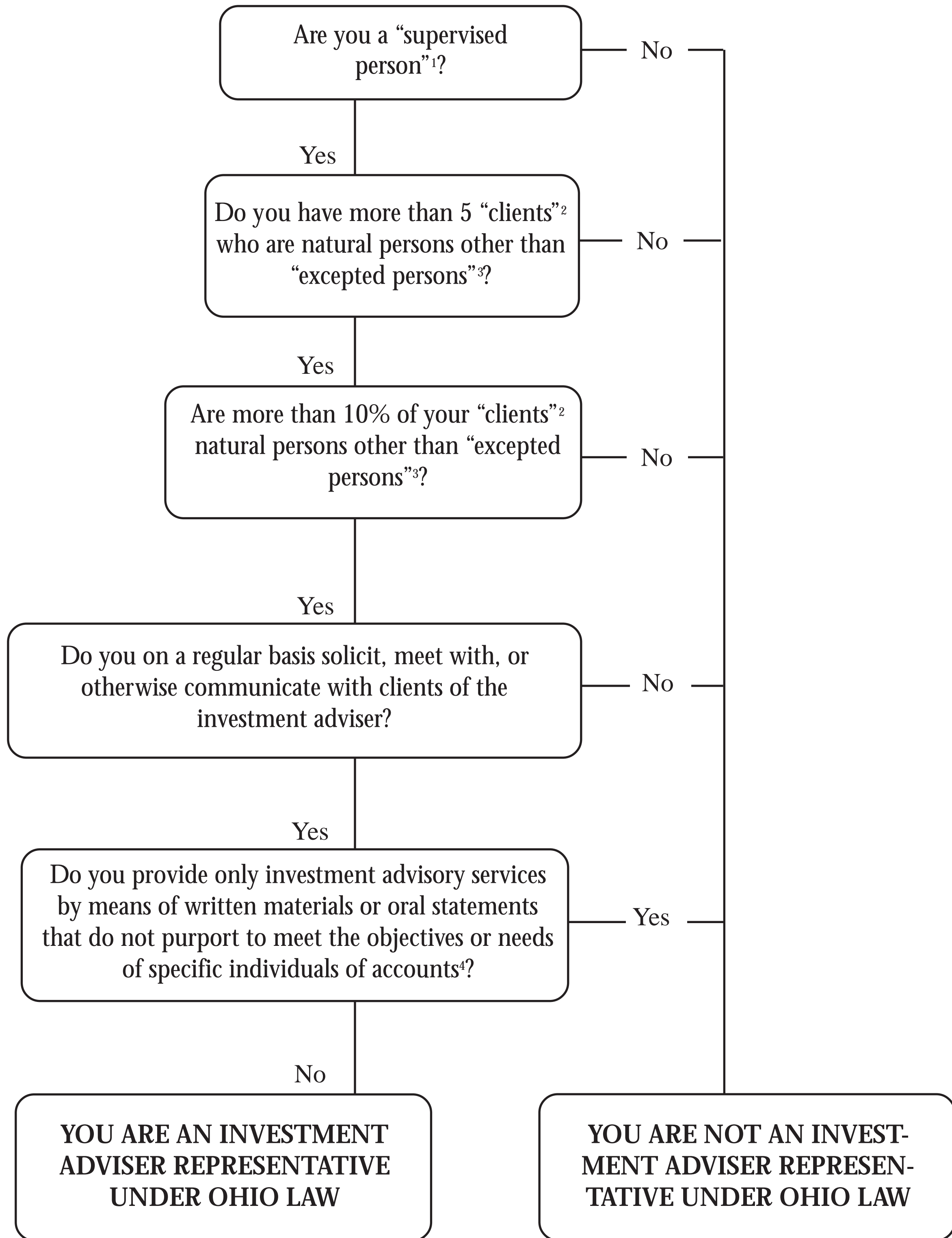
8. "Special compensation" for investment advice is compensation to the dealer or salesperson in excess of that which he or she would be paid for providing a brokerage or dealer service alone. Consequently, "special compensation" exists where there is a clearly definable charge for investment advice. See SEC Release No. IA-626, § V. (April 27, 1978).

9. For example, the Government National Mortgage Association ("GNMA").

ARE YOU AN INVESTMENT ADVISER REPRESENTATIVE UNDER OHIO LAW?

(R.C. 1707.01(II))

(The accompanying notes are an integral part of this flowchart.)



NOTES TO "ARE YOU AN INVESTMENT ADVISER REPRESENTATIVE UNDER OHIO LAW"?

1. "Supervised person" is defined in R.C. 1707.01(JJ) to mean a natural person who is any of the following:

   (1) a partner, officer, or director of an investment adviser, or other person occupying a similar status or performing similar functions with respect to an investment adviser; or

   (2) an employee of an investment adviser; or

   (3) a person who provides investment advisory services on behalf of the investment adviser and is subject to the supervision and control of the investment adviser.

   This definition of "supervised person" matches the federal definition of "supervised person" contained in section 202(a)(25) of the Investment Adviser Act of 1940. The definition of "investment adviser representative" contained in R.C. 1707.01(II) tracks the definition of that term set out in SEC Rule 203A-3(a) promulgated under the Investment Advisers Act of 1940.

2. R.C. 1707.01(II)(2) lists certain persons who are deemed to be a single client for purposes of this definition. R.C. 1707.01(II)(2) tracks SEC Rule 203(b)(3)-1 promulgated under the Investment Advisers Act of 1940.

3. "Excepted person" is defined in R.C. 1707.01(KK), and generally means a person who has: (i) at least $750,000 under the management of the adviser; or (ii) has a net worth (jointly with spouse) of more than $1,500,000; or (iii) is a "qualified purchaser" as defined in R.C. 1707.01(LL); or (iv) is an executive officer, director, trustee, general partner, or person serving in a similar capacity of the investment adviser; or (v) is a non-clerical employee of the investment adviser who participates in the investment activities of the adviser, and has so participated for at least 12 months. This definition of "excepted person" tracks the SEC's definition of "excepted person" contained in SEC Rule 203A-3(a)(3)(i) promulgated under the Investment Advisers Act of 1940, which in turn is based on SEC Rule 205-3(d)(1) promulgated under the Investment Advisers Act of 1940.

   "Qualified purchaser" is defined in R.C. 1707.01(LL), and generally means a natural person who owns not less than $5,000,000 in "investments" or who owns and invests on a discretionary basis not less than $25,000,000 in "investments." This definition of "qualified purchaser" is based on the SEC's definition of "qualified purchaser" set out in SEC Rule 205-3(d)(1)(ii)(B) promulgated under the Investment Advisers Act of 1940. For purposes of this definition of "qualified purchaser," the Division defines "investments" to mean "investments" as defined in section 2(a)(51)(A) of the Investment Company Act of 1940.

4. This is defined as "impersonal investment advice" by the SEC. See SEC Rule 203A-3(a)(3)(ii) promulgated under the Investment Advisers Act of 1940.

IA and IAR Licensing and Notice Filing Obligations

By Deborah Dye Joyce

As you have been reading throughout this issue of the *Ohio Securities Bulletin*, Am. Sub. H.B. 695, signed by Governor Voinovich on December 17, 1998 and effective as of March 18, 1999, gives the Ohio Division of Securities (Division) oversight of certain Investment Advisers ("IAs") and Investment Adviser Representatives ("IARs") in Ohio. This article will address when a person may act as an Investment Adviser or Investment Adviser Representative in Ohio, as well as types of filings that must be submitted to the Division.

It is important to note that the Investment Adviser and Investment Adviser Representative licensing provisions of Am. Sub. H.B. 695, sections 1707.141, 1707.151, and 1707.161, parallel the provisions of existing Revised Code sections 1707.14, 1707.15, and 1707.16 regarding licensing of securities dealers and salespersons. Similarities exist throughout the new licensing provisions, such as periods of effectiveness, renewal procedures and the "good business repute" standard. Also, the Division has developed companion administrative rules for implementing the statutory provisions of Am. Sub. H.B. 695.

In reading the following, keep in mind that three categories of filings will be discussed: (1) Investment Adviser Notice Filings; (2) Investment Adviser License Applications; and (3) Investment Adviser Representative License Applications.

The section of the National Securities Markets Improvement Act of 1996 (NSMIA) entitled the "Investment Adviser Supervision Coordination Act," became effective July 8, 1997, and generally reallocated regulatory oversight of Investment Advisers with "assets under management" of greater than $25 million to the SEC and those Investment Advisers with "assets under management" of less than $25 million to the states. States are therefore preempted from regulating those Investment Advisers that are registered pursuant to Section 203 of the Investment Advisers Act of 1940 ('40 Act) and those persons excepted from the federal definition of "Investment Adviser."

Who can act as an Investment Adviser in Ohio? New section 1707.141 contains the controlling provisions of who may act as an Investment Adviser in Ohio, and parallels existing Revised Code section 1707.14, the controlling provision regarding who may act as a securities dealer in Ohio. Section 1707.141(A) provides that no person shall act as an Investment Adviser in Ohio unless the person is: (1) licensed by the Division; (2) registered with the SEC and makes a notice filing with the Division; or (3) fits in one or both of the two exceptions from Investment Adviser licensure.

The licensing exceptions apply where the person has no "place of business" in Ohio and has only certain specified institutional clients, or has no "place of business" in Ohio and has only a de minimus number of clients during the preceding twelve months. These licensing exceptions are self-executing, meaning that the person is not required to make a filing with the Division. *See* section 1707.141(A).

Under section 1707.141(A)(2), an Investment Adviser registered pursuant to Section 203 of the '40 Act and who makes a notice filing in Ohio may act as an Investment Adviser in Ohio —but what are the standards for federal registration and what constitutes a notice filing?

Generally, in order to be registered with the SEC, the person must meet one— or more—of the following ten provisions. (These ten provisions regarding SEC registration eligibility comprise the Schedule I to the Form ADV):

- The person has "assets under management" of $25 million or more. (Originally, the threshold in the NSMIA was $25 million or more. The threshold was increased in Rule 203A-1(a) under the '40 Act to $30 million or more. Review, as well, the safe harbor provisions of Rule 203A-1(b) under the '40 Act which, together with Rule 203A-1(a), make registration with the SEC optional for Investment Advisers having "assets under management" between $25 million and $30 million.) *See* "The $25 Million Question for Ohio Investment Advisers" elsewhere in this issue of the *Bulletin.*

- The person has its principal office and place of business in Wyoming, the remaining state not currently regulating Investment Advisers. Two other states, Colorado and Iowa, did not have regulatory oversight of Investment Advisers and Investment Adviser Representatives at the time the NSMIA was passed, but began regulating Investment Advisers and Investment Adviser Representatives on January 1, 1999;

- The person has its principal office and place of business outside the United States;

- The person is an Investment Adviser to a registered investment company, a business inherently national in nature;

- The person is a nationally recognized statistical rating organization (NRSRO.) The Division understands that a determination of what constitutes a NRSRO is made by the SEC's Division of Market Regulation via no-action letters;

- The person is a pension consultant qualifying for the exemption in Rule 203A-2(b) under the '40 Act;

- The person is an Investment Adviser that controls, is controlled by, or is under common control with, an Investment Adviser eligible to maintain its SEC registration, and whose principal office and place of business are the same as the eligible Investment Adviser. See Rule 203A-2(c) under the '40 Act;

- The person is a newly formed Investment Adviser relying on Rule 203A-2(d) under the '40 Act. Generally, the person may register with the SEC if it reasonably believes that within 120 days of registering, it would otherwise be eligible to

Continued on page 12

IA and IAR Licensing

Continued from page 11

register with the SEC. The person must undertake to withdraw its SEC registration, if, after the 120th day, the person would be prohibited by Rule 203A(a) from registering with the SEC;

- The person has received an SEC order permitting SEC registration because it would be an unfair burden on interstate commerce or otherwise inconsistent with the purposes intended by the '40 Act;
- The person is a multi-state Investment Adviser relying on Rule 203A(e) under the '40 Act. Generally, the person would be required by the laws of thirty or more states to register as an Investment Adviser.

Despite the NSMIA's preemption provisions with regard to the states registering, licensing or qualifying federally registered Investment Advisers, the NSMIA specifically preserved the states' rights to receive from federally registered Investment Advisers, documents filed with the SEC, filing fees, and consents to service of process. This preservation of states' rights, in general, constitutes the notice filing prescribed by section 1707.141(B).

More specifically, Ohio Administrative Code (OAC) 1301:6-3-141(A) provides that a notice filing is comprised of a Form ADV, a filing fee of $100, documents filed with the SEC, and a consent to service of process. The Form ADV is used as both a registration document with the SEC and states, and may be used, in part, as a disclosure document to clients. The Form ADV contains nine schedules, not all of which may need to be filed by the person. Some of the more frequently used schedules include Schedule G, a balance sheet, Schedule H which may be used by sponsors of wrap fee programs to fulfill disclosure requirements, and Schedule I which pertains to SEC registration eligibility. Part II of the Form ADV may be used to satisfy the requirements of the "Brochure Rule," noted later in this article.

The Form ADV is a common thread, as you will see, for both notice filings and Investment Adviser License Applications. Likewise, the other components of the notice filing, the fee, consent to service of process and other documents filed with the SEC are also components of Investment Adviser License Applications. Unlike Investment Adviser License Applications, a notice filing is not a "request" to the Division. It is merely a notice to the Division that the federally registered Investment Adviser is operating in Ohio.

Notice filings are effective for the calendar year, thus expiring on December 31st, unless renewed. Renewal filings should therefore be submitted to the Division prior to expiration. The Division may, however, accept notice filings through January 10th, backdating effectiveness to January 1st. Filings received during the first ten days in January will incur an extra fee of $50 in addition to the regular $100 filing fee. *See* section 1707.17(A)(3) of Am. Sub. H.B. 695 and OAC 1301:6-3-141(F).

Am. Sub. H.B. 695 contains important "phase-in" provisions with regard not only to notice filings, but with regard to Investment Adviser and Investment Adviser Representative License Applications as well. Specifically, those persons subject to the requirements of sections 1707.141, 1707.151, and 1707.161 have until December 31, 1999 to comply.

Consequently, if persons subject to sections 1707.141, 1707.151, and 1707.161 submit the applicable filing and fee to the Division prior to October 1, 1999, the initial effective period will not only be through the remainder of 1999, but through December 31, 2000. <u>Without the "phase-in," persons subject to compliance with Sections 1707.141, 1707.151, and 1707.161 would have to immediately comply</u>. Note however, with regard to Investment Adviser License Applicants in Ohio, the "phase-in" provisions <u>only</u> pertain to those Investment Advisers currently registered as an investment adviser with the SEC. (See "Phase-In Provisions of Am. Sub. H.B. 695" elsewhere in this issue of the *Bulletin*.)

Pursuant to section 1707.141(A)(1), a person not a federally registered Investment Adviser, not able to place its reliance on one of the two licensing exceptions, but desiring to act as an Investment Adviser in Ohio, must apply for licensure. Section 1707.151 of Am. Sub. H.B. 695 provides that an Investment Adviser License Application shall consist of not only the Form ADV, filing fee, consent to service of process and other documents filed with the SEC (the notice filing components), but additional information as well.

Specifically, the applicant for Investment Adviser licensure must also submit information notifying the Division of its "designated principal" (Form ADV-OH/DP) and the identity of the Investment Adviser Representatives employed by, or associated with, the applicant (ADV-OH/IAR.) (Keep in mind that an Investment Adviser may only employ Investment Adviser Representatives duly licensed or excepted from licensure in Ohio. *See* section 1707.151(F).)

Since an Investment Adviser may be a natural person or an entity, an entity applying for licensure must designate a natural person to meet the minimum competency standard. The natural person Investment Adviser or Designated Principal must also submit a fingerprint card to the Division, if one is not already on file with the NASD or CRD.

Just as with existing licensing provisions for securities dealers, the natural person Investment Adviser or Designated Principal of an Investment Adviser must submit evidence that a minimum competency standard has been met. The minimum competency standard for advisers may be met in one of three ways.

First, the minimum competency standard may be met if the natural person submits evidence that he or she has passed one or more of eleven specified NASD examinations set forth in OAC 1301:6-3-151(B). The specified NASD examinations are the Series 6, 7, 8, 22, 24, 26, 39, 62, 63, 65, or 66.

Second, the minimum competency standard may be met if the natural person submits evidence that he or she has achieved one or more of five specified professional designations: the Certified Financial Planner (CFP), Chartered Financial Analyst (CFA), Chartered Financial Consultant (CFC), Chartered Investment Counselor (CIC), or Certified Public Accountant/Personal Financial Specialist (CPA/PFS).

Lastly, the minimum competency standard may be met if the natural person has been continuously registered as an in-

vestment adviser with the SEC on or before March 18, 1996.

Again, as with existing licensing provisions for securities dealers and salespersons, the Division is required by statute to make a determination of the "good business repute" of the applicant. In making this determination, the Division will consider the eleven factors enumerated in OAC 1301:6-3-19(D) such as the nature of acts and practices of the applicant, the existence of sanctions against the applicant, and whether the applicant has engaged in any conduct which would reflect on the applicant's reputation for honesty, integrity and competence.

As with notice filings, Investment Adviser licenses are effective for the calendar year and should be renewed prior to expiration. Likewise, renewal applications may be accepted by the Division through January 10th with an extra fee of half the regular filing fee. Unlike notice filings, the Division will send renewal license application packets to Investment Adviser licensees containing, among other items, a Renewal Questionnaire. *See* OAC 1301:6-3-151(F)(1).

It should be remembered that the "phase-in" provisions of Am. Sub. H.B. 695 apply not only to notice filers but to licensee applications as well. It is important to recall however, that only those Investment Advisers currently registered as an investment adviser with the SEC have the "phase-in" provisions available to them. Therefore, if you are not registered with the SEC as an investment adviser as of March 18, 1999, and on that date the provisions of section 1707.141 are applicable to you, you should immediately file an application for licensure with the Division or be able to rely on one or more of the specified exceptions to licensure. The Division will begin accepting license applications on February 15, 1999.

Investment Advisers often hold multiple licenses. Consequently, Am. Sub. H.B. 695 permits licensure as both an Investment Adviser and a securities dealer or salesperson. *See* section 1707.141(A)(1). Am. Sub. H.B. 695 also permits one to be licensed as an Investment Adviser and an Investment Adviser Representative in Ohio. *See* section 1707.161(B)(2).

An Investment Adviser license may be transferred to a successor entity that is substantially similar to the original Investment Adviser licensee upon submission to the Division of an application for transfer and appropriate filing fee. *See* section 1707.18(A).

OAC 1301:6-3-151 not only contains provisions regarding Investment Adviser licensing requirements, but contains provisions regarding certain responsibilities of a licensed Investment Adviser in Ohio. For the most part, these provisions parallel existing federal provisions and include books and records requirements (*See* OAC 1301:6-3-151(C) and Rule 204-2 under the '40 Act); record keeping and Division examinations (*See* OAC 1301:6-3-151(C)(5) and proposed OAC 1301:6-3-151(D)); prevention or misuse of nonpublic information (*See* OAC 1301:6-3-151(G)); the "Brochure Rule" (*See* OAC 1301:6-3-151(H), Part II of the Form ADV, and Rule 204-3 under the '40 Act); and investment advisory contracts (*See* OAC 1301:6-3-151(I) and Rules 202(a)(1)-1, 205-1, 205-2, and 205-3 under the '40 Act.) Though important aspects of Investment Adviser responsibilities, these provisions do not affect the application process itself beyond, possibly, the Division's determination of good business repute and so, will not be discussed in further detail at this time.

Thus far, this article has discussed two types of filings with the Division: notice filings made by federally registered Investment Advisers and applications for licensure in Ohio as Investment Advisers. The third type of filing created by Am. Sub. H.B. 695 is an application for licensure as an Investment Adviser Representative.

Section 1707.161 of Am. Sub. H.B. 695 contains the controlling provisions of who may act as an Investment Adviser Representative in Ohio. Likewise, section 1707.161 parallels existing provisions in section 1707.16 of the Revised Code regarding securities salesperson licensure. Specifically, section 1707.161 provides that no person shall act as an Investment Adviser Representative in Ohio unless the person is licensed in Ohio or fits in one or more of four exceptions from licensure.

The first exception to Investment Adviser Representative licensure provides that if a natural person licensed as an Investment Adviser by the Division does not also act as an Investment Adviser Representative for another Investment Adviser, then licensure as an Investment Adviser Representative is not necessary. (If, on the other hand, the natural person Investment Adviser acts as an Investment Adviser Representative for another Investment Adviser, then the natural person Investment Adviser must be licensed (or able to rely on a licensing exception) as an Investment Adviser Representative as well.)

The second exception from the licensing provisions of section 1707.161 is when the person has no "place of business" in Ohio and is employed by or associated with a federally registered Investment Adviser.

The third and fourth exceptions from the Investment Adviser Representative licensing provisions of section 1707.161 are when the person is employed by or associated with an Investment Adviser who has no "place of business" in Ohio and either the Investment Adviser's only clients in Ohio are certain institutional clients or are only a de minimus number of clients (Recall the prior discussion for section 1707.141 regarding the exceptions from Investment Adviser licensing.)

Each of the four exceptions from the Investment Adviser Representative licensing provisions is self-executing—no filing with the Division is necessary.

If an exception from the Investment Adviser Representative licensing provisions is not available, the person must apply for licensure. An Investment Adviser Representative license application consists of a Form U-4, "Uniform Application for Securities Industry Registration or Transfer" for each Investment Adviser for whom the person seeks to act as an Investment Adviser Representative. (An Investment Adviser Representative may act as an Investment Adviser Representative for one or two Investment Advisers—*see* section 1707.161(B)(1). In so acting, the Investment Adviser Representative applicant must submit evidence that both Investment Advisers have been notified of the dual affiliation). The application also includes a filing fee of $35, a fingerprint card, if one is not already on file with the NASD or CRD, and evidence that the Investment

Continued on page 14

IA and IAR Licensing

Continued from page 13

Adviser Representative meets the minimum competency standard.

Just as with existing licensing provisions for securities dealers and salespersons, and as with section 1707.151 provisions for Investment Adviser licensure, an Investment Adviser Representative applicant must show that he or she has met the minimum competency standard by submitting evidence that one or more of eleven specified examinations has been met, that one of five specified professional designations has been achieved, or that the person has been continuously registered as an investment adviser with the SEC since on or before March 18, 1996. Further, as with licensing provisions for securities dealers and securities salespersons and Investment Advisers, the Division is required by statute to make a determination of the "good business repute" of the applicant.

Like notice filings and Investment Adviser licenses, Investment Adviser Representative licenses are effective for the calendar year and should be renewed prior to expiration. Late filings may incur an additional fee.

"Phase-in" provisions, again, are applicable to Investment Adviser Representatives. Although compliance is not mandatory until December 31, 1999, Investment Adviser Representatives have an incentive to file early because the filing fee paid to the Division prior to October 1, 1999, covers both the 1999 license and the renewal for the 2000 calendar year.

In conclusion, keep in mind several general guidelines for Investment Advisers and Investment Adviser Representatives in Ohio and for each of the three new filings created by Am. Sub. H.B. 695:

- Exceptions from licensure do not require a filing with the Division.
- Effectiveness is for the calendar year, therefore renewals should be submitted prior to expiration at the end of each year.
- Late filings may be accepted through January 10th and incur an additional fee of one half the regular fee.
- Updates to filing materials should be promptly submitted to the Division.
- "Phase-in" provisions may be available.

Ms. Dye Joyce is the Division's Securities Registration Supervisor.

An Examination of the Changes to the Anti-Fraud Standards and Criminal Sanctions of Chapter 1707 in the Wake of Am. Sub. H.B. 695

by Caryn A. Francis

The Investment Adviser Act of 1940 (the '40 Act), focuses its prohibitions on several key areas which are most likely to result in fraud, deception and misappropriation. Am. Sub. H.B. 695 closely tracks the '40 Act and the rules promulgated thereunder. New R.C. section 1707.44(M) sets forth the general prohibitions for investment advisers (IAs) and investment adviser representatives (IARs). The Division's new rules promulgated under R.C. section 1707.44(M) delineate the exceptions and the manner in which compliance is possible. In addition to incorporating the '40 Act prohibitions into the statute and rules, R.C. section 1707.44 extends the prohibitions against misrepresentations and unlicensed activity to investment advisers and investment adviser representatives. To compliment these new anti-fraud prohibitions, the Ohio Securities Act will now have stiffer penalties for those who violate R.C. sections 1707.44 or 1707.042, and the rules promulgated thereunder.

As a general rule, the prohibitions under the existing sections of R.C. 1707.44 remain essentially unchanged. R.C. section 1707.44(A) has been amended to prohibit any investment adviser, or investment adviser representative[1], from engaging in any act or practice in violation of new sections 1707.141 or 1707.161, respectively. R.C. sections 1707.141 and 1707.161 require that all advisers be licensed by the Ohio Division of Securities.

The prohibition against affirmative misrepresentations under section 1707.44(B) has been expanded to prohibit making any false representation in advising for compensation, as to the value of securities, or as to the advisability of investing in, purchasing or selling securities, or in procuring an IA or IAR license. (*See* 1707.44(B)(5) and 1707.44(B)(3), respectively).

A new section has been added to incorporate the prohibitions set forth in section 206 of the '40 Act. R.C. section 1707.44(M) and the applicable rules are geared toward prohibiting certain types of activities which hold the greatest potential for abuse. These include, among other things, advertising, custody, and paying solicitors.

R.C. section 1707.44(M) is divided into three main subsections and closely tracks its federal counterpart. R.C. section 1707.44(M)(1) prohibits fraudulent acts and practices, or schemes to defraud, and prohibits advisers from acting as a principal for their own account while selling or purchasing a security from a client, without first obtaining the client's consent and disclosing the capacity in which the adviser is acting. Paragraph (M)(1) also permits the adoption of rules by the Division to prevent fraudulent activities. The rules promulgated under R.C. section 1707.44(M)(1) contain significant prohibitions and will be addressed below. R.C. section 1707.44(M)(2) prohibits an IA or IAR from having custody of any securities or funds unless they have followed the rules promulgated under this section. Finally, R.C. section 1707.44(M)(3) prohibits any person from making an untrue statement of material fact or omitting to state a material fact necessary to make the statement not misleading, in the solicitation of clients or prospective clients.

The rules promulgated under R.C. section 1707.44(M) can be found at 1301:6-3-44 (hereinafter "Rule 44"). Rules 44(A)-(G) closely follow their corresponding federal counterparts, found in Section 208 of the '40 Act as well as '40 Act rules 206(4) and 206(3).

Because advisers act in a fiduciary capacity to their clients, the advertising restrictions found in Rule 44(A) and its '40 Act companion, rule 206(4)-1, are fairly broad. "Advertising" is defined in Rule 44(A)(2) to include:

> any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, which offers ... any analysis, report or publication ... or graph, chart, formula or other device, which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell, or any other investment advisory service.

As should be obvious, advertisements must not contain any false or misleading statements, and must not represent that any report, analysis or other service will be provided without charge, unless they are in fact provided without any obligation whatsoever.[2]

Rule 44(A) also prohibits advisers from using testimonials of any kind in their advertising, or from referring to past, specific recommendations made by the adviser that were, or would have been profitable[3]. There are, however, some exceptions to the rule against using past, specific recommendations. If the advertisement sets out or offers to furnish a list of all the recommendations made by the IA or IAR within the immediately preceding period of not less than a year, then such recommendation is permissible.[4] However, if the list is provided separately from the advertisement, such list must contain various specifics about the recommended securities as well as a cautionary legend.[5]

Finally, Rule 44(A) prohibits representing in an advertisement that any graph, chart, formula or other device can, in and of itself, be used to determine which securities to buy or sell.[6] Again, there are exceptions to this rule. If the adviser prominently places disclosures in the advertisement about the limitations of the graphs, charts, etc., and the difficulties in using the same, then they may be included.

Rule 44(B) addresses custody or possession of funds or securities of clients. Rule 44(B) and the corresponding federal rule are designed to protect clients from the potential for abuse which can occur where an adviser has physical custody of a client's funds or securities. Specifically, the rule is geared toward avoiding the commingling of funds, the loss of securities, and to require a detailed accounting by the adviser with regard to both.

Whereas R.C. section 1707.44(M)(2) prohibits an adviser from having custody of any funds or securities, Rule 44(B) sets forth the manner in which custody is permissible. An IA or IAR is deemed to have custody if they directly or indirectly hold client funds or securities, have any authority to obtain possession of them, or have the ability to appropriate them.[7]

For an adviser to have custody without violating the statute or rules, the adviser must adhere to the following six steps: (i) the IA must give notice to the Division in writing that they have or may have custody. This notice can be given on Form ADV.[8] It should be noted that this provision does not apply to a federally licensed adviser; (ii) any <u>securities</u> in the custody of an adviser must be segregated, identified by client and kept in a safe place which is reasonably free from risk of destruction or other loss;[9] (iii) any <u>funds</u> in the custody of an adviser must be deposited in accounts held in the name of the adviser, where the adviser is named as agent or trustee, and only client funds are maintained in those accounts. In addition, the adviser must keep a separate detailed record of each client's interest in the bank account with dates and amounts of deposits and withdrawals;[10] (iv) the adviser must notify the client in writing of where and how the funds or securities will be maintained; [11] (v) the adviser must send an itemized statement at least once every three months to the client showing the funds and securities in their custody, and any debits, credits or transactions in the clients account during that period;[12] and (vi) the adviser must have a surprise examination conducted by an independent accountant of all the funds and securities in the custody of the adviser.[13]

The IA must file with the Division a certificate issued by the accountant describing the nature and extent of the examination that was made. A federally licensed investment adviser must file with the Division a copy of any certificate regarding the independent accountant exam at the time they file the same certificate with the SEC.[14]

Finally, a broker-dealer licensed under section 15 of the Securities Exchange Act of 1934 (the " '34 Act"), does not have to comply with the six steps set forth above, so long as the broker-dealer is either: (i) in compliance with Rule 15c3-1 of the '34 Act (the net capital rule); or (ii) a member of an exchange whose members are exempt from 15c3-1, and the broker-dealer is in compliance with all rules and settled practices of the exchange imposing requirements with respect to financial responsibility and the segregation of funds or securities carried for the account of customers.[15] The corresponding '40 Act rule for Rule 44(B) is rule 206(4)-2.

Rule 44(C) sets forth the standards an adviser must meet before they can make a cash payment to someone who solicits or refers clients on their behalf ("a solicitor"). This rule primarily focuses on giving disclosure to the client. The disclosure requirement exists to help ensure that the prospective client is put on notice that the solicitor's recommendation is not disinterested.

A solicitor who fails to give proper disclosure to the client may have enforcement action taken against him or her for acting as an unlicensed investment adviser. Failure to comply with all the provisions of this rule may also result in liability to the adviser for violating the anti-fraud provisions of the Ohio Securities Act.

To meet the standards of Rule 44(C), the IA or IAR engaging the solicitor must be either licensed by the Division, excepted from licensure, or in the case of a federally licensed IA, in compliance with the Division's notice filing requirements.[16] Further, the solicitor and the adviser must enter into a written agreement (the "Agreement"), which details the referral arrange-

Continued on page 16

Anti-Fraud Standards

Continued from page 15

ment. The Agreement must contain an undertaking by the solicitor, and require the solicitor to provide the client with a copy of the IA's current "brochure" and a copy of the solicitor's separate written disclosure document.[17] The adviser must also retain copies of such Agreement as required under the Division books and records rules. Finally, the IA must receive from the client a written acknowledgment stating that the client has received the solicitor's separate written disclosure document, along with a copy of the IA's "brochure".[18]

The requirements set forth above do not apply to a solicitor who (i) is a partner, officer, director, or employee of the Investment Adviser; (ii) has those same positions with an entity that is controlled by or is under common control with the Investment Adviser; or (iii) isn't affiliated with the Investment Adviser, but he or she is soliciting clients for an adviser who provides only impersonal investment advice (*i.e.,* written materials or other statements do not purport to meet the objectives or needs of a specific client).

Even if the solicitor can meet the tests enumerated above, an adviser cannot pay a solicitor who has been a "bad apple". These include solicitors who, among other things, have been subject to certain types orders by the SEC, or who have been convicted of certain felonies or misdemeanors within the last 10 years. Finally, the adviser must make a good faith effort to ensure that the solicitor has complied with all the provisions of their Agreement.[19] The corresponding '40 Act rule for Rule 44(C) is Rule 206(4)-3.

Rule 44(D) tracks Rule 206(4)-4 of the '40 Act, which deals with disclosure of certain material events. These material events include financial events, and legal or disciplinary events, both of which may be disclosed in the adviser's brochure. These material events must be disclosed promptly to existing clients, and at least 48 hours before entering into any advisory contract with a prospective client. An adviser may make this disclosure at the time of entering into the contract, if the client has an opportunity to terminate the contract, without penalty, within five business days.[20]

<u>Every</u> adviser must disclose any legal or disciplinary event that is material to an evaluation of the advisers integrity or ability to meet their contractual commitments to clients.[21] The rule lists a number of legal and disciplinary events for which there is a rebuttable presumption of materiality.[22] These include, among other things, criminal convictions for fraud, certain administrative proceedings before the SEC, and various proceedings before self regulatory organizations such as the NASD. However, it is important to note that an event may still be material even if it is not on the list.

Any adviser who has custody or discretionary authority over client funds or securities, or, who requires advance payment of advisory fees of more than $500 for services to be provided over periods greater than six months, not only has to disclose any legal or disciplinary event, but must also disclose any financial conditions that are reasonably likely to impair the adviser's ability to meet contractual commitments to clients.[23]

Rule 44(E) sets forth a series of general prohibitions which corresponds to Section 208 of the '40 Act. Rule 44(E) prohibits any adviser from representing or implying that they have been sponsored, recommended or approved by, or had their abilities or qualifications passed upon by the Division or any other state or federal agency. However, it is permissible for an adviser to represent that they are licensed by the Division or such other agencies, if that is in fact true.[24] Rule 44(E) also prohibits advisers from using the term "investment counsel" as descriptive of their business unless they in fact act as investment advisers as their principal business, and a substantial part of their business consists of rendering investment supervisory services.[25] Finally, an adviser is prohibited from using any person, directly or indirectly, to do anything that would result in a violation of the Ohio Securities Act, if the adviser had done the same act themselves.[26]

Rules 44(F) and 44(G) both address agency cross transactions. The rule is targeted at situations where there is a potential for "double dipping" by advisers. Advisers act in a fiduciary capacity for their clients and agency cross transactions hold the potential for abuse by advisers who may have their self interests in getting a commission or other fee ahead of their obligation to look out for their client. Rule 44(F) and '40 Act Rule 206(3)-1 provide an exemption for advisers who are licensed as dealers. Rule 44(G) and '40 Act Rule 206(3)-2 provide the means in which an adviser, who is not otherwise exempt as a dealer, may avoid the prohibition against agency cross transactions.

Agency cross transactions occur where the adviser acts as broker for both an advisory client as well as the person on the other side of the transaction. A broker-dealer registered with the Division as well as the SEC is exempt from the agency cross transaction prohibition, but only if one of three standards apply: (i) the broker-dealer acts as an adviser <u>solely</u> by means of publicly distributed written materials or oral statements, or by distributing materials which do not meet the objectives or needs of specific individuals or accounts, (ii) the broker-dealer acts as an adviser solely by means of issuing statistical information which contains no expressions of opinion as to the investment merit of a particular security, or (iii) if the broker-dealer acts as an adviser by distributing a combination of the types of materials set forth above, then those materials must include a statement that the broker-dealer who is acting as an adviser may be acting as a principal for their own account or as an agent for another person, in any transaction.[27] Nothing in the exemption relieves the advisers of their disclosure obligations under other provisions of section 1707.44(M).[28]

If the adviser is not a broker-dealer who is exempt, then there are several standards that must be met under Rule 44(G) to ensure that the adviser does not run afoul of the agency cross transaction prohibition. First, the adviser must give full disclosure to their client about the nature of the agency transactions, and then obtain a written authorization from their client that grants the adviser permission in the future to effect agency cross transactions.[29] With <u>each</u> agency cross transaction, the adviser must provide a written confirmation to the client setting forth a number of items, including the nature of the transaction, the amount of remuneration received, and who paid the remuneration to the adviser.[30] The adviser must give each client, at least annually, a written disclosure statement which identifies the total number of transactions during that period and the total amount of commissions or other remuneration received.[31]

In addition, both the written confirmation and the written disclosure statement

are required to have conspicuous statements that the written consent previously granted by the client may be revoked at any time.[32] At no time may any adviser, or anyone controlling, controlled by or under common control with the adviser, recommend a transaction to both the buyer and seller involved.[33]

Finally, even if advisers meet all the standards enumerated above, they must be sure to always give the client the best price on securities, as well as "best execution", which means that trades are executed on client's behalf such that the client's total cost or proceeds in each transaction is the most favorable under the circumstances. In assessing whether this standard is met, an adviser should consider the full range and quality of a broker's services, including such things as the broker's execution capability, commission rate, financial responsibility, responsiveness to the adviser, and the value of any research services provided.[34]

R.C. section 1707.99 sets forth the penalties for violations of R.C. sections 1707.042 or 1707.44. From 1982 through 1996, a criminal conviction for a violation of these sections was punishable as a fourth degree felony and a fine not exceeding $2,500. A fourth degree felony allowed for a maximum of 18 months in prison. In 1995, due to Am. Sub. Senate Bill No. 2, this punishment was down-graded to a fifth degree felony. Am. Sub. H.B. 695 will revamp the structure of R.C. section 1707.99. The penalties section of the Ohio Securities Act will now be a sliding scale based on the amount of funds or securities involved in the offense or the loss to the victim. This sliding scale was based upon a scale established in the "Exploitation of the Elderly" bill, H.B. 632.[35]

The following is a summary of the penalties for violations of R.C. 1707.44, the rules promulgated thereunder, and R.C. 1707.042:

a. Less than $500 = a fifth degree felony (up to 12 months in prison) and a fine of up to $2,500. (R.C. section 1707.99(A))

b. $500 or more but less than $5,000 = a fourth degree felony (up to 18 months in prison) and a fine of up to $5,000. (R.C. section 1707.99(B))

c. $5,000 or more but less than $25,000 = a third degree felony (up to 5 years in prison) and a fine of up to $10,000. (R.C. section 1707.99(C))

d. $25,000 or more but less than $100,000 = a second degree felony (up to 8 years in prison) and a fine of up to $15,000. (R.C. section 1707.99(D))

e. $100,000 or more = a first degree felony (up to 10 years in prison) and a fine of up to $20,000. (R.C. section 1707.99(E))

As a result of the sliding scale penalties, violations of the anti-fraud provisions of the Ohio Securities Act will subject the white collar criminal to substantial punishment.

For each new section and rule under the Ohio Securities Act, there is a corresponding section or rule from the '40 Act. As a result, those investment advisers and investment adviser representatives who have been adhering to the requirements of the '40 Act and its rules, will not run afoul of the Ohio Securities Act's new prohibitions. However, for those who knowingly violate the anti-fraud prohibitons of the Securities Act, there are stiff new penalties which may result in significant jail time.

Endnotes

[1] IAs and IARs may alternatively be referred to as "advisers" throughout this article.

[2] O.A.C. Rule 1301:6-3-44(A)(1)(d) and (e)

[3] O.A.C. Rule 1301:6-3-44(A)(1)(a) and (b)

[4] O.A.C. Rule 1301:6-3-44(A)(1)(b)

[5] O.A.C. Rule 1301:6-3-44(A)(1)(b)(i) and (ii)

[6] O.A.C. Rule 1301:6-3-44(A)(1)(c)

[7] Form ADV Instructions: "General Definitions"

[8] O.A.C. Rule 1301:6-3-44(B)(1)

[9] O.A.C. Rule 1301:6-3-44(B)(2)

[10] O.A.C. Rule 1301:6-3-44(B)(3)(a)-(c)

[11] O.A.C. Rule 1301:6-3-44(B)(4)

[12] O.A.C. Rule 1301:6-3-44(B)(5)

[13] O.A.C. Rule 1301:6-3-44(B)(6)

[14] O.A.C. Rule 1301:6-3-44(B)(6)

[15] O.A.C. Rule 1301:6-3-44(B)(7)(a) and (b)

[16] O.A.C. Rule 1301:6-3-44(C)(1)(a)

[17] O.A.C. Rule 1301:6-3-44(C)(1)(d)(ii) and (iii).

Note: Although this rule only requires <u>third party</u> solicitors to provide a copy of the IA's brochure, solicitors who are either affiliated with the IA, or soliciting clients for the provision of impersonal investment advice, also have to provide prospective clients with a copy of the IA's brochure under separate provisions of the '40 Act rules.

[18] O.A.C. Rule 1301:6-3-44(C)(1)(e)

[19] O.A.C. Rule 1301:6-3-44(C)(1)(f)

[20] O.A.C. Rule 1301:6-3-44(D)(3)

[21] O.A.C. Rule 1301:6-3-44(D)(1)(b)

[22] O.A.C. Rule 1301:6-3-44(D)(2)(a)-(c)

[23] O.A.C. Rule 1301:6-3-44(D)(1)(a)

[24] O.A.C. Rule 1301:6-3-44(E)(1) and (2)

[25] O.A.C. Rule 1301:6-3-44(E)(3)(a) and (b)

[26] O.A.C. Rule 1301:6-3-44(E)(4)

[27] O.A.C. Rule 1301:6-3-44(F)(1)(a)-(d)

[28] O.A.C. Rule 1301:6-3-44(F)(3)

[29] O.A.C. Rule 1301:6-3-44(G)(1)(a)

[30] O.A.C. Rule 1301:6-3-44(G)(1)(b)(i)-(iv)

[31] O.A.C. Rule 1301:6-3-44(G)(1)(c)

[32] O.A.C. Rule 1301:6-3-44(G)(1)(d)

[33] O.A.C. Rule 1301:6-3-44(G)(1)(e)

[34] Exchange Act Release No. 23170 (April 23, 1986)

[35] H.B. 632 is expected to be reintroduced in 1999.

Ms. Francis is the Attorney Inspector for the Division.

New Law to Impact Enforcement of Securities Provisions

By Desiree T. Shannon

Several new provisions included in the newly enacted Am. Sub. H.B. 695 will significantly impact the Division of Securities' enforcement functions. The most notable change in the code sections that impact the Division's enforcement authority is that Investment Advisers (IAs) and Investment Adviser Representatives (IARs) will be subject to the same investigatory remedies and procedures that now apply to other sellers and issuers of securities.

The meatier new provisions are found in R.C. 1707.23. This section is the linchpin of the Division's enforcement function, since it outlines how the Division may investigate violations of the securities act, as well as actions the Division may take against violators. R.C. 1707.23(A) formerly required "any person to file with (the Division)…as to any facts or circumstances concerning the issuance, sale, or offer for sale of securities within this state by said person…" This section has been revised to allow the Division to require filings concerning "…the person's acts or practices as an investment adviser or investment adviser representative within this state…" R.C. 1707.23(B) has always allowed the Division to examine sellers, dealers, salespersons and issuers under oath, as well as to examine books and records held by the same. The revised version of this code section will now permit the same examinations of IAs and IARs.

R.C. 1707.23(D) allows for the suspension and revocation of licenses issued by the Division that will now be held by IAs and IARs, as well as for dealers and salespersons. This section references R.C. 1707.19, which more specifically addresses violations that can lead to suspension and revocation of these licenses. R.C. 1707.23 (E) currently allows the Division to initiate criminal proceedings for violations of prohibitions found in sections R.C. 1707.042 and R.C. 1707.44. These prohibitions address, among other things, the conduct of parties involved in control bids, selling unregistered securities and making misrepresentations in the course of selling securities. As revised, R.C. 1707.23(E) allows the Division to also initiate criminal prosecutions for violations of any rules adopted under these sections. R.C. 1707.23(F) will require IAs to furnish to the Division copies of brochures, advertisements, publications, analysis or reports or any writings they publish or distribute. This section formerly required the same of securities dealers.

R.C. 1707.23(H) allows the Division to issue Cease and Desist Orders against persons who violate provisions found in Chapter 1707 of the Revised Code. The revised version of this statute will additionally allow such orders to be issued for violations of rules adopted under the chapter. Finally, an entirely new provision, R.C. 1707.23(I), allows the Division to issue and initiate contempt proceedings regarding subpoenas and subpoenas duces tecum at the request of securities administrators of other states, if "it appears to the Division that the activities for which the information is sought would violate Chapter 1707 of the Revised Code if the activities had occurred in this state." This would allow greater cooperation with other states' enforcement efforts against scam artists who operate across state borders. The Division would in effect enforce subpoenas for cooperating out-of-state regulators who are pursuing targets residing in Ohio.

R.C. 1707.25 currently allows the Director of Commerce to apply to common pleas court for an injunction restraining the issuance, sale or offer for sale of securities by persons who fail to obey a Division subpoena or fail to provide information or testimony as required by the Division pursuant to its authority. New language also allows such an injunction to restrain persons from acting as an IA or IAR under these circumstances. R.C. 1707.27 allows the Division to seek a receivership against any person who has committed a "substantial violation" of R.C. 1707.01 to 1707.45 or who has used any act, practice or transaction "declared to be illegal, prohibited or declared fraudulent" to the material prejudice of purchasers or holders of securities. The revised version of the statute amends this language to allow such receiverships where clients of IAs or IAR's are involved, as well as purchasers or holders of securities.

R.C. 1707.36 deals with the powers of the Attorney-Inspector. The Attorney-Inspector is essentially the head lawyer of the Division's enforcement section. The powers of this office have been expanded. The former version required the Attorney-Inspector to investigate and report upon all complaints and alleged violations of the laws relating to the issuance and sales of securities. The revised version allows the Attorney-Inspector to investigate possible violations of rules promulgated under these laws. This expanded investigatory authority would include all statutory revisions and rules applying to IAs and IARs. R.C. 1707.36 has also been changed to designate the Office of the Attorney-Inspector a criminal justice agency in "investigating reported violations of law relating to securities and investment advice." This would allow the enforcement attorneys working on behalf of the Division access to the computerized databases administered by the National Crime Information Center or the Law Enforcement Automated Data System (LEADS) in Ohio, as well as to other computerized databases dispensing criminal justice information.

Finally, R.C. 1707.22 extends appeal rights currently available to dealers and salespersons to IAs and IARs whose licenses have been suspended, refused, revoked or denied renewal. These appeal rights are found in Chapter 119 of the Revised Code.

Ms. Shannon is an Enforcement Staff Attorney with the Divison and Editor of the Ohio Securities Bulletin.

The $25,000,000 Question for Ohio Investment Advisers

By Michael P. Miglets

Commissioner's Note: The most common way for an investment adviser to determine whether it is under the jurisdiction of the SEC or the Division is to determine its "assets under management." This calculation is made pursuant to a set of standards promulgated by the SEC. The Division does not administer these standards, but does provide the following article as an overview of the "assets under management" determination.

After the enactment of the National Securities Markets Improvement Act of 1996 ("NSMIA"), investment advisers with principal offices and places of business in Ohio were permitted to remain registered with the Securities and Exchange Commission ("SEC"). While NSMIA gave the SEC jurisdiction over investment advisers with assets under management in excess of $25,000,000 and the states jurisdiction over the smaller investment advisers, the SEC also retained jurisdiction over all investment advisers in states which did not regulate investment advisers. As the Ohio Securities Act did not include investment adviser regulations, investment advisers with a principal office and place of business in Ohio remained registered with the SEC regardless of the amount of assets under management. With the effectiveness of Am. Sub. H.B. 695 on March 18, 1999, investment advisers in Ohio will be required to determine if they may remain registered with the SEC under Section 203(A) of the Investment Advisers Act of 1940 or if they must become licensed with the Division.

Schedule I to the Form ADV requires an investment adviser to indicate that it has assets under management of at least $25,000,000.00 to remain registered with the SEC, unless the investment adviser has its principal office and principal place of business in Wyoming or meets one of eight other conditions. Instruction No. 7 provides investment advisers with a series of definitions and tests to be used in determining the total assets under management. The key factors in determining the amount of assets under management are: (1) whether the account is a securities portfolio; (2) what is the value of the portfolio; and (3) whether the investment adviser provides continuous and regular supervisory or management services.

To constitute a securities portfolio, an account must have at least 50% of its total value in securities. For purposes of the 50% test, cash and cash equivalents, including bank deposits, certificates of deposit, bankers acceptances and similar bank instruments, are treated as securities. Securities portfolios may include: (1) family and proprietary accounts of the investment adviser, unless the investment adviser is a sole proprietor; (2) accounts for which the investment adviser receives no compensation; and (3) accounts of clients who are not U.S. residents. For a sole proprietor, personal assets of the investment adviser must be excluded from the assets under management.

Once an investment adviser has determined the account is a securities portfolio, the investment adviser must determine the value of the securities portfolio. The entire amount of the securities portfolio is to be included if the investment adviser provides continuous and regular supervisory or management services. If the investment adviser provides continuous and regular supervisory or management services for only a portion of the securities portfolio, only that amount which receives such services need be included for purposes of determining assets under management. For example, if only $2,000,000 of a $10,000,000 securities portfolio is managed by an investment adviser, only $2,000,000 will apply toward the assets under management test for that investment adviser. The value of real estate or businesses, which are managed on behalf of a client but not as an investment, also must be deducted from the value of the securities portfolio. So, if an investment adviser served as a rental agent for a client's real estate, the value of the real estate may be deducted from the total value of the securities portfolio. Finally, the full value of securities purchased on margin is included to determine if the investment adviser has $25,000,000 or more of assets under management.

Continuous and regular supervisory or management services include: (1) accounts where the investment adviser has discretionary authority and provides ongoing supervisory or management services; or (2) accounts where the investment adviser does not have discretionary authority, but has an ongoing responsibility to select or make recommendations, based on the needs of the client, as to specific securities or other investments that the account may purchase or sell, and if such recommendations are accepted by the client, the investment adviser is responsible for arranging or effecting the transaction. Factors to consider include: (1) the terms of the advisory contract; (2) form of compensation; and (3) the management practice of the investment adviser.

The fact that an advisory contract indicates that ongoing management services will be provided suggests that the account receives continuous and regular supervisory or management services. This presumption may be rebutted by other provisions of the advisory contract or the actual services provided by the investment adviser.

If compensation under the advisory contract is based on the average value of assets under management over a specified period of time, this suggests that the investment adviser is providing continuous and regular supervisory or management services. Payments based on hourly fees or retainers based on a percentage of assets covered by a financial plan do not indicate that the investment adviser is providing continuous and regular supervisory or management services. The SEC's examples of accounts which do not receive continuous and regular supervisory management services include, but are not limited to: (1) accounts where the investment adviser provides only market timing recommendations to buy or sell; (2) impersonal advice such as newsletters; (3) accounts where the investment adviser provides only an initial asset allocation with no on-going monitoring or reallocation; and

Continued on page 20

$25,000,000 Question

Continued from page 19

(4) accounts where the investment advice is on an intermittent or periodic basis, such as an account reviewed on an annual or quarterly basis, at the request of the client or in response to a market event. Examples of accounts with continuous and regular supervisory or management services include: (1) accounts where the investment adviser allocates assets among a series of mutual funds, even without discretionary authority if the account receives continuous review and management; and (2) accounts where the investment adviser allocates assets among other investment advisers under a grant of discretionary authority with the ability to hire and fire investment advisers and to reallocate assets.

If an investment adviser includes assets which are managed on a non-discretionary basis to meet the $25,000,000 assets under management test to remain registered with the SEC, the investment adviser must provide a typed statement with Schedule I detailing the nature of the supervisory or management services provided to the non-discretionary accounts. This statement is to verify that the investment adviser is actually providing continuous and regular supervisory or management services. The statement would not have to include any information on the discretionary accounts managed by the investment adviser. If the investment adviser manages in excess of $25,000,000 of assets in discretionary accounts, this statement does not have to be provided as the $25,000,000 or more of assets under management test has already been satisfied.

For specific questions regarding the completion of Schedule I and the standards to continue to maintain an SEC registration, an investment adviser may contact the SEC's Task Force on Investment Adviser Regulation at (202) 942-0716. Investment advisers with less than $25,000,000 of assets under management may contact the Division at (614) 644-7381 to obtain a packet with information on the Division's licensing procedures. Additional information on Ohio's investment adviser regulations is available on the Division's website at http://www.securities.state.oh.us.

Securities Notice Filings Under New R.C. 1707.092

By Deborah Dye Joyce

A defining characteristic of many state securities laws, including the Ohio Securities Act, is the authority of the state securities administrator to approve or deny a proposed securities offering based on qualitative standards. The common name for this process of considering the substantive terms and conditions of an offering is "merit review." However, Title I of the National Securities Markets Improvement Act of 1996 (NSMIA) entitled the "Capital Markets Efficiency Act of 1996" preempted the states' abilities to conduct merit reviews on offerings involving the federally defined category of "covered securities," but specifically preserved the states' rights to receive notice filings. In addition, the NSMIA specifically preserved the states' rights to investigate and bring enforcement actions with respect to fraud or deceit, and to suspend offers or sales of "covered securities" as a result of the failure to submit any filing or fee required by state law and permitted by the NSMIA. *See* section 102 of the NSMIA as it amended section 18 of the Securities Act of 1933.

Filings with the states by issuers of "covered securities" are called notice filings and are the subject of this article. Although the category of "covered securities" created by the NSMIA includes several different types of offerings including certain listed securities, sales to qualified purchasers, and securities of certain federally exempt offerings (the largest category of which involves Rule 506 offerings—*see* "Rule 506 Amendments and Ohio's Model Accredited Investor Exemption" elsewhere in this issue of the *Bulletin*), this article will primarily deal with offerings by investment companies which have registered or have filed a registration statement with the Securities and Exchange Commission (SEC).

Prior to the NSMIA, investment companies, more generally known by the public as "mutual funds," filed applications for registration with both the SEC and the Ohio Division of Securities (Division). The applications filed with the Division for registration by coordination or qualification received a substantive, or merit, review. As a result of the NSMIA, investment companies must still make a

Phase-In Provisions of Am. Sub. H.B. 695

By Thomas E. Geyer

Phase-in provisions of Am. Sub. H.B. 695 are applicable to certain investment advisers and investment adviser representatives and are designed to provide time for a smooth transition from federal to state oversight.

R.C. 1707.141(C)(1) provides that if on March 18, 1999, a person is registered as an investment adviser with the SEC and is required to be licensed as an investment adviser by the Division, that person has until December 31, 1999, to become licensed by the Division. Similarly, R.C. 1707.141(C)(2) provides that if on March 18, 1999, a person is registered as an investment adviser with the SEC and is required to make a notice filing with the Division, that person has until December 31, 1999, to make its initial notice filing with the Division.

To encourage advisers to make license and notice filings before the end of 1999, R.C. 1707.17(B)(3) and (4) provide that license or notice filing fees paid to the Division on or before October 1, 1999, will cover the initial filing as well as the renewal for the 2000 calendar year.

Finally, R.C. 1707.161(F) provides that if on March 18, 1999, a person is required to be licensed as an investment adviser representative by the Division, that person has until December 31, 1999, to become licensed as an investment adviser representative by the Division.

filing with the Division, but the filing no longer receives a merit review and substantive comments are no longer issued by the Division.

As a first step in aligning the Ohio Securities Act with the "covered securities" provisions of the NSMIA, Ohio Administrative Code 1301:6-3-09 was amended on August 4, 1997 to delete the merit standards for investment company offerings and to set forth the procedures in Ohio for making notice filings by investment companies. Section 1707.092 of Am. Sub. H.B. 695 goes one step further by codifying the notice filing provisions permitted by the NSMIA for investment companies and offerings of securities involving "covered securities" that are not otherwise subject to sections 1707.02 through 1707.091 of the Revised Code.

Notice filings by managed or non-managed investment companies should be submitted to the Division prior to sales in Ohio. Specifically, the notice filing consists of a duly executed consent to service of process pursuant to Revised Code 1707.11 (which may be incorporated by reference if previously filed with the Division—*see* section 1707.092(B)(2)), a two prong filing fee, and (1) a copy of the federal registration statement or (2) a Form NF or U-1 <u>and</u> a copy of the fund's most recent prospectus and statement of additional information.

As noted, the filing fee is two-pronged and includes a flat fee of $100 plus a calculated fee of one tenth of one per cent of the aggregate amount of securities sought to be sold in Ohio. The calculated fee has a minimum of $100 and a maximum of $1000. Consequently, an investment company issuer wishing to sell an aggregate amount of $1,000,000 or more of securities in Ohio—including an indefinite amount—would submit maximum total filing fees of $1100. *(See* sections 1707.092(A)(1)(b), 1707.092(A)(2)(b), and 1707.092(B)(1).)

Since there is not a notice filing "form" that is filed with the SEC—rather a registration statement is used—section 1707.092 gives the investment company the option of submitting either a copy of the registration statement or the uniform Form NF or U-1. If the registration statement is used as the notice filing, a separate prospectus and statement of additional information is not necessary as those documents are contained therein. Use of the Form NF or U-1 necessitates the filing with the Division of a prospectus and statement of additional information.

Historically, both the investment company industry and the Division prefer the use of either the Form NF or the Form U-1 due to the clarity with which the information is relayed on the uniform forms. (For example, the issuer may not wish to sell in Ohio all that is contained in the federal registration statement. On the other hand, use of the uniform forms allows the issuer to clarify what fund(s), portfolio(s), and class(es) are to be eligible for sale in the state, despite what is contained in the often voluminous registration statements.) Name changes and increases to the amount eligible to be sold in Ohio are also made on the Form NF or U-1.

Copies of the final prospectus for an initial filing for either a managed or non-managed investment company should be filed with the Division once SEC effectiveness is obtained. *See* section 1707.092(A)(1)(c) and 1707.092(A)(2)(c).

Investment companies seeking to renew a notice filing should look to the provisions of OAC 1301:6-3-09(D). Whether an initial or renewal filing, an investment company notice filing is effective for thirteen months and should be renewed prior to expiration. *See* section 1707.092(D). The Division will issue a Certificate of Acknowledgement to the issuer upon receipt of a complete notice filing.

Whereas section 1707.092(A) and (B) generally pertain to offerings by federally registered investment companies, section 1707.092(C) contains the notice filing provisions for offerings involving "covered securities" that are <u>not</u> otherwise subject to sections 1707.02 through 1707.091 of the Revised Code. As with other notice filings, the components of notice filings made pursuant to this section are a consent to service of process, filing fees, and copies of documents filed with the SEC.

Sections of the Ohio Securities Act Added or Amended by Am.Sub. H.B. 695

(new sections appear in italics)

§ 1707	Brief Description
.01(B)	reference to "bond investment companies" deleted
.01(E)	"issuer" exception from the definition of "dealer" amended to include "member or manager of"
.01(O)	definition of "bank" amended to include "credit unions"
.01(X)	definition of "investment adviser" amended
.01(II)	*definition of "investment adviser representative" added*
.01(JJ)	*definition of "supervised person" added*
.01(KK)	*definition of "excepted person" added*
.03(Q)(1)	reference to "or any rule . . . made to carry out section 4(2)" deleted
.03(W)(2)	citation to SEC rules corrected
.03(W)(5)	waiver authority deleted
.03(X)	*exemption for sale pursuant to federal Rule 506 added*
.03(Y)	*"model accredited investor" exemption added*
.092	*investment company notice filing provision added*
.093	*authority to accept electronic filings added*
.11	references to 03(X), 03(Y), and notice filings added
.14(A)(1)(b)	dealer licensing exception amended to include 03(X) and 03(Y)
.141	*investment adviser licensing and notice filing requirement added*
.151	*investment adviser license application procedures added*
.161	*investment adviser representative licensing requirement and license application procedures added*
.17	license renewal and fee provision amended to include investment advisers and investment adviser representatives
.18	license transfer provision amended to include investment advisers and investment adviser representatives
.19	license refusal, suspension and revocation provision amended to include investment advisers and investment adviser representatives
.20	rulemaking authority amended to include reference to "clients or prospective clients"
.22	appeal rights amended to include investment adviser and investment adviser representative
.23	enforcement powers amended to include references to investment advisers and investment adviser representatives; reciprocal subpoena authority added
.25	injunctive authority amended to include investment advisers and investment adviser representatives
.27	receivership provision amended to include investment adviser and investment adviser representative
.36	designation of attorney inspector as a "criminal justice agency" codified
.391	corrective filing provision amended to include 03(X) and 03(Y)
.42	civil liability provision amended to add civil liability for investment advisers and investment adviser representatives
.431	"bringing together" exception amended to exclude investment advisers and investment adviser representatives
.44(A)(2)	*prohibition on violating investment adviser or investment adviser representative licensing or notice filing obligation added*
.44(B)(5)	*prohibition on false representations for purposes of giving investment advice added*
.44(M)	*investment adviser and investment adviser representative anti-fraud standard added*
.46	authority of the commissioner amended to include reference to investment adviser and investment adviser representatives
.48	record retention provision amended to give Division rulemaking authority regarding record retention
.99	penalty provision amended

Licensing Fees Under the Ohio Securities Act
(including Am. Sub. H.B. 695, eff. 3/18/99)

LICENSE	INITIAL APPLICATION	TIMELY RENEWAL[1]	LATE RENEWAL[2]
Securities Dealer	$30 per salesperson,[3] but not less than $150 nor more than $5,000. *(1707.17(B)(1))*	$30 per salesperson, but not less than $150 nor more than $5,000.[4] *(1707.17(B)(1))*	$30 per salesperson, but not less than $150 nor more than $5,000, plus one-half of that figure.[5] *(1707.17(B)(1))*
Securities Salesperson	$50 *(1707.17(B)(2))*	$50[6] *(1707.17(B)(2))*	$50[6] *(1707.17(B)(2))*
Investment Adviser	$200 *(1707.17(B)(3))*	$200 *(1707.17(B)(3))*	$300 *(1707.17(B)(3))*
Investment Adviser Notice Filing	$100 *(1707.17(B)(4))*	$100 *(1707.17(B)(4))*	$150 *(1707.17(B)(4))*
Investment Adviser Representative	$35 *(1707.17(B)(5))*	$35 *(1707.17(B)(5))*	$52.50 *(1707.17(B)(5))*

Notes

1. A "timely renewal" is a renewal received by the Ohio Division of Securities (the "Division") by December 31 of the calendar year in which the license is set to expire.

2. A "late renewal" is a renewal received by the Division between January 1 and January 10 of the calendar year immediately subsequent to the calendar year in which the license was set to expire.

3. Per salesperson licensed with the Division. Zero to five salespersons result in the minimum of $150, and $30 is added for each additional salesperson, up to $5,000.

4. Because the renewal fee is a "calculated fee," not a "fixed fee," dealer license renewal fees cannot be processed by the CRD system. Instead, the Division's Renewal Questionnaire and dealer license renewal fee must be sent directly to the Division.

5. For example, a dealer whose timely renewal fee is $5,000 would pay a late renewal fee of $7,500.

6. In contrast to the dealer license renewal fee discussed in note 4, NASD members must pay this salesperson license renewal fee through the CRD system.

Supervision of Independent Contractors

Commissioner's Note: Reprinted below is a letter from Lori Richards of the Securities and Exchange Commission regarding the supervision of independent contractors. The Division shares the views of the Commission and expects Ohio licensed securities dealers to have in place a system of supervising independent contractors that satifies the dealer's supervisory obligations under the Ohio Securities Act and related adminstrative rules. This letter is reprinted with the permission of the Commission.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON D.C. 20005

April 8, 1998

Marc E. Lackritz
President
Securities Industry Association
1401 Eye Street, NW
Washington, D.C. 20005-2225

Re: Supervision of Independent Contractors

Dear Marc:

I am writing today to alert your members to an area of focus for Commission and Self-Regulatory Organization examiners -- supervision by broker-dealers employing independent contractors.

Broker-dealers must supervise registered representatives who are independent contractors. As the Court of Appeals for the Ninth Circuit held in *Hollinger v. Titan Capital Corp.,* 914 F.2d 1564 (9th Cir. 1990)(en banc), there is no support in the federal statutory scheme for distinguishing between registered representatives who are employees or agents, and those who are independent contractors. Thus, when we examine broker-dealers employing independent contractors, regardless of the securities product they may sell, we expect to find adequate supervisory systems within the meaning of Section 15(b)(4)(E) of the Exchange Act.

Of, course, we recognize that each broker-dealer may develop its own supervisory system. We do not believe that there is any one "model" supervisory system that must be followed by all firms. We do believe, however, consistent with the Exchange Act, that all broker-dealers should have a system in place which can reasonably be expected to prevent and detect, insofar as practicable, violations by supervised persons. As the Commission has recognized in two enforcement actions, *Consolidated Investment Services, Inc.,* 61 SEC Docket 21 (Jan. 5, 1996) and *Royal Alliance Associates, Inc.,* 63 SEC Docket 1843 (Jan. 15, 1997)(settled), even the small and remote offices often used by independent contractors must be supervised.

In sum, I would like to remind your members that independent contractors must be supervised, and that oversight of such supervision is a priority for the Commission's examination program. If you wish, you may share this letter with your members.

Sincerely,

Lori A. Richards

cc: Stuart Kaswell
Senior Vice President and General Counsel

Investor Protection and Education

by Karen Terhune

Saving and Investing Education Week

The Council of Securities Regulators of the Americas (COSRA) organized a first ever week-long campaign, Saving and Investing Education Week, held from March 29 to April 4, 1998. The Campaign was aimed at educating the public, from Canada to Chile, on savings, investing and avoiding securities fraud. Twenty-one countries throughout the Western Hemisphere held educational events for their citizens during this week.

The North American Securities Administrators Association (NASAA) worked with the U.S. Securities and Exchange Commission and other organizations in U.S.A. in planning events for this week. In Canada, the Canadian Securities Administrators (CSA) coordinated investor educational provincial initiatives for this week.

Much time and effort was put into the many educational events held throughout Ohio during this week. The following summary includes a brief description of investor education initiatives by the Division during this week:

- **Seminar Programs**. On March 30th, former Director of Commerce Donna Owens and American Association of Retired Persons (AARP) Ohio President Joseph C. Sommerville kicked off the Saving and Investing Education Week at the Eleanor M. Kahle Senior Center in Toledo by announcing a new "telephone hotline" sticker for the Division's toll-free number. Presentations were also made by Owens at the Chillicothe Chapter of Public Employees Retirement System on March 24th, and by Commissioner Tom Geyer and other staff to civic groups, senior citizen centers, and Ohio high schools and colleges throughout the week. On April 2nd, Owens and Commissioner Tom Geyer introduced the "Investor Bill of Rights" during a presentation at the Fairborn Senior Center. Commissioner Geyer introduced "Investment Scams: What Con Artists Don't Want You To Know," the new investor education video produced by the IPT, at the Garfield Heights Senior Center on March 31st.
- **In-School Programs**. In-school presentations were a focus of Ohio's campaign. Former director Owens, Commissioner Geyer and Division staff visited 10-15 high school and college classes around the state throughout the week. The presentations stressed the importance of personal financial planning and how to protect yourself from investment and securities fraud.
- **Media Programs**. The Division unveiled an enhanced version of its Web site at a press conference, which also includes additional investor education information and an "on-line" complaint filing system at a news conference on March 31st. Commissioner Tom Geyer appeared on a talk radio show and on television in Youngstown on April 2nd. The Department distributed a series of investor education articles to local newspapers and issued a news release prior to each planned event. The Department also issued news releases that highlighted a particular aspect of saving and investing daily. The Division's activities throughout the week were covered by numerous television stations, radio stations and newspapers.
- **Money 2000**. The Division promoted Money 2000 during the campaign week in connection with the in-school programs. The Division coordinated efforts with The Ohio State University Extension program, who promotes this program locally.
- **Ballpark Estimate**. The Division distributed the Ballpark Estimate during the campaign in connection with the staff's presentations.
- **Other Programs**. Governor George Voinovich issued a proclamation declaring the week of March 29th - April 4th to be "Saving and Investing Education Week" in the State of Ohio.
- **Distribution of Investor Education Materials**. The Division distributed investor education materials in connection with all seminar presentations and in-school programs. The new investor education video: "Investment Scams: What Con Artists Don't Want You To Know" was sent to approximately 200 Ohio libraries. A new telephone sticker was distributed that reminds people to "investigate before investing" and lists the Division's toll-free investor protection hotline. Two new pamphlets, "Bulletin For Older Investors" and "How to Spot Boiler Room Scams" were released along with a new investor education folder.

Seven Commerce employees made presentations in conjunction with this week to various types of groups, including the following: preparatory school students, the Rotary Club, vocational students, the Urban League, high school students, Senior Centers, college business and law students, Public Employee Retirement System Retirees, and career center students. Over twenty news organizations, including newspapers, and television and radio stations in Ohio covered the activities of the Division during this week, which helped to further educate the public to make wise and appropriate investment decisions through their coverage.

Distribution of Investor Educational Video to Ohio Libraries

In April, the Division distributed a new investor education video to 200 Ohio libraries. The videos, titled "Investment Scams: What Con Artists Don't Want You To Know" were provided to the Division by the Investor Protection Trust, a non-profit organization.

The 17-minute video explains how individual investors can spot and avoid fraud and illustrates how fraud schemes work. The narrator is David Leisure, who first came to fame in the 1980s in a widely remembered series of advertisements featuring the "lying car salesman" Joe Isuzu. The video plays on the viewer's memory of the unscrupulous Joe Isuzu character in order to take the viewer into the mindset of the con artist.

National Summit of Retirement Income Savings

To coincide with the National Summit of Retirement Income Savings at the White House, the Department of Commerce issued a release in June encouraging Ohioans to remember the basics of investing. Ohioans are encouraged to set realistic investment expectations, diversify their portfolios and recognize that all investments carry risks.

In addition, the Department of Commerce issued a release announcing all the free investor education materials available from

Continued on page 28

Capital Formation Statistics

Amounts in Thousands (rounded up)

Filing Type	Fourth Quarter 1998	YTD 1998
Exemptions		
Form 3(Q) & Form D*	$563,054	$3,105,141
Form 3(W)	19,254	77,126
Registrations		
Form .06	8,299	654,601
Form .09	315,528	707,416
Form .091	2,473,366	9,011,274
Investment Companies		
Definite	172,598	645,646
Indefinite**	689 filings = 689,000	2669 filings = 2,669,000
TOTAL	**$4,241,099**	**$16,870,204**

**Reflects sales actually reported. Remaining categories reflect amount of securities registered or eligible to be sold in Ohio by issuers.*
***Investment companies may seek to sell an indefinite amount of securities by submitting maximum fees. Based on the maximum filing fee of $1100, an indefinite filing represents the sale of a minimum of $1,000,000 worth of securities, with no maximum. For purposes of calculating an aggregate capital formation amount, each indefinite filing has been assigned a value of $1,000,000.*

Because the Division's mission includes enhancing capital formation, the Division tabulates the aggregate dollar amount of securities to be sold in Ohio pursuant to filings made with the Division. As indicated in the notes to the table, the aggregate dollar amount includes a value of $1,000,000 for each "indefinite" filing. However, the table does not reflect the value of securities sold pursuant to "self-executing exemptions" like the "exchange listed" exemption in R.C. 1707.02(E) and the "limited offering" exemption in R.C. 1707.03(O). Nonetheless, the Division believes that the statistics set out in the table are representative of the amount of capital formation taking place in Ohio.

Editor's Note: The Division Enforcement Section Reports for the fourth quarter of 1998 will appear in the next issue of the Ohio Securities Bulletin.

Registration Statistics

The following table sets forth the number of registration and exemption filings received by the Division during the fourth quarter of 1998, compared to the number of filings received during the fourth quarter of 1997. Likewise, the table compares the total for 1998 to the total for 1997.

Filing Type	4th Qtr '98	1998	4th Qtr '97	1997
1707.03(Q)	351	1502	381	1402
1707.03(W)	14	55	20	66
1707.04	0	0	0	0
1707.041	1	1	1	6
1707.06	36	126	25	147
1707.09	26	72	20	657
1707.091	80	346	120	1958
NF**	1036	4202	983	1690
1707.39	6	11	4	18
1707.391	25	114	28	129
Total	1575	6429	1582	6073

**Includes 214 filings submitted on federal Form D for offerings made pursuant to Rule 506 of Regulation D. Use of the federal Form D was not available before April 21, 1997.*

***The Form NF is a form adopted by the North American Securities Administrators Association, Inc. to be used by investment companies in making notice filings. The form was drafted as a result of the National Securities Markets Improvement Act of 1996, and is used at the election of the issuer. Usage of the Form NF began in 1997, with its usage increasing throughout the year.*

Licensing Statistics

The table below sets out the number of Salesmen and Dealers licensed by the Division at the end of the first, second, third and fourth quarters of 1998, compared to the corresponding quarters of 1997.

	End of Q4 1998	End of Q4 1997	End of Q3 1998	End of Q3 1997	End of Q2 1998	End of Q2 1997	End of Q1 1998	End of Q1 1997
Number of Salespersons Licensed:	89,152	83,238	88,796	83,545	85,526	82,135	81,210	80,289
Number of Dealers Licensed:	2,137	2,170	2,151	2,154	2,106	2,113	2,082	2,050

Investor Protection and Education

Continued from page 25

the Division of Securities. Former director Owens announced "Through a wide variety of investor education materials, we are educating Ohioans on the risks, rewards and potential pitfalls of the investment process."

Investor Education Newspaper Columns

The Department of Commerce began issuing an ongoing series of newspaper columns on investor educational topics. These investor education articles are suitable for columns, particularly in smaller weekly newspapers. In 1998, the following columns were issued: (1) "Things to Remember When Choosing a Stockbroker"; (2) "It's Time to Start Saving for Retirement"; and (3) "Beware of Investment 'Opportunities' by Those You Know." The Department will be periodically sending additional columns to Ohio newspapers.

1998 Ohio State Fair

The Division participated in August at the 1998 Ohio State Fair by distributing investor education information. The Division's new publications released during "Saving and Investor Education Week" were distributed, along with its other investor education publications. Participation at the Ohio State Fair allowed the Division to once again target educational efforts toward the large attendee population.

Notepad for Investors

In November, the Department of Commerce announced the availability of a new investor notepad, which prompts investors to record information such as the date of the broker's call, the nature of the investment, how it was described to them, the broker's name and their CRD number.

The notepad consists of fifteen 8-1/2 x 11 inch two-sided sheets that are printed in notepad fashion so investors get into the habit of making written records of the conversations with their brokers. The release issued by the Department noted that investors who take good notes and maintain their records are much more likely to prevail if they later have a dispute with their broker. The notepad form can also be downloaded from the Division's Web site at www.securities.state.oh.us.

Holiday Telephone Hotline Sticker

In December, Commissioner Tom Geyer distributed a supply of telephone hotline stickers, printed in holiday colors of red and green, to all Ohio County Prosecutors and Sheriffs. The Commissioner requested their assistance in distributing the "Investigate Before You Invest Telephone Reminder Sticker" during the holiday season. Commissioner Geyer informed the prosecutors and sheriffs that "As the holidays approach, Ohio citizens need to be aware of swindlers who use the telephone to promise 'can't miss' investment deals with 'guaranteed returns.'"

Ms. Terhune is the Assistant Manager of the Division's Enforcement Section.

OHIO SECURITIES BULLETIN

Ohio Division of Securities
77 South High Street, Floor 22
Columbus, Ohio 43215

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