OHIO SECURITIES BULLETIN

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FINRA'S New Suitability Rules And Their Impact In Ohio

Department of Commerce

Division of Securities

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Ohio Securities Bulletin

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OHIO

DEPARTMENT OF
COMMERCE
DIVISION OF
SECURITIES

The Financial Industry Regulatory Authority (FINRA) recently implemented two new rules which broaden the previous suitability obligations placed on firms and associated persons. Effective July 9, 2012, FINRA Rule 2090 (Know Your Customer) and FINRA Rule 2111 (Suitability) require firms and associated persons to have a clear understanding of their products and their customers prior to and while making recommendations involving securities. FINRA Rule 2090 is modeled after former New York Stock Exchange (NYSE) Rule 405(1) and requires firms to use reasonable diligence in opening and maintaining every account, and requires firms to know the essential facts concerning every customer.[1] FINRA Rule 2111 (Suitability) is modeled after former National Association of Securities Dealers (NASD) Rule 2310 and requires that a firm or associated person "… have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer …." [2]

Application for Ohio Licensees

In Ohio, all individuals and entities who engage in purchasing, selling, or providing advice concerning securities must be licensed by the Ohio Division of Securities (the "Division") or properly exempted from licensure. Ohio's regulatory standards regarding securities professionals are contained in a set of conduct and anti-fraud provisions in the Ohio Securities Act and the Administrative Rules promulgated thereunder.

Ohio's suitability rule, OAC 1301:6-3-19(A)(5), provides that no dealer or salesperson shall "sell, purchase, or recommend the sale or purchase of any security without reasonable grounds to believe that the transaction or recommendation is suitable for the customer, based upon reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other relevant information known to [the] dealer or salesperson."[3] Similar to FINRA Rules 2090 and 2111, Ohio law requires dealers and salespersons to have a reasonable belief that a transaction or recommendation is suitable for a customer based on the customer's investment objectives. Although Ohio's suitability rule is not as specific as the FINRA Rules with respect to the profile information that the dealer or salesperson is required to obtain, it does require that the suitability determination be based upon "any relevant information known to the dealer or salesperson."[4]

Moreover, in practice, many Ohio licensees are also FINRA members. To obtain and maintain a license in Ohio as either a dealer or salesperson, the Division must make an affirmative finding that the dealer or salesperson is of "good business repute."[5] In making that determination, the Division is guided by factors which include an applicant or licensee's compliance with FINRA rules.[6] A FINRA member's failure to comply with FINRA Rules 2090 or 2111 could prevent the Division from being able to find that dealer or salesperson is of good business repute.

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Comments from Commissioner Andrea Seidt

I'm excited to begin the new year as the Division of Securities plans new technological advances to better serve you.

The Division is in the process of implementing a new database program, called STAR, which is designed specifically for state securities regulators. It offers a number of benefits to the industry, the investing public, and the Division's staff. With this new program, registration filers will soon be able to submit electronic filings for each of our major registration filing types. Registration filers will also receive enhanced access to their filings through a new and improved web portal replacing the existing ERNIE database. These enhancements will provide a more convenient and less expensive method of filing for our customers and should significantly reduce the number of paper files received by the Division.

In another technological update, industry and public users will also be able to search any final Division orders and copies of our Bulletin using date and full-text searching queries. Meanwhile, the Department of Commerce is working to upgrade the Commerce website that will make the Division's content more impactful and much easier to navigate. Please stay tuned for updates in future Bulletins on these exciting projects in 2013.

I would also like to share with you some Division highlights from 2012. I will start by recognizing the Division's most prized resource, our employees, who have worked tirelessly this past year to protect and serve Ohio investors. With their leadership, the Division has:

- performed a thorough review of the Ohio Securities Act and associated rules, which will lead to a significant regulatory reform effort by the Division in 2013;

- helped more than 100 mid-sized investment advisers make a seamless switch from SEC to state registration here in Ohio (and will even have performed the first on-site examination for every switching firm in the first quarter of 2013);

- reduced the time it takes to review registration filings;

- made significant contributions in several criminal fraud cases, one of which yielded a hefty 13 ½ year sentence in December; and

- hosted another successful Securities Conference and set of Advisory Committee Meetings at a new location in Reynoldsburg (thanks to our sister Division, the State Fire Marshal).

I am very proud of our achievements and look forward to working with you in 2013.

Andrea Seidt
Securities Commissioner

Message from Commerce Director David Goodman:

Dear Securities Professional:

As we enter 2013, we are already hard at work on the new biennial budget for the State of Ohio. Throughout the current budget, we have worked to use the money you pay through licensing fees wisely. In the Division, staff positions are being filled more quickly to serve you better. As Commissioner Seidt discussed in her column, electronic filing has been a priority to save you time with your registration filings and enable us to respond to you more quickly. Customer service continues to be a top priority. We want you to be able to concentrate on your core business to fuel Ohio's economy and create jobs.

In the coming months, you can expect a balanced state budget proposal. There will be a continued focus on government at all levels providing quality service that Ohioans expect along with creative sharing to reduce taxpayer costs. If present trends continue, Ohio will see additional contribution to the Rainy Day Fund (Budget Stabilization Fund). When Governor Kasich entered office, the Fund was depleted to 89 cents and now has a balance of $481,999,131.83. While the current balance is a large amount of money by anyone's standards, it is just 1.8% of the total state budget; less than economists recommend for state governments to hold as an emergency reserve.

We are working to serve you and build a stronger Ohio in 2013. If you have any ideas or comments you would like to share with me, I am always happy to hear from you: David.Goodman@com.ohio.gov.

David Goodman
Director, Ohio Department of Commerce

Looking for a past issue of the Bulletin?

If you are in need of a past Bulletin issue, you can find past issues on the Division's website at www.com.ohio.gov/secu/bulletins.aspx.

From this page, you can use the Abstract Search function to search by title, author, issue or abstract.

We currently have links on the website for issues dating 1994 to 2012. For issues prior to 1994, please contact Karen Bowman at 614-995-5791 or via e-mail karen.bowman@com.state.oh.us for a hard copy of that issue.

The Ohio Securities Bulletin is a quarterly publication of the Ohio Department of Commerce, Division of Securities.

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 Karen Bowman at karen.bowman@com.state.oh.us for editorial guidelines and publication deadlines. The Division reserves the right to edit articles submitted for publication.

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Investment advisers and investment adviser representatives ("IARs") who are not dually licensed as dealers or salespeople are not explicitly subject to Ohio or FINRA's suitability rules. Rather, investment advisers and IARs stand in a fiduciary relationship with their clients, whereby they maintain: (1) a duty to employ reasonable care to avoid misleading clients; (2) a duty to have a reasonable independent basis for their investment advice; (3) a duty to ensure that their investment advice is suitable; and (4) a duty to avoid or disclose all conflicts of interest.[7] Investment advisers and IARs may wish to refer to the new FINRA suitability rules as a starting point for carrying out their obligations to their clients.[8]

FINRA Rule 2090 – Know Your Customer

FINRA Rule 2090 requires its members to "use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer and concerning the authority of each person acting on behalf of such customer."[9] For purposes of this Rule, FINRA has explained that "essential facts" are those required to effectively service the account, act in accordance with any special handling instructions for the account, understand the authority of all persons acting on the account, and comply with all governing laws, rules, and guidelines.[10] The "know your customer" fact gathering obligation arises immediately upon a customer opening an account, regardless of whether the member or associated person has actually made any recommendations to the customer.

FINRA Rule 2111 – Suitability

FINRA Rule 2111 mandates that members and associated persons have a clear understanding of both the product and the customer. Rule 2111 provides:

A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.[11]

Essentially, Rule 2111 broadens existing suitability obligations in the following ways:

(1) it applies to investment strategies and recommendations, including recommendations to hold a security;

(2) it expands the list of explicit types of necessary customer profile information that firms and associated persons are required to obtain; and

(3) it enumerates three specific suitability obligations.[12]

Similarly to NASD Rule 2310, the new Rule uses a broker's "recommendation" as the triggering event for application of the Rule and continues to apply a flexible 'facts and circumstances approach' in determining what communications would constitute such a recommendation.[13] FINRA applies an objective, rather than subjective, test in determining whether a recommendation has been made.[14] Important factors in this regard are whether a particular communication from a firm or associated person to a customer would reasonably be viewed as a suggestion that the customer take action or refrain from taking action regarding a security or strategy.[15] Regardless of whether the communication is initiated by a person or a computer software program, the more the communication is uniquely tailored to the recipient, the more likely it will constitute a recommendation.[16] Rule 2111 also applies to recommended "investment strategies."[17] The Rule states that the term should be interpreted broadly, and would include recommendations that amount to "calls to action," regardless of whether they result in a transaction or reference a specific security.

FINRA also expanded the suitability obligation into new territory, in that Rule 2111 expressly covers situations where the broker is making explicit recommendations to "hold" (or maintain an allocation in) a security.[18] FINRA views recommendations to "hold" to be "investment strategies" falling within the scope of Rule 2111 because customers are often relying on a firms' or associated persons' investment expertise and knowledge in making such recommendations. Firms and associated persons should now consider how and when to document the suitability of recommendations to "hold."[19]

Importantly, suitability in accordance with Rule 2111 is still assessed only at the time of the recommendation, regardless of whether the implemented strategy is ultimately successful. FINRA did not create any new ongoing duties to monitor or make subsequent recommendations to a customer's investments.[20]

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Rule 2111 also includes an expanded list of explicit types of information that firms and associated persons must attempt to gather and analyze as part of a suitability analysis.[21] The Rule adds five new profile factors, specifically: the customer's age, investment experience, time horizon, liquidity needs, and risk tolerance. While Rule 2111 does not define these new profile factors, FINRA provides some guidelines to this terminology in Regulatory Notice 11-25.[22] The Rule states that when a customer discloses "any other information" to their broker in connection with a recommendation, the broker must consider that information in his or her suitability analysis.[23] The Rule does not, however, require a firm to update all existing customer-account documentation, nor does the Rule include any explicit documentation requirements. Rather, FINRA states that the essential element of the Rule is that the member firm or associated person exercise reasonable diligence to ascertain a customer's investment profile, and that generally, asking for this information is sufficient.[24] In cases where the customer information is unavailable despite the firm's reasonable diligence, the firm must analyze whether it has sufficient understanding of the customer to properly evaluate the suitability of a specific recommendation.[25] In instances where a customer has multiple accounts with varying investment profiles between accounts, FINRA recommends firms document the customer's intent for each specific account to assess the suitability for each.[26]

Finally, one of the most important aspects of Rule 2111 is that it enumerates three specific suitability obligations:

(1) reasonable-basis suitability;
(2) customer-specific suitability; and
(3) quantitative suitability.

Reasonable-basis suitability requires a broker to have a reasonable basis to believe, based on reasonable diligence, that the recommendation is suitable for at least some investors. FINRA has stated that reasonable-basis suitability is an objective standard and what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the firm or associated person's familiarity with the security or investment strategy.[27] The reasonable diligence conducted on the investment itself must provide the firm and associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy.[28]

Customer-specific suitability requires that a broker have a reasonable basis to believe that the recommendation is suitable for a particular customer based on that customer's investment profile.[29]

Quantitative suitability re-quires a broker who has actual or *de facto* control over a customer account have a reasonable basis for believing that a series of recommended trans-actions, even if suitable when viewed in isolation, are not excessive and unsuitable in light of the customer's investment profile when taken together.[30] FINRA has identified the turnover rate, cost-equity ratio, and use of in-and-out trading in a customer's account as possible factors for finding that the activity at issue was excessive.[31]

Conclusion

FINRA states that the "know-your-customer" and suitability obligations are essential to ensuring investor protection and promoting fair dealing with customers.[32] Both FINRA members and non-FINRA Ohio licensees should carefully consider the obligations set forth in FINRA Rules 2090 and 2111 and compare them with their current policies and procedures for assessing the suitability of all recommendations and investment strategies. Licensees may find guidance on these new rules by visiting FINRA's new dedicated web page:

http://www.finra.org/Industry/Issues/Suitability/

which consolidates information and resources regarding suitability requirements. All licensees should consider developing their own best practices for assessing when and how to document their compliance with the standard of care owed to their customers at every stage of the account relationship. Doing so will not only serve to protect the investor, but the licensee as well.

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[1] FINRA Rule 2090; FINRA Regulatory Notice 11-02.
[2] FINRA Rule 2111(a).
[3] FRIEDMAN, HOWARD M., OHIO SECURITIES LAW AND PRACTICE §§ 25–27 (3d ed. 2012).
[4] Ohio Administrative Code 1301:6-3-19(A)(5).
[5] Ohio Revised Code Sections 1707.15(E) and 1707.16(D).
[6] *See e.g.,* Ohio Administrative Code 1301:6-3-19(D)(7) and (11).
[7] FRIEDMAN, HOWARD M., OHIO SECURITIES LAW AND PRACTICE § 27.10 (3d ed. 2012), citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194, 84 S. Ct. 275 (1963).
[8] With respect to recommendations to retail customers, it appears that the new FINRA suitability rules are further closing the gap between the standard of care applied by broker

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dealers and salespeople and that applied by investment advisers and IARs. See SEC Staff Study on Investment Advisers and Broker Dealers As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, at Executive Summary, ii (Jan. 2011) ("These recommendations are intended to make consistent the standards of conduct applying when retail customers receive personalized investment advice about securities from broker-dealers or investment advisers. The Staff therefore recommends establishing a uniform fiduciary standard for investment advisers and broker-dealers when providing investment advice about securities to retail customers that is consistent with the standard that currently applies to investment advisers."); see also, FINRA Regulatory Notice 12-25 ("In interpreting FINRA's suitability rule, numerous cases explicitly state that 'a broker's recommendations must be consistent with his customers' best interests.'").

[9] FINRA Rule 2090.

[10] FINRA Rule 2090, Supplementary Material.

[11] FINRA Rule 2111(a).

[12] FINRA Rule 2111.

[13] FINRA Regulatory Notice 11-02.

[14] FINRA Regulatory Notice 11-02.

[15] FINRA Regulatory Notice 11-02.

[16] FINRA Regulatory Notice 11-02.

[17] FINRA Rule 2111; FINRA Regulatory Notices 11-02 and 12-55 ("investment strategy" would cover "recommendations to invest in specific types of securities … or in a market sector, regardless of whether the recommendations identify *particular* securities."). Note, the Rule does provide a safe-harbor for various types of communications that are educational in nature and do not include recommendations regarding a particular security or securities. See FINRA Rule 2111.03 and FINRA Regulatory Notice 12-25.

[18] FINRA Regulatory Notice 12-55. FINRA's application of a suitability assessment for "hold" recommendations is a divergence from prior U.S. Supreme Court decisions. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S. Ct. 1917 (1975) and *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit,* 547 U.S. 71, 126 S. Ct. 1503 (2006).

[19] FINRA Regulatory Notice 12-25 (FINRA suggests firms adopt a risk-based approach in identifying which recommendations to document, considering the nature of the securities and the particular circumstances involved, such as timing and market conditions).

[20] FINRA Regulatory Notice 12-55. Note that the fiduciary duty standard imposed on investment advisers and IARs does not have the same limitation.

[21] FINRA Regulatory Notice 11-02.

[22] FINRA Regulatory Notice 11-25.

[23] FINRA Regulatory Notice 12-25.

[24] FINRA Regulatory Notices 11-25 and 12-25.

[25] FINRA Regulatory Notices 11-25 and 12-25.

[26] FINRA Regulatory Notice 11-25.

[27] FINRA Regulatory Notice 11-02.

[28] FINRA Regulatory Notices 11-02 and 12-25.

[29] FINRA Regulatory Notice 11-02. In addition, FINRA Rule 2111 provides an exemption from the customer-specific suitability requirement for recommendations to institutional investors in certain circumstances. See FINRA Rule 2111(b) and FINRA Regulatory Notices 11-02 and 12-25 for additional information.

[30] FINRA Regulatory Notices 11-02 and 12-25 ("The quantitative suitability obligation … codifies excessive trading cases.").

[31] FINRA Regulatory Notice 11-02.

[32] FINRA Regulatory Notice 11-02.

Status of Securities and Exchange Commission (SEC) Rulemaking on Title III of the JOBS Act (CROWDFUNDING)

President Barack Obama signed the Jumpstart Our Business Startups Act of 2012 (the "JOBS Act") into law on April 5, 2012. Title III of that Act, the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012, is more commonly known as the "CROWDFUND Act." The CROWDFUND Act creates an exemption from SEC registration for issuers raising no more than $1,000,000 through a public offering facilitated by an online funding portal or broker-dealer.

It is important for prospective crowdfunding issuers, funding portals, broker-dealers and other interested parties to note that the exemption created by the CROWDFUND Act is not available until the SEC and the Financial Industry Regulatory Authority ("FINRA") complete all of the rulemaking required by the statute. Until the SEC and FINRA complete rulemaking in this area, any offers or sales of securities purporting to rely on the crowdfunding exemption are in violation of Ohio and federal securities laws.[1] There is no date certain by which the rulemaking will be completed and securities transactions complying with the CROWDFUND Act's exemption will become legal.

The CROWDFUND Act required the SEC to complete its rulemaking by December 31, 2012. However, the SEC recently confirmed that it will not complete its rulemaking until sometime in 2013.[2] To date, the SEC has only completed approximately one-third of its required rulemaking under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. At the 2012 SEC Government-Business Forum on Small Business Capital Formation on November 15, 2012, Meredith Cross, recently departed Director of the SEC Division of Corporation Finance, stated that before Title III rules would even be proposed, the Commission would adopt the Rule 506 bad-actor disqualifiers required by the Dodd-Frank Act, and then adopt final rules implementing Title II of the JOBS Act.

Until the SEC and FINRA complete rulemaking in this area, any offers or sales of securities purporting to rely on the crowdfunding exemption are in violation of Ohio and federal securities laws.[1]

On November 26, 2012, SEC Chairman Mary Schapiro announced that she would be stepping down effective December 14.[3] President Obama announced that current Commissioner Elisse Walter would act as Chairman until a permanent replacement could be nominated and confirmed by the Senate. It is unclear what effect this change and the current makeup of the Commission will have on the pace and priority of SEC rulemaking. Finally, the CROWDFUND Act also requires FINRA to complete rulemaking implementing certain provisions of the statute. It is unlikely that FINRA will begin its rulemaking process prior to the SEC's adoption of final rules. The CROWDFUND Act places no deadline on FINRA's rulemaking.

Both the SEC and FINRA have invited the public to submit views on their rulemaking initiatives under the JOBS Act. The Division has already submitted its views and formal comment on the Commission's proposed rule under Title II. Division staff is currently preparing views on the CROWDFUND Act for submission to the SEC and FINRA. Be on the lookout for a more in depth discussion of the implementation of crowdfunding in the next edition of the Bulletin, after submission of the Division's views to the SEC.

[1] See, http://www.sec.gov/spotlight/jobsact/crowdfundingexemption.htm.

[2] See, "2013: A Year of Continuing Progress", U.S. Securities and Exchange Commission Fiscal Year 2012 Agency Financial Report at 28-31 (2012) (available at: http://www.sec.gov/about/secpar/secafr2012.pdf).

[3] See, http://sec.gov/news/press/2012/2012-240.htm

Ohio Securities Conference Featured Nationally-Recognized Experts

The 2012 Ohio Securities Conference featured nationally-recognized experts who addressed emerging issues in securities regulation.

The Conference, which was held on October 12, drew more than 100 guests and was by all accounts a success. The event featured panel discussions and presentations by leading securities law professors, private practitioners, and industry regulators. The Division was honored to host attorneys David Sheehan and Thomas Long, counsel for Bernie Madoff bankruptcy trustee Irving Picard, who conducted a panel discussion on civil recovery in securities fraud cases. Sheehan and Long were joined by Matt Fornshell, receiver in the Joanne Schneider Ponzi scheme case, and David Meyer, class action counsel for defrauded investors. The Division also hosted a panel discussion of the JOBS Act, with special emphasis on Title II and the changes to Rule 596 and Title III's crowdfunding provisions. The panel featured the Division's own Mark Heuerman, as well as University of Dayton law professor Eric Chafee, University of Colorado professor J. Robert Brown, and securities counsel Sean Peppard.

The Conference also featured a litigation update by Tom Geyer, Esq. and law professor Steven Davidoff of the O.S.U. Moritz College of Law. The Division closed the Conference with a presentation by each of its section chiefs regarding the rule changes and highlights of the past year. As always, during the Conference lunchtime break, the Division hosted its annual Advisory Committee meetings, which provide a valuable opportunity for the public and the Division to converse about legal issues and policy concerns. (The notes from these meetings are summarized separately in this Bulletin issue.)

This year's Conference was held at the Ohio Fire Academy, a spacious, state-of-the-art facility in Reynoldsburg. This venue allowed the Division to extend invitations to a larger audience while limiting event costs. The feedback from our guests was positive, and we look forward to hosting future Conferences at the Fire Academy location.

The Division thanks Professor Geoffrey Rapp and the University of Toledo College of Law for co-sponsoring the Conference, and for sharing their time and considerable expertise with the securities community in Ohio. The Division also thanks the attendees at the Conference's Advisory Committee meetings. Your support and feedback allow the Division to continue to fulfill its mission of promoting capital formation while protecting the investing public.

The Division looks forward to welcoming you to the 2013 Conference!

Don't Miss Out on Next Year's Conference!

If you would like to receive information on the 2013 Ohio Securities Conference, we would be happy to forward registration information when available.

Please provide your contact information, including email address, to

Shannon.Himes@com.ohio.gov

Ohio Division of Securities employees participating in this year's Securities Conference from left to right: Frank Esposito, Mark Heuerman, Commissioner Andrea Seidt, Anne Followell, Shannon Himes and Janice Hitzeman.

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2012 Advisory Committee Meeting Notes

For many years, the Division has hosted Advisory Committee Meetings during its annual Securities Conference. These Committees serve as valuable vehicles for interaction between the Division and the public. Since 1980, the Division has communicated policy positions through its Advisory Committee Meetings, received feedback on Division proposals, and gained valuable perspective on the impact and implications of Division practices. The Advisory Committee membership is open to any interested individuals, including representatives of the securities industry, the accounting and legal professions, and investors. The notes from the 2012 Advisory Committee Meetings are included below.

Enforcement Advisory Committee Meeting

The Enforcement Advisory Committee session was attended by 21 members, including representatives from the Ohio Attorney General's Office, industry representatives, and various attorneys representing both industry and investor perspective. Janice Hitzeman, Attorney Inspector, and Harvey McCleskey, Deputy Attorney Inspector, led the meeting on behalf of the Enforcement Section.

The first item on the agenda was an update on the indictment, plea and sentence in the *State v. Schneider* case filed in Cuyahoga County, CR-05-472739-B. As many of the attendees were aware, Joanne Schneider and her husband Alan were indicted years ago for committing a $60 million real estate investment Ponzi scheme. Alan Schneider pleaded guilty to his crimes in 2009 and received probation. Joanne Schneider also pleaded guilty in 2009 and received a three-year sentence. That sentence was overturned on appeal as being contrary to a 10-year mandatory sentencing provision, and the matter was remanded for sentencing. On remand, the Cuyahoga County Court of Common Pleas refused to allow Joanne to withdraw her plea and sentenced her to 10 years. This conviction was also overturned on appeal for impermissibly denying Schneider's plea withdrawal, and the matter was again remanded and set for trial. On August 20, 2012, the first day of trial, Joanne Schneider and prosecutors entered into a plea agreement. Joanne Schneider was sentenced to nine years for her securities crimes, which included securities fraud, sale of unregistered securities, theft, and engaging in a pattern of corrupt activity.

The second item discussed was the recent opinion issued by the Eighth District Court of Appeals in the *State v. Willan* case, 2011-Ohio-6603, C.A. No. 24894, originating from a criminal conviction following a jury trial in Summit County. The attendees discussed the amicus briefs filed by the Ohio Department of Commerce, NASAA and the Ohio Prosecuting Attorneys Association for the discretionary appeal with the Ohio Supreme Court in *Willan*. Of particular concern was the impact of the decision on Ohio's securities fraud statue, R.C. 1707.44(G), as the appellate decision imposed a new reliance element to the crime. The decision also added a reliance element to R.C. 1707.44(C), declaring that the Division must prove its reliance on any false statements in registration filings. Furthermore, the appellate decision deviated from the appellate court finding in *Schneider* by refusing to apply a 10-year mandatory minimum sentence for pattern of corrupt activity offenses where the predicate act is a felony in the first degree. The Supreme Court denied the appeal, but reconsidered on the sole issue of the sentencing guidelines. That case has yet to be decided.

The final items the Enforcement Advisory Committee discussed were proposed changes to the Ohio Securities Act relating to issues arising in the *Willan* case and *Dillabaugh*. As mentioned earlier, the *Willan* decision negatively impacted R.C. 1707.44(C) and R.C. 1707.44(G), and the committee discussed possible amendments to those statutes. The *Dillabaugh* case implicated both R.C. 1707.26 and 1707.27 – the Division's powers to seek injunctions and the powers of receivers appointed by the Division. *Dillabaugh* involved an appeal to the Ohio Supreme Court regarding the Division's ability to enjoin or freeze the proceeds of securities crimes when held by third parties. *Goodman v. Hanseman*, 132 Ohio St.3d 23, 2012-Ohio-1587. The Second District Court of Appeals had ruled that R.C. 1707.26 only permitted injunctions against those who had violated the Ohio Securities Act. The Ohio Supreme Court agreed with the Division and vacated this decision, albeit for jurisdictional rather than substantive reasons, thereby negating the need to amend R.C. 1707.26. The *Dillabaugh* receivership actions, however, called into question the need for changes to the receivership provisions under R.C. 1707.27. The receiver in the *Dillabaugh* matter was thwarted in his efforts to recover investors funds by the court's application of the *in pari delicto* doctrine. See *Hanseman v. Dillabaugh*, Montgomery County Court of Common Pleas, 2011 CV 00361. The committee discussed possible changes to the language of R.C. 1707.27 in order to avoid application of this doctrine and to allow receivers to stand in the shoes of investors when pursuing civil recovery.

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As the meeting drew to a close, members discussed the possibility of having bi-yearly Enforcement Advisory Committee meetings in the future, and whether the meetings could be by teleconference or webinar. Many attendees expressed an interest in attending future meetings. The Advisory Committee meeting was then adjourned and attendees returned to the Conference. Attendees were encouraged to contact the Division if they have issues that arise during the year.

Licensing Advisory Committee Meeting

The Licensing Advisory Committee held its annual meeting in connection with the Division's Ohio Securities Conference. Sixteen members of the industry, attorneys, Division staff, and others attended. Anne Followell, Licensing Chief, led the meeting on behalf of the Licensing Section.

The Division discussed the licensure, examination, and renewal of the "switching" investment advisors. As a result of the Dodd Frank Wall Street Reform and Consumer Protection Act, investment advisers having less than $100 million in assets under management (now known as "mid-size investment advisers") were required to switch from being registered with the Securities and Exchange Commission (SEC) to state registration. As part of a two-year undertaking, NASAA and the Division worked with the SEC to ensure a smooth transition. The Division conducted outreach to the investment advisor community in Cleveland, Cincinnati, and Columbus, along with numerous telephone calls and emails to assist the IAs switching over to state regulation. The SEC worked closely to provide numbers to the Division identifying how many switching firms had their principal place of business in Ohio. In total, approximately 110 firms switched from SEC registration to Ohio. The Division has begun conducting field exams of the "switching" advisers, with the goal of learning about these new licensees' business practices and explaining compliance with Ohio rules. As renewal season approaches, the Division advised that switching IAs must pay all renewal fees on time, or the IARD filing system will automatically terminate the license after December 31, 2012. There were no questions from the attendees.

The next topic discussed was the examination of dealer branch offices in Ohio. While the Division's examination focus remains on state-registered investment advisers, the Division has begun conducting dealer branch office examinations this past year. One attendee asked if the branch offices were going to be provided a list of what documents the Division will require during examination. The Division stated that the notice regarding the exam would identify certain records to be made available for examination.

The Division's technology advancements were discussed. In the next few months, the Division will be switching to STAR, which is a database used by many states securities regulators, as the software is specifically geared to securities regulators. The Division anticipates more efficient service to its licensees once the new system is in place and fully operational.

Next, the Division discussed the possibility of having semi-annual or quarterly advisory committee meetings in order to continue the dialogue between the Division, licensees, and practitioners. There was a consensus among attendees to meet more frequently. The Division is committed to meeting on at least a semi-annual basis, possibly by phone or web-conference. In terms of industry networking groups, one attendee mentioned the Central Ohio Compliance Association and another attendee mentioned that Cleveland has a similar group.

The next topic discussed was regulatory reform. The Division announced that it has been reviewing its statute and rules in response to Governor Kasich's Common Sense Initiative ("CSI"), changes in technology and recordkeeping, and changes in federal law. The Division opened the discussion for ideas from attendees as to what topics should be included in the regulatory reform. The attendees suggested the following for consideration:

1. Amending the definition of "good business repute" in the Ohio Securities Act

2. Compulsory directors and officers insurance for dealers

3. Amending the definition of "finder" under the Ohio Securities Act

The Division then discussed some of the statute and rule amendments already under consideration. First, the Division addressed the recent *State v. Willan* appellate decision. The Division has taken a hard look at its statutes and rules and is proposing amendments to provide clarification and prevent further rulings that would allow the payment of transactional based compensation to unlicensed salespeople. The Division is considering adopting the definition of dealer set forth in the Uniform Securities Act. The next set of revisions discussed CSI and the Division's efforts to make statutory provisions more transparent and

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consistent. Such revisions include, but are not limited to:

(1) creating a licensing exemption for a dealer if all of the firm's Ohio clients are institutional investors;

(2) allowing dual licensure of salespeople who work with affiliated dealer firms;

(3) adopting the Uniform Securities Act's definition of "institutional investor";

(4) codifying Division policy regarding the requirements for a dealer's designated principal;

(5) adopting express provisions that would apply to firms that engage in unlicensed sales in Ohio prior to applying for a license; and

(6) reconciling and clarifying Ohio rules where they are inconsistent with the instructions to the Form ADV.

The Advisory Committee meeting was adjourned in order for attendees to return to the Ohio Securities Conference. Attendees were encouraged to contact the Division if they have issues that arise during the year.

Registration Advisory Committee Meeting

The Division opened with the remark that it hopes to proceed with financial statement reform for registration by description and qualification filings. The reforms focus on recurring issues encountered by the Division. The first issue involves registrations by description that allow the filing of unaudited financial statements by large issuers. The Division highlighted potential consequences of the current language in light of a recent securities fraud case. The other issue involves a 90-day financial statements requirement. Financial statements more than 90 days old are considered stale under the Ohio Administrative Code and are not accepted by the Division. This can cause unique problems for issuers desiring to conduct an offering in the months of January, February, or March as the typical September 30 financial statements have become stale, but the year-end financial statements are not yet available. Legislation from last session, House Bill 600, would implement changes to address these issues. That legislation would also have changed "generally accepted accounting practices" to "generally accepted accounting principles," would have defined the financial statements required, and would have permitted the filing of financial statements up to 135 days old, which is consistent with Regulation S-X of the U.S. Securities and Exchange Commission. House Bill 600 also included a provision that would allow a "hardship exception" by rule, under which it would have the authority to waive audited financial requirements by taking into consideration the size of and the cost to the issuer.

The Division also next discussed other regulatory reform measures that it might pursue. The first is a proposed reform of the mortgage note exemption in R.C. Section 1707.03(H) to make it consistent with the mortgage note exemption under the Uniform Securities Act. The "single purchaser" and "single sale" concept in existing R.C. Section 1707.03(H) is frequently misinterpreted. Sellers of mortgage notes often fail to consider that the definition of "sale" includes any offer or advertisement, and thus a "public offering" for one purchaser is ineligible for the exemption. The Uniform Securities Act language could clarify the mortgage note exemption and increase consistency across states.

Another reform proposal would change the definition of "Institutional Investor" pursuant to R.C. Section 1707.01(S) to be consistent with the Uniform Securities Act standard. This would eliminate the existing problem that any corporation could qualify as an institutional investor. The filing of articles of incorporation should not result in any sole proprietor qualifying as an institutional investor. The Uniform Securities Act language would clarify the institutional investor definition and increase consistency across states.

The Division also discussed establishing a clear deadline to make a corrective filing pursuant to O.A.C. 1301:6-3-391 for Rule 506 offerings. Currently, there is no definitive deadline to make the corrective filing. An issuer that fails to properly file the Form D and $100 filing fee in order to avail itself of the exemption under R.C. Section 1707.03(X) has an infinite amount of time to file a Form D and $200 penalty fee. The Division proposed a revision that limits the time period in which to make a corrective filing to six months for a traditional Rule 506 offering, and one month for the prospective Rule 506(c) offering. These deadlines are consistent with the corrective filing deadlines for R.C. Section 1707.03(Q) and R.C. Section 1707.03(W) private offerings, and 1707.06 public offerings.

Other potential changes discussed were "clean-up" in nature, such as eliminating references in statutes and rules to the old Form 3-O filing, and changing the numbering of section 4(2) of the Securities Act of 1933 to section 4(a)(2) to conform to changes made to the federal securities law by the JOBS Act.

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Advisory Committee Meeting continued...

The Division also mentioned problems staff has observed with offerings that are filed. The Advisory Committee was informed that issuers may receive correspondence from the Division if their filing includes projections. The Division noted that projections frequently are accompanied only by boilerplate cautionary language and no explanation of the assumption made, no identification of information relied upon, and no justification of the reasonableness of the factual basis for the matters projected. The Division also noted that financial projections seem to be getting more aggressive, projecting performance out over longer periods and doing so more specifically. The Division reminded issuers that the safe harbor for forward looking statements under section 27A of the Securities Act of 1933 is not available to non-34 Act reporting companies. Issuers using projections can only rely on bespeaks caution principles. Boilerplate legalese warnings do not necessarily insulate an issuer from liability on unreasonable projections. The Division summarized the elements of bespeaks caution doctrine.

The Division also highlighted exemption filings from counsel or paralegals signing the forms attesting to the truthfulness of the offering and information contained therein. The Division routinely sends such letters back to counsel requiring the application or form to be signed by the issuer. Ohio Securities Act prohibitions and liabilities may extend to issuer's counsel or the paralegal who signs and represents to the Division the truthfulness of statements made in the offering.

The next matter of discussion involved updating one factor of the test of whether an entity is a subject company for purposes of a tender offer in Ohio. The definition of "subject company" pursuant to R.C. Section 1707.01(Y)(1) includes either a principal place of business in Ohio or owning or controlling assets with a fair market value of at least one million dollars. The one million dollar threshold has not been updated for inflation. This part of the test may inadvertently trigger an entity as a subject company in Ohio for intangible assets, financial management issues or assets in transit through Ohio. The Division is considering whether the test may trigger a filing for a company without a significant nexus to Ohio. Efforts are underway to examine modernizing the control bid statute.

The last topic of the meeting was a reminder that the private placement memorandums will need to be filed with FINRA if a FINRA member is selling the offering pursuant to new FINRA Rule 5123. Only one member firm needs to file the private placement memorandum for an offering.

The Advisory Committee was adjourned. Attendees were encouraged to contact the Division if they have issues that arise during the year.

ENFORCEMENT SECTION REPORTS

Jason E. Schwartz

On August 2, 2012, following a criminal referral by the Ohio Department of Commerce Division of Securities, Jason E. Schwartz of North Baltimore, Ohio was indicted by a Wood County grand jury on 4 criminal counts, including securities fraud, theft and passing bad checks. Schwartz was the owner of TLC Genetics, LLC, a company located in Bucyrus, Ohio. In raising $120,000 from two investors, Schwartz is accused of failing to disclose to the investors that he was under federal investigation for mortgage fraud, of which he was later convicted and sentenced to five months in prison. He also allegedly failed to disclose to investors that his prior company owed more than $600,000 in federal and state taxes, and had filed bankruptcy. Schwartz is accused of using the investor funds, immediately after receiving them, to pay personal bills, mortgage payments, and his wife's credit card bill. The matter is set for a pretrial conference on January 15, 2013.

Isaac J. Castile III

On December 4, 2012, Isaac J. Castille III was sentenced to 13 ½ years in prison and ordered to pay restitution in the amount of $255,000. Isaac J. Castile III, of Reynoldsburg, was found guilty on October 19, 2012 by a Franklin County jury on 2 counts of theft and 9 counts relating to securities fraud, unregistered sales and false representations in the sale of securities. Castile was the chairman and CEO of Metropolitan Enhancement Corporation, a Columbus, Ohio-based corporation. Castile told investors that he would invest their funds in U.S. Treasury bills and promised annual returns of 50 percent and 100 percent. The Treasury bills were not purchased.

Jennifer L. Willis

On December 10, 2012, federal marshals arrested Jennifer L. Willis, of Columbus, in Atlanta in connection with her indictment by a Franklin County grand jury. Following a criminal referral by the Ohio Department of Commerce Division of Securities, Willis was indicted on eight felony charges: two counts of misrepresentations in the sale of a security; two counts of unlicensed sale of securities; two counts of fraud in the sale of securities; and two counts of theft by deception. Jennifer Willis, also known as Jennifer Hildebrand, was accused of stealing $28,000 from two central Ohio investors – one of whom she met through an online social networking site. Instead of investing the money as the investors directed, Willis used the money to fund her personal spending sprees. Willis allegedly told investors that she was licensed by the U.S. Securities and Exchange Commission (SEC). She has never been licensed by the SEC or the Division of Securities. Willis also told investors that she worked with GSA Energy LLC, out of Texas. She was not a company employee and was not authorized to sell shares on the company's behalf. Willis said she was working to fund oil platform investments.

Jeffrey G. Kelly

On December 11, 2012, a federal grand jury charged Jeffrey G. Kelly, 44, formerly of Hilliard, Ohio, with defrauding investors in private investment funds he created out of $1,523,710 between May 2006 and July 2011. Carter M. Stewart, United States Attorney for the Southern District of Ohio, and Edward J. Hanko, Special Agent in Charge, Federal Bureau of Investigation, announced the indictment. The case was referred by the Division of Securities. The indictment alleges that Kelly solicited some of the clients of his insurance and investment company, J.G. Kelly Financial Group, to invest in private funds named Superior Financial Resources, LLC, and J.G. Kelly Equities Group, LLC, among others, he claimed he owned and operated. Kelly allegedly told investors that he would invest their money in annuities, stocks, a pooled income fund, real estate investment trusts, corporate bonds, commodities contracts, staples contracts, medical and commercial managed real estate, venture capital, corporate and commercial paper, financial services and T-bills. Instead, the indictment alleges, Kelly diverted investor money to pay his own personal and business expenses, as well as to repay earlier investor-clients with money solicited and received from later investor-clients. Kelly allegedly sent some of his investors fabricated portfolio summary reports. The indictment charges Kelly with 13 counts of wire fraud and three counts of mail fraud, each of which is punishable by up to 20 years in prison. He is also charged with one count of interstate transportation of stolen securities which is punishable by up to ten years in prison.

William F. Morgan

On December 19, 2012, William F. Morgan, of North Canton, was indicted on 44 counts by a Stark County grand jury. Following a criminal referral by the Ohio Department of Commerce Division of Securities, Morgan was indicted on six counts of grand theft; nine counts of theft from the elderly; 14 counts of selling unregistered securities; and 15 counts of securities fraud. He is accused of selling $162,000 in unregistered securities to approximately 15 investors, primarily from Stark County. At least nine of the investors were elderly. The investors believed they were investing in a Stark County limited partnership titled MA & P Partnership, which Morgan organized and managed. The investors were told that the partnership invested in various platforms, including oil futures and companies listed on the stock exchange. The Division of Securities investigation led to a cease and desist order against Morgan in May 2012. The Division found that Morgan sold unregistered securities, failed to properly account for investor money, and made fraudulent statements to investors. Investors were told by Morgan that their investment was safe and secure and there was no way they could lose their investment. Instead of directly investing their funds, Morgan placed their money in his bank account.

Get Monthly Enforcement Reports via e-mail

Would you like to receive a monthly news release on the Division of Securities' criminal cases and Division orders?

You can do so by sending your e-mail address to:

karen.bowman@com.state.oh.us

While we will still be reporting the quarterly updates in our Bulletin, this is an opportunity to receive the information in a more timely fashion.

2012 Ohio Securities Conference

Steven M. Davidoff, The Ohio State University Moritz College of Law; Andrea Seidt, Securities Commissioner; and Thomas E. Geyer, Bailey Cavalieri LLC.

Geyer and Davidoff presented "On Facebook, M&A and Morrison: A Look at Hot Topics in Securities Litigation."

Fornshell, Meyer, Sheehan and Long presented "Fallout From Fraud: Options for Recovery."

Matthew L. Fornshell, Ice Miller LLP; David P. Meyer, Meyer Wilson; David J. Sheehan and Thomas Long, Baker Hostetler.

Mark R. Heuerman, Division of Securities; Eric C. Chaffee, University of Dayton School of Law; J. Robert Brown, Jr., University of Denver, Sturm College of Law; and Sean T. Peppard, Ulmer & Berne LLP.

Heuerman, Chaffee, Brown and Peppard presented "JOBS Act Compliance: Crowdfunding and Rule 506 Reform."