

OHIO SECURITIES BULLETIN

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A PRIMER ON BITCOINS

“Those who cannot remember the past are condemned to repeat it.” (George Santayana, *Reason in Common Sense Vol. 1: The Life of Reason*, 1906)

When Europeans arrived in North America, Native Americans used clam shells for currency. Those clam shells had no value themselves, except as made into jewelry with the beads (wampum), and could be obtained by picking them up on a beach. The value of the shells increased as a factor of how hard it was to produce the beads made from the shells and the geographic distance the shells traveled from their original location.¹

One thousand years ago, in the Maldive Islands, cowry shells were easily obtained and Arab traders would purchase shells, transport them to Africa and resell or trade them at 1000 per cent profit. But by the mid-1800’s, the supply produced an inflationary spiral, costing more to transport than they were worth, resulting in it being unprofitable to trade in the shells.²

What is Bitcoin? Bitcoin is a both a digital currency and a transfer system. A “transfer system” refers to the ability to move the bitcoin value from one person to another. A “digital currency” is one that is electronically created and stored, as opposed to physical currencies. There have been other open-source, peer-to-peer, digital currencies; before and after Bitcoin.³ The popularity of Bitcoin as a digital currency is because it was the first completely decentralized “cryptocurrency”.⁴ Bitcoin, introduced in January, 2009, was the first virtual currency that dealt with issues relating to record-keeping and transferability (the “double-spending” problem, discussed below).⁵ From Bitcoin a number of other cryptocurrencies were created, including Litecoin and Peercoin.⁶ The lower-case “bitcoins” is usually used to refer to the virtual currency; whereas “Bitcoin” is used to refer to the system that creates bitcoins.⁷

What makes Bitcoin such a hot item? For starters, it is an intriguing concept for those of a technical predilection. It also comes with a certain amount of anonymity and ease of transference, making it attractive to a criminal element. For those not attracted to the anarchical or technical nature of a cryptocurrency, some are drawn to the investment: the reported value a bitcoin increased from nothing in January 2009, to over \$1000 in November 2013. Most of that increase in value occurred in 2013 - \$13 to \$1076 per bitcoin – and came with significant price fluctuations. Today the value of a bitcoin is in the \$500 range, and the volatility has caused many to dismiss the validity of bitcoins as a currency.⁸

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Ohio Securities Bulletin

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OHIO

DEPARTMENT OF
COMMERCE

DIVISION OF
SECURITIES

**REGISTRATION CLOSING OCTOBER 15, 2014
2014 SECURITIES CONFERENCE
INFORMATION ON PAGE 13**

Comments from Commissioner Andrea Seidt

Fall greetings, readers of the Ohio Securities Bulletin. It has been another busy quarter for the staff and I as we conclude our responsibilities at the North American Securities Administrators (NASAA) Fall Conference and make the final preparations for our biggest event of the year – the 2014 Ohio Securities Conference. We have moved the Ohio Conference back to downtown Columbus, utilizing the beautiful space of the Renaissance Hotel for your conference and meeting needs. There is a great lineup of speakers to inform and inspire you on this All Hallows' Eve and still plenty of room for you and your colleagues to attend. Please get your registrations in as soon as possible.

I want to say a quick thank you to the folks who traveled to Indianapolis, Indiana for the NASAA Fall Conference as I passed the gavel to incoming NASAA President, Bill Beatty,



NASAA's "Blue Sky Cube" Award

of Washington. I was incredibly honored to receive NASAA's "Blue Sky Cube" in the company of my staff and colleagues. It was a challenging but great year and I could not have been more pleased to end my term by launching two initiatives that are important to the association and my home state of Ohio. NASAA has convened two new working groups to tackle fee disclosures and the issues facing senior and vulnerable investors in our securities markets. I am confident that, working together, regulators and industry will find the proper path in these areas.

Before I close, I would like to introduce you all to the new Co-Editors-in-Chief of the Ohio Securities Bulletin – Corporation Finance Counsel Andrew Howard and Enforcement Attorney Kyle Evans. They bring renewed energy and enthusiasm to the work of this great publication. One of their goals is to increase the "Ohio focus" in future issues to ensure the content is relevant and useful to the Ohio securities practitioner. I understand they will be soliciting articles from our subscribers so if you have an idea for an article or a piece that you think would be appropriate for inclusion in the Ohio Securities Bulletin, please reach out to Drew or Kyle. They can be reached at Andrew.Howard@com.state.oh.us and Kyle.Evans@com.state.oh.us respectively.

I look forward to seeing and hearing from many of you at the Ohio Securities Conference on October 31 – I promise we are only offering treats, no tricks. See you there.

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 Andrew Howard (Andrew.Howard@com.state.oh.us) or Kyle Evans (Kyle.Evans@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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Bitcoins are created by a process called “mining,” a transaction-clearing process. Thousands of computers around the world, with special hardware and extra capacity, work on the Internet, frequently in groups, to process Bitcoin transactions. These computers are termed “miners.” At regular intervals (on average, 10 minutes) one of these Bitcoin miners completes the computation necessary to finish the “block” of the blockchain ahead of its rivals and receives a reward of a certain number of bitcoins, making mining highly competitive. Originally, miners earned 50 bitcoins for each successful equation-solving mining operation, but the program was set up to reduce the reward by half every 4 years to limit the supply of bitcoins in circulation. As a result, the maximum number of bitcoins to be created will not exceed 21 million.⁹

Bitcoins may be obtained by mining, which involves a large capital outlay and an investment of time, or they may be purchased with conventional (sovereign) currency. Exchanges exist that will facilitate this purchase, or trade, of cash for bitcoins; and now exchanges reportedly accept credit cards, although with the associated risks of scammers. There were over 70 such exchanges at the beginning of 2014, located all over the world.¹⁰ Sellers of bitcoins will sometimes deal individually, but there are also a growing number of Bitcoin ATMs that will allow instant purchases of bitcoins with currency.

In order to “hold” or store the bitcoins, a “wallet” is created that contains the public and private cryptographic keys; essentially, these are the encrypted codes used to prove a person owns these particular bitcoins.¹¹ The wallet may either be held electronically by the owner of the bitcoin or stored with an on-line wallet service, a third-party web-based provider. It is

also possible to simply print out the secret codes and store the piece of paper in a secure location.¹² Since the person who possesses the encryption keys own the bitcoins, a hacking attack, a lost or crashed device, or a lost piece of paper can mean that the bitcoins are lost. Unlike federally insured deposits, there is no protection if bitcoins go missing.¹⁶

Although the majority of transactions occurring up to this point appear to have been speculators,¹⁷ leading to attendant volatility, bitcoins were created to provide an alternative, non-centralized, payment system (an anti-Federal Reserve).¹³ When using bitcoins in a purchase transaction, the payment –transferring to a different wallet – signals that there has been a transaction to the Bitcoin network. This message is a digitally signed instruction transferring the ownership of the bitcoins from the owner’s Bitcoin address to a different address. The transfer is then recorded in a public ledger, or spreadsheet, called the Blockchain, located on the web.¹⁴ Every transaction that has ever been made using bitcoins is recorded in this one location as part of an attempt to resolve the “double-spending” problem that plagued earlier digital currencies. “Double-spending” refers to a flaw which allows the currency to be spent a second time before the person in the first transaction can claim ownership.¹⁵ Maintaining the blockchain, by the processing of transactions, is what is referred to when bitcoins are “mined.”

Bitcoin has been synonymous with anonymity. The decentralized nature and the use of encrypted identifiers lend privacy to transactions using bitcoins. Capitalizing on the perceived anonymity of bitcoins, illicit transactions – e.g.: drugs – have utilized bitcoins.¹⁶ In October 2013, the FBI seized approximately 26,000 bitcoins from the operator of the underground website “Silk Road.”¹⁷

¹ NEHEMIA VREELAND, Wampum: *The Native Substitute for Currency in North America*, 7 BRIT. NUMISMATIC J., 341-350 (1910).

² COLIN NARBETH, *The Cowry Shell as Money*, 6 MOLLUSC WORLD (2004).

³ See JOHN VILLASENOR, CODY MONK & CHRISTOPHER BRONK, *Shadowy Figures: Tracking Illicit Financial Transactions in the Murky World of Digital Currencies, Peer-to-Peer Networks, and Mobile Device Payments*, THE BROOKINGS INST. (2011), available at <http://pubs.cs.rice.edu/sites/pubs.cs.rice.edu/files/ShadowyFigures.pdf>; TYLER MOORE, *The Promise and Perils of Digital Currencies*, 6 INT’L J. CRITICAL INFRASTRUCTURE PROTECTION, 147-149 (2013), available at <http://bitcoinmenow.com/wp-content/uploads/2013/12/The-promise-and-perils-of-digital-currencies-.pdf>.

⁴ INVESTOPEDIA, <http://www.investopedia.com/terms/c/cryptocurrency.asp>.

⁵ JERRY BRITO & ANDREA CASTELLO, *Bitcoin: A Primer for Policymakers* (Mercatus Center at George Mason University) (2013).

⁶ OLGA KHARIF, *Bitcoin Wannabe Litecoin Emerges as Low-Price Challenger*, BLOOMBERG.COM, Apr. 24, 2014, available at <http://www.bloomberg.com/news/2014-04-24/bitcoin-wannabe-litecoin-emerges-as-low-price-challenger.html>.

⁷ See FINCEN, *Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies*, Mar. 18, 2013, available at http://fincen.gov/statutes_regs/guidance/html/FIN-2013-G001.html.

⁸ BITCOIN PRICE INDEX, <http://www.coindesk.com/price/>

⁹ RITO & CASTELLO, *supra*.

¹⁰ PLANET BITCOIN, <http://planetbtc.com/complete-list-of-bitcoin-exchanges/>.

¹¹ BRITO & CASTELLO, *supra*.

¹² GETTING STARTED WITH BITCOIN, <https://www.weusecoins.com/en/getting-started>.

¹³ See FRIEDRICH A. HAYEK, *Denationalisation of Money: The Argument Refined* (INST. ECON. AFF. 3RD ED. 2011) (1990), available at <https://mises.org/books/denationalisation.pdf>.

¹⁴ BRITO & CASTELLO, *supra*.

¹⁵ *Id.*

SOCIAL MEDIA AND SECURITIES REGULATION

The website would offer a wide assortment of products and bitcoins were the preferred medium of exchange. Because bitcoins may be transmitted instantaneously, without a middleman, and identifying buyers and sellers is difficult, the Silk Road, and reputedly, other websites, could foster the sale of drugs, weapons and anything else a purchaser was inclined to buy.

The anonymous nature of Bitcoin is only at surface level.²³ The public availability of the blockchain allows transactions to be linked to persons, by doing some research. While there are services that provide for a hiding of the actual transaction history associated with the particular bitcoin,²⁴ the Treasury Department has indicated that the bank secrecy regulations apply to bitcoin transactions, necessitating bitcoin intermediaries (e.g.: bitcoin exchanges) to collect personal information on customers.¹⁸

MtGox, formerly one of, if not the largest, bitcoin exchanges, began as an exchange in July of 2010. In May of 2013, the US government issued a warrant to MtGox's US subsidiary as a result of its failure to be licensed by the US Financial Crimes Enforcement Network (FinCEN) as a money transmitter.²⁶ Evidencing one of the problems of virtual currencies, MtGox was constantly plagued with breaches in security,²⁷ eventually leading to a "loss" of 850,000 bitcoins in February 2014, valued at the time at over \$450 million. Although some 200,000 were later found, MtGox had entered Japanese bankruptcy.¹⁹ And MtGox was by no means the first or only to experience losses; the list is extensive.

Would you accept bitcoins in trade for goods or services, or invest your savings in bitcoins? Many do – Overstock.com being one example – but many would not, among them Warren E. Buffett and many of those who lost all their bitcoins in the MtGox collapse.²⁰ In the next Ohio Division of Securities Bulletin, notable regulatory actions will be examined in this article's conclusion.

Internet social networking is quickly becoming a mainstay of contemporary American life, through which people connect with friends, send and receive invitations, publicize their careers, and do just about everything else that formerly required a face-to-face or written request. For broker-dealers (and almost anyone else in the financial services industry), utilizing the most advanced means of communicating with existing and potential clients is critical to its business. Social networking, fraught with the possibility of security and privacy risks, presents a substantial compliance challenge, yet many firms have concluded that this challenge must be met as the growth of social networking websites continues to expand.

Social networking can be conducted through social media sites - such as LinkedIn or Facebook - as well as through blog sites and online bulletin boards. The type of information published or conveyed in these forums raises issues for licensees in four main areas:

- (1) Record Retention Requirements;
- (2) Rules Related to Advertisements;
- (3) Suitability (broker-dealer firms and their representatives) and Fiduciary Duty (investment advisers and their representatives); and
- (4) Supervision.

RECORD RETENTION REQUIREMENTS

For Ohio-registered investment advisers and their representatives, the requirements regarding retention of documents and records are set forth in O.A.C. 1301:6-3-15.1. Investment advisers are required to maintain originals of all written communications received and copies of all written communication sent by the

¹⁶ MARIE CLAIR VAN HOUT & TIM BINGHAM, 'Silk Road', *The Virtual Drug Marketplace: A Single Case Study of User Experiences*, INT'L J. DRUG POL'Y (2013), available at <http://www.gwern.net/docs/sr/2013-van-hout.pdf>.

¹⁷ ANDY GREENBERG, *FBI Says It's Seized \$28.5 Million in Bitcoins from Ross Ulbricht, Alleged Owner of Silk Road*, FORBES, October 25, 2013; DONNA LEINWAND LEGER, *How FBI Brought Down Cyber-Underworld Site Silk Road*, USA TODAY, May 15, 2014.

¹⁸ See FINCEN, *supra*.

¹⁹ EILEEN YU, *Mt. Gox Bitcoin Investors Voice Anger After Creditors Meet*, ZDNET, July 24, 2014, available at <http://www.zdnet.com/mt-gox-bitcoin-investors-voice-anger-after-creditors-meet-7000031948/>; See *Coinlab Inc. v. Mt Gox KK*, 2014 U.S. Dist. LEXIS 60238, 2014 WL 1744709 (W.D. WASH. 2014).

²⁰ KASHMIR HILL, *Bitcoin Battle: Warren Buffett vs. Marc Andreessen*, FORBES, Mar. 26, 2014, available at <http://www.forbes.com/sites/kashmirhill/2014/03/26/warren-buffett-says-bitcoin-is-a-mirage-why-marc-andreessen-thinks-hes-wrong/>.

²¹ OHIO ADMIN. CODE 1301:6-3-01(E)(1)(g). Note: If an investment adviser sends any notice, circular or other advertisement offering any report, analysis, publication or other investment advisory service to more than ten persons, the investment adviser is not required to keep a record of the names and addresses of the persons to whom it was sent, unless the document is distributed to persons named on any list, in which case the investment advisor must maintain a copy of the communication and a memorandum describing the list and source of the individuals named.

²² *Id.* at 1301:6-3-15.1(E)(1)(k).

²³ *Id.*

investment adviser relating to any recommendation made or proposed to be made and any advice given or proposed to be given.²¹ This includes communications conducted via social media websites, blog sites, or the internet. Investment advisers are also required to maintain a copy of each notice, circular, advertisement, newspaper article, investment letter, bulletin or other communication (collectively “communications”) that the investment adviser circulates or distributes, directly or indirectly, to ten or more persons, other than persons connected with the investment adviser.²² If the communication *recommends* the purchase or sale of a *specific security* and does not state the reasons for the recommendation, the investment adviser must prepare and maintain a memorandum indicating the reasons that the recommendation was made.²³ Generally, the retention period for communications which relate to recommendations made or proposed to be made is five years from the date the communication was published or disseminated.²⁴

In evaluating the use of social networking websites for broker-dealer firms and their representatives, the Division takes guidance from rules and regulatory notices promulgated by the SEC and FINRA. Firms and representatives must retain copies of communications and posts on social media in accordance with Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934 and FINRA Rules 3110.09 and 2210(B)(4). In January 2010, FINRA issued Regulatory Notice 10-06 providing substantive guidance to broker-dealer firms and their representatives who maintain an online presence through websites, blogs, online bulletin boards and social media. In August, 2011, FINRA issued additional guidance in Regulatory Notice 11-39.

RULES RELATED TO ADVERTISEMENTS

For broker-dealer firms, FINRA Rule 2210 sets forth the requirements for dealer firms who advertise their products or services. In certain circumstances, firms are required to file a copy of their retail communications

with FINRA’s Advertising Regulation Department no less than ten days prior to its publication or use.²⁵ Subject to certain exclusions, a registered principal must also approve each retail communication before its earliest use or its filing with FINRA’s Advertising Regulation Department.²⁶

Investment advisers and their representatives are subject to O.A.C. 1301:6-3-44(A), which sets forth certain prohibitions on advertisements published, circulated or distributed to the public. For instance, Ohio rules provide that it is a fraudulent, deceptive or manipulative act, practice or course of business to publish, circulate or distribute, indirectly or directly, an advertisement that includes any of the following:

- (1) a testimonial of any kind for services rendered by the licensee;²⁷
- (2) a reference to any recommendations which were or would have been profitable to any person;²⁸
- (3) a representation, without limitation, that any graph, chart, formula, or device being offered will assist a person in making his or her own decision regarding which securities to buy or sell;²⁹ or
- (4) any untrue statement of a material fact, or any statement that is otherwise false or misleading.³⁰

The term “advertisement” includes any communication by electronic means, including social media websites and blogs that include an analysis, report or publication concerning securities or any other investment advisory service with regard to securities.³¹

In addition to the general prohibitions applicable to both dealers and investment advisers in R.C. 1707.44, investment advisers and investment adviser representatives are specifically prohibited in the solicitation of clients or prospective clients, from *making any untrue statement of a material fact* or omitting to

²⁴ *Id.* at 1301:6-3-15.1(E)(5)(a), (c).

²⁵ FINRA Rule 2210(c)(1). “Retail communication” means any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period. FINRA Rule 2210(a)(5).

²⁶ FINRA Rule 2210(b)(1).

²⁷ OHIO ADMIN. CODE 1301:6-3-44(A)(1)(a).

²⁸ *Id.* at 1301:6-3-44(A)(1)(b).

²⁹ *Id.* at 1301:6-3-44(A)(1)(c).

³⁰ *Id.* at 1301:6-3-44(A)(1)(e).

³¹ *Id.* at 1301:6-3-44(A)(2).

³² OHIO REV. CODE ANN. § 1707.44(M)(3).

³³ *In re Valhalla Investment Advisor, Inc.* and Eric T. House, Division Order No. 13-035, November 20, 2013, entered with a

Consent Agreement from the Respondents.

³⁴ *In re Curtis L. Luckett, III*, Division Order No. 14-013, May 16, 2014. Respondent’s LinkedIn page stated, “Currently, Jewell-Jackson Oil & Gas (JJOG) Supply has over 12,000 acres of Sweet Crude Oil and Natural Gas supply. JJOG is drilling and currently producing oil from ‘PROVEN’ oil grounds (NOT wildcatting). All of the Oil & Gas reserves can be found on the Kentucky Geological Surveys website, along with maps & plateau data to show ‘Proven Oil & Gas’ reserves. In 2013, JJOG will be a major player in the Oil & Gas supply. Currently, the company I own, Secure Options is not only an investor, but is helping other investors interested to get involved.”

³⁵ *In re SoMoLend Holdings, LLC* 14-004, February 10, 2014, entered with a Consent Agreement from Respondent SoMoLend

state a material fact that, in light of the circumstances under which the statements were made, would be necessary to make the statement not misleading.³² This prohibition applies to the solicitation of clients through social media, blog sites and the internet, generally.

In 2013, the Division took administrative action against an Ohio investment adviser representative for engaging in a number of Ohio securities law violations, one of which included misuse of social media to advertise his investment adviser services. By including a testimonial on his LinkedIn page, the investment adviser engaged in fraudulent, manipulative or deceptive conduct as defined and prohibited in O.A.C. 1301:6-3-44 (A)(1) (a).³³

The Division also initiated recent action against individuals and entities who did not maintain an Ohio securities license based, in part, on information being published on social media websites and blogs. In Division Order No. 14-013, the Division found that the Respondent acted as an unlicensed securities dealer in the sale of unregistered securities and committed fraud, in part, based on false or misleading information that was contained in his online LinkedIn page.³⁴ And in Division Order Number 14-004, the Division found that the Respondent engaged in the sale of unregistered securities, in part, by soliciting investors through blog sites and various other websites.³⁵

SUITABILITY AND FIDUCIARY DUTY

Broker-dealer firms and their representatives must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security 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.³⁶ 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. For suitability determinations, whether a particular online communication constitutes a "recommendation" for purposes of Rule 2111 will depend on the facts and circumstances of the communication.³⁷ Similarly, Ohio law prohibits a dealer or salesperson from selling, purchasing, or recommending the sale or purchase of any security without reasonable grounds to believe that the transaction or recommendation is suitable for the customer.³⁸

Investment advisers and investment adviser representatives stand in a fiduciary relationship with their clients.³⁹ As fiduciaries, investment advisers and investment adviser representatives have an affirmative duty of utmost good faith and full and fair disclosure of all material facts.⁴⁰ Fiduciary responsibility includes, but is not limited to:

- the duty to employ reasonable care to avoid misleading clients,
- the duty to have a reasonable independent basis for investment advice, and
- the duty to insure that investment advice is suitable.

These duties apply to investment advice or recommendations that may be published, distributed or circulated via social media, blogs or other internet-based avenues.

SUPERVISION

To ensure that all firm representatives understand and carry out policies regarding social media, firms would be well-advised to create and disseminate a policy that is specific to social media - rather than attempting to graft existing electronic communications policies onto

Holdings, LLC. Note: The allegations against the Co-Respondent, Candace S. Klein, filed in Division Order No. 13-022, which include acting as an unlicensed dealer or salesperson, sale of unregistered securities, securities fraud and misrepresentations in the sale of securities are still pending. The administrative hearing is scheduled to resume November 10, 2014.

³⁶ FINRA Rule 2111(a).

³⁷ See FINRA, NOTICE TO MEMBERS 01-23 (2001) for additional guidance concerning when an online communication is a "recommendation" under NASD Rule 2310 (superseded by FINRA Rule 2111).

³⁸ OHIO ADMIN. CODE 1301:6-3-19(A)(5).

³⁹ FRIEDMAN, HOWARD M., OHIO SECURITIES LAW AND PRACTICE § 27.10 (3d ed. 2013).

⁴⁰ Transamerica Mortg. Advisors, Inc. (TAMA) v. Lewis, 444 U.S. 11, 17, 100 S. Ct. 242, 62 L. Ed. 2d 146 (1979).

⁴¹ OHIO ADMIN. CODE 1301:6-3-15.1(D).

⁴² *Id.* at 1301:6-3-15.1(D)(1).

⁴³ FINRA Rule 3110.07.

⁴⁴ FINRA Rule 3110.08.

⁴⁵ The Division acknowledges references to FRIEDMAN, HOWARD M., OHIO SECURITIES LAW AND PRACTICE § 27 (3d ed. 2013) throughout this article.

⁴⁶ OHIO REV. CODE ANN. § 1707.01(X).

⁴⁷ Ohio law defines an investment adviser representative generally as a natural person who gives specific advice on behalf of an investment adviser to a certain minimum number of natural person clients through regular meetings or communications. In conduct-

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social networking. Investment advisers licensed in Ohio have a duty of reasonable supervision, which requires them to reasonably supervise their investment adviser representatives and other employees with the goal of preventing violations of the Ohio Securities Act, the Securities Act of 1933, the Securities Exchange Act of 1934, and the Commodity Exchange Act.⁴¹ An investment adviser can fulfill their obligation, in part, by establishing and implementing procedures to detect and prevent violations of the law by their investment advisers, employees and associates.⁴² In applying the Ohio rules for investment advisers, the Division takes guidance from the same rules issued by FINRA for broker-dealer firms, setting forth requirements for supervision on electronic communication and advertising.

FINRA Rule 3110(b)(4) requires broker-dealer firms to have supervisory procedures, which are appropriate for the firm's business, size, structure, and customers, to review incoming and outgoing written (including electronic) correspondence and internal communications relating to its securities business. In particular, the supervisory procedures must require the firm's review of incoming and outgoing written (including electronic) correspondence to properly identify and handle in accordance with firm procedures, customer complaints, instructions, funds and securities and communications that are of a subject matter that require review under FINRA rules and federal securities laws. A cursory review of the communication is insufficient.

A broker-dealer firm must identify what communication was reviewed, the identity of the reviewer, the date of review and the firm's actions taken as a result of any significant regulatory issues identified during the review.⁴³ A supervisor or principal may delegate review functions to an unregistered person; however, the supervisor or principal remains ultimately responsible for the performance of all necessary supervisory reviews.⁴⁴

ing these activities, an investment adviser representative meets the general criteria of being in the business of providing advice regarding securities for compensation. OHIO REV. CODE ANN. § 1707.01(CC).

⁴⁸ *The Ohio Advisory Package*, pg. 3, available at http://www.com.ohio.gov/documents/secu_OhioAdvisoryPackage.pdf.

⁴⁹ NASAA Investment Adviser Guide, available at <http://www.nasaa.org/industry-resources/investment-advisers/investment-adviser-guide/>; and OHIO REV. CODE ANN. § 1707.141.

⁵⁰ OHIO REV. CODE ANN. § 1707.161.

⁵¹ *Id.* at § 1707.01(X).

⁵² *Id.*

⁵³ *Id.*; see also FRIEDMAN, HOWARD M., OHIO SECURITIES LAW AND PRACTICE § 27.02 (3d ed. 2013).

CONCLUSION

Social media is a powerful tool that can create a wider audience for services and products provided by licensed individuals and firms within the securities industry. However, with great power comes great responsibility. Licensees must exercise caution in publishing information through the internet and social media in order to comply with state and federal law. The ability of social networks to provide a wide, unrestricted audience, coupled with the intermingling of users personal and professional lives, create a greater risk of compliance issues when compared to e-mail or instant messaging. A specific social networking policy that is consistently monitored and enforced will go far to ensure that a firm's employees utilize social media in accordance with Ohio and federal securities laws and are consistent with that firm's strategic goals.

DO I NEED A LICENSE?

The Ohio Division of Securities commonly receives two questions: (1) what is investment advice; and (2) do I have to be licensed to give it?⁴⁵ The Ohio Securities Act as set forth in Ohio Revised Code section 1707 provides for oversight of investment advisers,⁴⁶ and their natural person agents, investment adviser representatives,⁴⁷ operating in Ohio. As a general matter, and subject to certain limited exceptions, all investment advisers operating in Ohio must either be (1) licensed by the Division or (2) in compliance with certain notice filing requirements.⁴⁸ Generally speaking, investment advisers with less than \$100 million in assets under management must register in the state(s) where they have a place of business and in which they have clients, while investment advisers with more than \$100 million under management must register with the Securities and Exchange Commission and file notice in the states where they are doing business.⁴⁹ Similarly, subject to certain limited exceptions, all investment adviser representatives with a place of business in Ohio must be licensed by the Division.⁵⁰

⁵⁴ FRIEDMAN, *supra*. (citing SEC Release No. IA-1092, [Vol.6] FED. SEC. L. REP. (CCH) ¶56, 156E § II.A.3. (Oct. 8, 1987)).

⁵⁵ FRIEDMAN, *supra*.

⁵⁶ Ohio's definition of what constitutes a security is very broad. A non-exhaustive list of examples of securities, as defined by the Ohio Securities Act is set forth in Revised Code 1707.01(B).

⁵⁷ FRIEDMAN, *supra*. (citing The Maratta Advisory, Inc., SEC No-Action Letter, 1981 SEC No-Act. LEXIS 3791 (July 16, 1981))

⁵⁸ OHIO REV. CODE ANN. § 1707.01(X).

⁵⁹ Revised Code 1707.01(CC)(1)(b) provides an exclusion from the definition of investment adviser representative if the natural person provides advisory services only by means of written materials or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts.

The concept of what may constitute investment advice is expansive. Investment advice can be given by a professional, governed by a written agreement and for a set fee, or it can be given in a less formal manner. It is these less formal situations that beg the question whether the person rendering the advice must be licensed. The Ohio definition of investment adviser is almost identical to the federal definition, contained in the Investment Advisers Act of 1940. Under Ohio law, an “investment adviser” is defined as *a person who, for compensation, is engaged in the business of providing advice regarding securities.*⁵¹ The Ohio Securities Act contains two descriptive clauses of persons that fit within the definition of investment adviser:

- 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; and
- Any person, who for compensation and as part of regular business, issues or promulgates analyses or reports concerning securities.⁵²

These clauses contain three requirements, which when met, classify one as an investment adviser under Ohio law. First, the person providing the advice must receive some economic benefit.⁵³ Even compensation not provided by the recipient of the advice satisfies this requirement. Furthermore, the requirement may be satisfied where a person receives a single fee for providing a bundle of services, which includes the provision of investment advice.⁵⁴

Second, the individual providing the advice must be “engaged in the business.” This means that the person holds himself or herself out as an investment adviser or as one who provides investment advice; this

person receives compensation that represents a clearly definable charge for providing advice about securities; or, the person, on anything other than rare, isolated and non-periodic instances, provides specific investment advice.⁵⁵

Finally, the advice must pertain to “securities.”⁵⁶ Discussions regarding securities holdings or investments while developing an overall financial plan or program satisfy this third element even if the discussions do not include specific “buy” or “sell” recommendations.⁵⁷ Market timing advice satisfies this element, as does advice about asset allocation, market trends, and day-trading recommendations. Keep in mind that it is not necessary that a person’s activities consist *exclusively* of investment advisory services in order to qualify that person as an investment adviser. Rather, the test is whether any part of the person’s activities meets the three elements of “for compensation,” “engaged in the business,” and “regarding securities.”

Specific facts and circumstances determine whether an individual is giving investment advice and whether he or she needs to be licensed. Since the test for determining if someone is an investment adviser or investment adviser representative depends on the person’s *activities*, the person’s professional title is irrelevant. For example, limiting the investment advice to friends and family may not trigger licensing requirements if that person does not receive any form of compensation for the advice.⁵⁸ Whereas, speaking to a group of individuals about securities investing in general may be permissible without a license, even if that individual is paid.⁵⁹ However, licensing requirements may be triggered should an audience member approach the speaker and want to personalize the investment advice.⁶⁰

While there are several triggers for investment adviser licensure, Ohio law also excludes several classes of persons from the definition of investment adviser.⁶¹

⁶⁰ *See id.*

⁶¹ *See* Investment Advisers Act of 1940, § 202(a)(11)(A)-(F).

⁶² OHIO REV. CODE ANN. § 1707.01(X)(2)(b).

⁶³ *Id.* at §1707.01(X)(2)(g).

⁶⁴ OHIO ADMIN. CODE 1301:6-3-01(L)(1).

⁶⁵ Ohio law defines “solicitor” as any person who, directly or indirectly, solicits any client for, or refers any client to, an investment adviser or investment adviser representative. *See* OHIO ADMIN. CODE 1301:6-3-44(C)(4)(c).

⁶⁶ FRIEDMAN, *supra* at § 27.02(C)(1); and OHIO ADMIN. CODE 1301:6-3-01(L)(2).

⁶⁷ OHIO ADMIN. CODE 1301:6-3-44(C).

⁶⁸ *Id.*

⁶⁹ FRIEDMAN, *supra* at § 27.10 (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194, 84 S. Ct. 275, 11 L. Ed. 2d 237 (1963); and *Transamerica Mortg. Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11, 17, (1979)).

⁷⁰ *Id.*

These exclusions track the state exclusions from the federal definition of investment adviser. One category of excluded persons includes attorneys, accountants, engineers, and teachers whose performance of advisory services is “solely incidental” to the practice of their profession. Three factors are relevant as to whether the advice is “solely incidental” to their profession:

- First, whether the person holds himself or herself out to the public as an investment adviser, financial planner, or other provider of advisory services;
- Second, whether the advisory services are rendered in connection with and reasonably related to the professional services; and
- Third, whether the fee charged for advisory services is based on the same factors as those used to determine the fee for the other professional services provided.

The Ohio Securities Act allows several other exclusions from licensure. Specifically, there are licensing exclusions available for publishers of bona fide newspapers,⁶² persons who give advice only as to certain government and government-sponsored securities,⁶³ and persons who privately advise a small number of sophisticated clients provided that they do not hold themselves out generally to the public as an investment adviser.⁶⁴

One important nuance to Ohio investment adviser licensing involves solicitors.⁶⁵ Unlike many states which require persons acting as solicitors to be licensed, under Ohio law, a solicitor must be licensed only if the solicitor meets the definition of investment adviser or investment adviser representative and there are no applicable exceptions from the licensing requirements.⁶⁶ In other words, Ohio law does not require that solicitors *per se* be licensed with the Division, but licensing requirements may be triggered if the solicitor, through his or her conduct, falls within the definition of an investment adviser or investment adviser representative.

That said, Ohio law does place strict compliance requirements on the investment advisers and investment adviser representatives that use solicitors.⁶⁷ For example, an Ohio licensed investment adviser or investment adviser representative must conduct due diligence before contracting with a solicitor. In addition, Ohio Administrative Code 1301:6-3-44(C) prohibits an Ohio-licensed investment adviser or investment adviser representative from paying a solicitor unless there is a written agreement between the solicitor

and the investment adviser or investment adviser representative. Ohio’s solicitor regulations further require a solicitor’s written disclosure statement. The solicitor’s written disclosure statement must disclose the nature of the relationship and affiliation between the solicitor and investment adviser or investment adviser representative, and must contain a statement disclosing the terms of the compensation arrangement between the solicitor and investment adviser or investment adviser representative. This disclosure document must be provided to all referred clients.⁶⁸

Determining whether a person is *legally* an investment adviser, investment adviser representative or not – regardless of the person’s actual title – is critical because engaging in unlicensed activity may result in violations of the Ohio Securities Act, as well as exposure to potential civil liability for breach of the fiduciary duty. Under well-settled federal and Ohio law, investment advisers and investment adviser representatives stand in a fiduciary relationship with their clients.⁶⁹ They are bound by an affirmative duty of utmost good faith and full and fair disclosure of all material facts.⁷⁰ It is because of these important, guiding principles that many investment adviser arrangements mandate that the advice-giver be licensed. Thus, whether or not a person is in fact an investment adviser or investment adviser representative necessitates critical analysis.

Generally speaking, under the Ohio Securities Act, any person who for compensation, is engaged in the business of providing advice regarding securities is likely to be deemed an investment adviser under Ohio law. So before engaging in any securities work for a client or potential client, it is wise to carefully think about the scope of services being offered and whether these services require an investment advisers’ license. The Division is available to provide guidance to specific questions about this topic.

ENFORCEMENT SECTION REPORTS

Millenium Advisors, LLC

On June 18, 2014, the Division entered a Cease and Desist Order with Consent under Division Order No. 14-017 against Millenium Advisors, LLC, a North Carolina securities dealer. The Order found that Millenium Advisors, LLC had dealt securities in Ohio without a license and had improperly engaged in 648 securities transactions. As part of the Consent Agreement, Millenium agreed to disgorge net profits the firm received from the transactions during the period the firm was unlicensed.

Timothy K. Fife

On June 19, 2014, the Division issued a Notice of Opportunity for Hearing and Notice of Intent to Suspend or Revoke the Ohio Investment Adviser License of Timothy K. Fife, with a principal business address in Westlake, Ohio. The Notice was filed in Division Order No. 14-018, which alleges that Mr. Fife provided false information in his application for licensure and fraudulently induced an elderly client to invest \$400,000 as a long-term investment in leveraged and inverse exchange traded funds (ETFs) by telling him that the investment was low-risk and would contain a stop-loss feature. Based on additional considerations - including complaints filed with FINRA that were settled for over \$1.14 million - the Division alleges that Mr. Fife is not of good business repute. Three of the FINRA complaints involved claims of unsuitable ETF investments. The administrative hearing in this case is scheduled to begin November 18, 2014.

Mental Financial Services, LLC/Erin Mental-Gaeta

On July 28, 2014, the Division issued a Notice of Opportunity for Hearing and a Notice of Intent to Suspend or Revoke the Investment Adviser and Investment Advisor Representative Licenses of Mental Financial Services, LLC and Erin Mental-Gaeta, both located in Columbus, Ohio. The Notice was filed in Division Order No. 14-

019, which alleges both parties failed to respond to examination deficiency letters for four months, and failed to maintain and produce business records required under the Ohio Securities Act for an additional five months. The administrative hearing in this matter is scheduled to begin November 25, 2014.

Michael A. Gelotti

On August 8, 2014, the Division entered a Cease and Desist Order and Consent Agreement in Division Order No. 14-020 against Michael A. Gelotti, located in Strongsville, Ohio. The Order found that Mr. Gelotti acted as an unlicensed securities dealer or salesperson by soliciting and selling securities to four Ohio investors and one Indiana investor in exchange for compensation. The securities were issued by a Florida company, FUSO Polk County 135, LLC. The total amount of securities sold exceeded \$198,000.

Robert F. Coil

On August 29, 2014, the Division issued Order No. 14-021 terminating a prior Division Order against Robert F. Coil. Mr. Coil entered a Consent Agreement with the Division agreeing to fulfill his obligations under a settlement agreement with aggrieved investors. Additionally, Mr. Coil agreed to waive any statute of limitations defense and

submit to the continuing jurisdiction of the Division should he default on any settlement terms.

Vault Options

On September 3, 2014, the Division issued a Notice of Opportunity for Hearing and Notice of Intent to Issue a Cease and Desist Order against Vault Options, an internet-based binary options trading platform operating through the website www.vaultoptions.com. The Notice, issued in Division Order No. 14-022, alleges that Vault Options is based in New York and operates a website in Herfordshire, England. The Notice further alleges that Vault Options fraudulently induced an elderly Ohio investor to invest \$50,000 by promising a 100 percent secure investment experience with returns up to 500 percent.

OTHER MATTERS

On December 5, 2014, the Tuscarawas County Bar Association is sponsoring a one-hour CLE course at the Tuscarawas County Law Library. The CLE will be presented by the Ohio Division of Securities.

For more information, please contact Kathy Moreland, CLE Program Coordinator for the Tuscarawas County Bar Association, at (330) 365-3224.

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If you are in need of a past Bulletin issue, you can find past issues on the Division's website at <http://www.com.state.oh.us/secu/bulletins.aspx>.

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See Nationally-Recognized Speakers on Emerging Issues:

Back to Basic (v. Levinson) - Hot Topics in Securities Litigation

Critical analysis of key Supreme Court decisions, including the recent Halliburton ruling (mostly) upholding Fraud on the Market Theory

FINRA Expungement Roundtable: Perspectives from Claimants, Industry, and Regulators

A lively debate of the pros and cons of expunging broker disclosures, and what FINRA is trying to do about it

Alternative Investments for the Masses?

A look into the exploding popularity of Alternative Investments among retail investors, and whether the securities laws adequately safeguard investors from the new market focus on complex products

Division of Securities Regulatory Update

Useful compliance tips for you and your clients

Registration Closes October 15, 2014!

Full Agenda and Registration Form Available Here:

<http://www.com.ohio.gov/secu/default.aspx>