Ohio Department of Commerce
Division of Securities

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Securities Bulletin

Ohio Department of Commerce, Division of Securities

Securities Licensees in Ohio Owe a Fiduciary Duty to the Client

By D. Michael Quinn, Division Counsel

Fiduciary … means (as a noun) a person holding the character of a trustee … in respect to the trust and confidence involved in it and the scrupulous good faith and candor which it requires.
Blacks Law Dictionary, Fifth Edition.

The conversations about fiduciary relationships taking place at the national level have focused on federal law, whether the discussion focuses on investment advisers or dealers.[1] Those conversations have generally not included a discussion about the various state considerations. When considering this topic, it is incumbent on an industry member and any legal representative to recognize that the discussion does not end with the pronouncement of the federal assessment.

The Ohio Supreme Court has defined a fiduciary relationship as a relationship in which one party to the relationship places a special confidence and trust in the integrity and fidelity of the other party to the relationship, and there is a resulting position of superiority or influence, acquired by virtue of the special trust. *In re Termination of Employment of Pratt* (1974), 40 Ohio St. 2d 107, 115. *See also: Mathias v. Rosser*, 2002-Ohio-2772, 18 (2002, Tenth Dist. Ct. App.).

In Ohio, the Securities Act does not use the word fiduciary and only recently has an Ohio Administrative Code rule promulgated by the Division of Securities (the "Division") specifically used the word fiduciary to describe the relationship between an investment adviser and its clients.[2] This does not mean that investment advisors have not been, or are not, fiduciaries. Ohio has incorporated the federal fiduciary obligations imposed on all investment advisers. While the Investment Advisers Act of 1940 does not mention the word fiduciary either, the U.S. Supreme Court has long held that common law imposes upon investment advisers a fiduciary relationship with their clients.[3]

Regardless of ambiguity or vacillation at the federal level, Ohio case law has applied a fiduciary duty to dealers and salespersons. This relationship of special trust has been found to exist in the relationship between a securities broker and a client. *Burns v. Prudential Sec., Inc.*, 167 Ohio App. 3d 809, 828-29 (2006); *Lawarre v. Fifth Third Secs.*, 2012-Ohio-4016, ¶ 13 (Ct. App.).[4] "Ohio, in general, has an expansive view of the relationship between a broker and client. 'The liabilities of a broker to his [principal] are those of an agent. The relation of principal and agent is always regarded by the court as a fiduciary one, implying trust and confidence.' 10 Ohio Jurisprudence 3d (1995) 96, Brokers, Section 116." *Burns v. Prudential Sec., Inc., supra*, 828-29. "There is general agreement that a broker or financial advisor is in a fiduciary relationship with his clients." *Mathias v. Rosser*, 2002-Ohio-2772, 18 (2002, Tenth Dist. Ct. App.) (citations omitted). A securities dealer has a fiduciary duty to his clients. *Friedman v. Ohio Dep't of Ins.*, 2003-Ohio-5076, 15-16 (Eighth Dist. Ct. App.) (citations omitted). These holdings have been made by the various courts regardless of the type of broker the facts involved – securities, insurance, or mortgage.

continued on page 2

Table of Contents

Fiduciary Duty…1
A to Z with L & E…3
Soft Dollars…4
Protecting Seniors…6
Enforcement Update…8
Registration Update…12
Division & Industry News…13
Ohio Securities Exchange…14

[1] Dealers herein is used to refer to all Brokers and Dealers. See RC 1707.01(E).
[2] OAC 1301:6-3-44(E)(1)(f).
[3] S.E.C. v. Capital Gains Research Bureau, 375 U.S. 180 (1963).
[4] Compare Ohio law to federal where a distinction is drawn between a broker handling discretionary accounts vs. non-discretionary accounts. See: Sekerak v. Nat'l City Bank, 342 F. Supp. 2d 701, 712 (N.D. Ohio 2004).

John R. Kasich, Governor
State of Ohio

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Securities Licensees in Ohio continued from page 1

Some of the case law is confusing because it seems to be at odds. But a close reading reveals that the confusion results from a difference between the federal and state approaches. The federal position is exemplified by *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc*., 461 F. Supp. 951 (E.D. Mich. 1978), wherein the court summarized the parties' positions as: "Plaintiff argues that a broker has a fiduciary duty to his customer similar to that owed by an attorney to his client. Defendants contend that a stockbroker has a limited duty to serve his customer's financial interest within the framework of a single transaction only. Neither position is entirely accurate." That court then went on to describe the difference in the duties owed by the broker based upon whether the customer has a non-discretionary, verses discretionary, account with his broker. The court wrote that "[i]n a non-discretionary account each transaction is viewed singly. In such cases the broker is bound to act in the customer's interest when transacting business for the account; however, all duties to the customer cease when the transaction is closed." *Id,* 952-953. Other courts may phrase their language even more directly. (See: *Dow Corning Corp. v. Merrill Lynch & Co*. (In re Merrill Lynch Auction Rate Sec. Litig.), No. 09 MD 2030 (LAP), 2011 U.S. Dist. LEXIS 35363, at *39 (S.D.N.Y. Mar. 29, 2011) ("[T]here 'is no general fiduciary duty inherent in an ordinary broker/customer relationship,' particularly where, as here, the account is nondiscretionary.")(*Citations omitted.*))

In contrast, the Ohio law is different. In *Burns v. Prudential Sec., Inc., supra*, the court took some time to differentiate between discretionary and non-discretionary accounts noting that, while citing to *federal* cases, discretionary accounts impose a fiduciary relationship and, generally, non- discretionary accounts do not. However, even in federal decisions, the *Burns* court noted - and, in overruling one assignment of error in the instant case, held that - "if a non-discretionary broker assumes control of his clients' accounts and performs transactions at *his own discretion* without the clients' approval, the broker must take on the duties of a discretionary broker…" *Id* at 828 (emphasis in original). When citing to the state of Ohio law, the court made the statement quoted, above, that Ohio has an expansive view of the relationship between a broker and client, that of an agent to his principal, which is *always* regarded as a fiduciary relationship. See *Id*, at 828. Even federal courts have recognized the difference between federal and Ohio law and that Ohio law will impose a fiduciary duty on a broker, regardless of the discretionary nature of the account. See: *Glimcher Co., LLC v. Deavers the Shops at Ety Vill. LLC*, No. 2:09-cv-797, 2010 U.S. Dist. LEXIS 38214 at page 24 (S.D. Ohio Apr. 19, 2010).

The Division's position regarding the application of fiduciary duties to IAs and IARs, and dealers and salespersons has been set out in various Orders over the years. In overruling Respondent's objection and finding that he was acting in a fiduciary capacity, the Division's final order in: *In The Matter Of: Mark Alan Pantenburg, CRD No. 2540858*, 2012 Oh. Sec. LEXIS 26 (Order No. 12-026), observed that "There is a general agreement in Ohio that the relationship between a financial advisor and his or clients, in particular, is fiduciary in nature." *(sic) (Citations omitted.)* Whether an investment adviser representative or a securities salesperson, the role of the licensee has been considered to be a fiduciary. *See: In The Matter of Respondent Mark Monaco*, CRD Number 2060978, 2003 Oh. Sec. LEXIS 1 (Order No. 03-020) ("A securities salesperson is a fiduciary to a client/investor in which the client/investor places a special confidence and trust in the integrity and fidelity of the salesperson."); and: *In The Matter Of: Michael E. Minot CRD No. 1161076*, 2002 Oh. Sec. LEXIS 104 (Order No. 02-103) ("Once securities salesperson licensure had been obtained, Respondent would have entered a fiduciary relationship with his clients, owing them the utmost trust and good faith, committing to perform reasonable due diligence on their behalf, and committing to ensure their suitability for the investment proffered by him."). *In The Matter Of: Securities Dealer License No. 16264, of Columbus Skyline Securities, Inc.; et al*., 1992 Oh. Sec. LEXIS 35 (Order No. 92-051). ("The fiduciary duty a dealer and salesmen owe to the public requires that the price of securities which they sell must be reasonably related to the market price of the security and the market price is best determined by arm's-length negotiated transactions between dealers and by the prices persons in the industry are willing to pay or have paid for the same securities.")

So what constitutes being a fiduciary? Ohio courts have described it in various ways but the general tenor is always the same. A fiduciary relationship is "a relationship in which special confidence and trust is reposed in the integrity and fidelity of another and there is a resulting position of superiority or influence, acquired by virtue of this special trust." *Groob v. Keybank*, (2006) 108 Ohio St.3d 348. A fiduciary owes a duty of good faith, loyalty, refraining from self-dealing, and disclosure, *Wing Leasing, Inc. v. M & B Aviation, Inc*. (1988), 44 Ohio App. 3d 178, and utmost good faith and loyalty, *Cruz v. South Dayton Urological Assoc., Inc*. (1997), 121 Ohio App. 3d 655.

continued on page 3

Securities Licensees in Ohio continued from page 2

A fiduciary duty is generally defined as '"[a] duty of utmost good faith, trust, confidence, and candor owed by a fiduciary * * * to the beneficiary * * *; a duty to act with the highest degree of honesty and loyalty toward another person and in the best interests of the other person"', *DiPasquale v. Costas*, (2010) 186 Ohio App. 3d 121, 151, and to practice good faith, loyalty, refraining from self-dealing, and disclosure, *Franks v. Rankin*, 2012-Ohio-1920, ¶ 34 (Ct. App.).

In, *In The Matter Of: Timothy K. Fife, CRD 2437888*, 2016 Oh. Sec. LEXIS 12, 22 (Order No. 16-012), the Division observed: "An IAR's fiduciary duty includes: (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." *(Citation omitted.)*

Whether as an investment adviser or investment adviser representative, or as a dealer or salesperson, under Ohio law these securities licensees owes a fiduciary duty to the client.

A to Z with L & E

The Division's Licensing and Examination Section (L & E) provides timely and important information covering a wide-range of topics from "A to Z" that affects licensees.

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Quarterly Question

I have arrangements with clients in which my advisory fees are deducted directly from their accounts upon my instruction to the custodian. Do I have custody? If I do have custody solely because my fees are deducted from client accounts in this manner, how does that affect my ADV?

The deduction of advisory fees or other expenses by the custodian upon instruction of the adviser[1] does fit within the definition of "custody" per Ohio Administrative Code § 1301:6-3-44(B)(3)(a)(ii), which reads in part (emphasis added):

(B) Custody or possession of funds or securities of clients.
(3) Definitions. For the purpose of this rule:
(a) "Custody" means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. Custody includes:

***

<u>(ii) Any arrangement, including a general power of attorney, under which the investment adviser or investment adviser representative are authorized or permitted to withdraw client funds or securities maintained with a custodian upon the investment adviser's or investment adviser representative's instruction to the custodian;</u>

Since custody is limited to the deduction of advisory fees, ADV Part 1A Item 9(F), which asks how many *persons*[2] act as a qualified custodian for your clients, <u>should be answered with at least "1"</u>. However, Items 9(A), (B), and (D) can be answered "No," as these are for advisers who have a more direct form of custody (answering "Yes" to these questions could subject you to annual audits, surprise examinations, and other compliance requirements). Item 9(C) doesn't need answered under this scenario.

Since you are deemed to have custody under the Ohio Administrative Code, you should refer to the instructions for Part 2A of Form ADV for more information on the proper verbiage to be used for Item 15.

[1] If the client instructs the custodian to deduct the adviser's fees, the adviser would not have custody. From the SEC "Staff Responses to Questions About the Custody Rule," Question III.1 https://www.sec.gov/divisions/investment/custody_faq_030510.htm.

[2] Persons includes, but is not limited to, you and your related persons.

A to Z continued from page 3

Spotlight on William Pultinas

Will is a Senior Examiner for the Division. He is a Certified Public Accountant, a Certified Fraud Examiner and has passed the Chartered Financial Analyst Level 1 exam. He currently serves on NASAA's Exams Advisory Committee and the NASAA Investment Adviser Zone Project Group. As an examiner Will has an important role with the Division to ensure licensee compliance within the Ohio Securities Act and associated rules. Will has been with the Division for 17 years, after earning his degree at Miami University. Will said what he most enjoys about his work is "meeting the licensees and working in a collaborative effort to build a strong foundation of compliance and financial record keeping." In his spare time, Will enjoys spending time with his family.

A Few Words About Soft Dollars

By Joyce Cleary, Securities Specialist

Soft Dollars, as defined by the United States Securities and Exchange Commission ("SEC") are "arrangements under which products or services, other than the execution of securities transactions, are obtained by an adviser from or through a broker-dealer in exchange for the direction by the adviser of client brokerage transactions to the broker-dealer." [1]

Soft Dollars generally occur when an investment adviser, having discretionary authority of their clients' accounts, pays more than the lowest available commission to a broker-dealer in return for research products and services.

While advisers may receive research services from a broker-dealer for doing business with them, if the adviser does not use commissions (or commission credits[2]) to obtain such research, the arrangement is *not* considered Soft Dollars. This has been a common error in the understanding of Soft Dollars with a number of Ohio investment advisers.

Securities regulators view Soft Dollars arrangements with skepticism, which can cause further review in their examination process because they may affect the best execution of securities transactions and cause the client to pay more than the lowest available commission. Soft Dollars, therefore, raise questions about whether an investment adviser has breached their fiduciary duty.

Such broker-dealer research benefits the adviser by relieving the adviser from having to purchase that product or service on its own with "hard dollars." The issue then becomes more concerning if the product or service obtained from the broker-dealer benefits only the adviser, or only other clients of the adviser, and not the client whose trades generated the Soft Dollars. Soft Dollars belong to the client. Full disclosure is therefore extremely important to the adviser's fiduciary duty to avoid violating the anti-fraud provisions.

Section 28(e) of the Securities Exchange Act of 1934 allows and provides a "safe harbor" for "discretionary" investment advisers to pay an increased commission, above what another broker-dealer would charge for executing the same transaction, for research and brokerage services, *provided the adviser has made a good-faith determination that the value of the research and brokerage services qualifies as reasonable in relation to the amount of commissions paid*. However, it does not protect an adviser from their fiduciary obligation to seek best execution on behalf of the account.

Further, under SEC guidelines, the determination as to whether a product or service is considered "research" or "other brokerage services" and therefore eligible for Section 28(e)'s safe harbor is whether it provides lawful and appropriate assistance to the investment manager in performance of its investment decision-making responsibilities.[3] Conduct outside of the safe harbor of Section 28(e) may constitute a breach of fiduciary duty.

continued on page 5

1 The Office of Compliance, Inspections and Examinations, U.S. Securities and Exchange Commission, Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds (September 22, 1998).

2 Credits from commissions would be like receiving a $1 credit from a broker for every $2 of commissions received by the broker.

3 Interpretive Release Concerning the Scope of Section 28(e) of the Securities and Exchange Act of 1934 and Related Matters, 17 CFR Part 241 (Release No. 34-23170) (1986)

Soft Dollars continued from page 4

Examples of "research" or "brokerage services" eligible for Section 28(e)'s safe harbor, would be: software that uses market information; advice from broker-dealers on order executions or strategies; data services providing market data such as quotes, sale prices, trading volumes, company financial data, and economic data; research reports; and meetings, seminars or conferences where they relate to research.[4]

Examples of ineligible "research" and "brokerage services" would be things like membership dues, SRO fees, licensing fees, rent, utilities, entertainment, marketing, meals, legal expenses, travel expenses, computers, or software used for administrative purposes. Please note that these lists are not all inclusive.[5]

The use of Soft Dollars requires full disclosure. Specifically,

- Item 8G (1) of Part 1A of Form ADV asks advisers: "Do you or any related person receive research or other products or services other than execution from a broker-dealer or a third party in connection with client securities transactions?" This calls for disclosure of Soft Dollars arrangements.
- Item 8G (2) of Part 1A of Form ADV asks "If 'yes' to G.(1) above, are all the 'soft dollar benefits' you or any related persons receive eligible 'research or brokerage services' under section 28(e) of the Securities Exchange Act of 1934?"

Advisers are also required to disclose their practices regarding the use of Soft Dollars in response to Item 12 of the Form ADV Part 2A.

Those disclosures should include the following:

- Explain the procedures you used during your last fiscal year to direct client transactions to a particular broker-dealer in return for soft dollar benefits.
- Describe the types of products and services you or any of your related persons acquired with client brokerage commissions (or markups or markdowns) within your last fiscal year.
- If you may cause clients to pay commissions (or markups or markdowns) higher than those charged by other broker-dealers in return for soft dollar benefits (known as paying-up), disclose this fact.
- Explain that when you use client brokerage commissions to obtain research or other products or services, you receive a benefit because you do not have to produce or pay for the research products or services.
- Disclose that you may have an incentive to select or recommend a broker-dealer based on your interest in receiving the research or other products or services, rather than on your clients' interest in receiving most favorable execution.
- Disclose whether you use soft dollar benefits to service all of your clients' accounts or only those that paid for the benefits.
- Identify potential conflicts of interest and how the adviser will address them.

Failure to make required disclosures on the Form ADV can result not only in regulatory action, but in cases where the client relies on a deficient Form ADV, could also be grounds for a fraud claim by that client.

Investment adviser representatives should always evaluate whether the products and services they receive from broker-dealers are appropriate. They must evaluate their Soft Dollar relationships on a regular basis to ensure they are disclosed properly and that they do not negatively impact the best execution of client transactions.

In addition, the fact that a firm accepts Soft Dollars might also undermine any claim of being a fee-only advisory firm.

Joyce Cleary is a Securities Specialist for the Division of Securities. She serves as a Field Examiner focusing on the compliance of state-licensed investment advisers.

4 The Office of Compliance, Inspections and Examinations, U.S. Securities and Exchange Commission, Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds (September 22, 1998).

5 Id.

A to Z continued from page 5

Protecting Seniors from Financial Exploitation Federally and in Ohio

By Kelly Igoe, Licensing Compliance Counsel

The Division is closely monitoring several federal and state initiatives aimed at protecting seniors from financial exploitation.

Federal Rules and Proposals

The U.S. Securities and Exchange Commission (SEC) in February approved amendments to an existing rule and adoption of a new rule proposed by the Financial Industry Regulatory Authority (FINRA) intended to protect seniors from financial exploitation. FINRA Rules 2165 and 4512 (as amended) will take effect Feb. 5, 2018.

These two rules will now:

1) require FINRA members to make reasonable efforts to obtain the name of and contact information for a trusted contact person for a customer's account: and

2) permit FINRA members to place temporary holds on the disbursement of funds or securities from the accounts of specified customers, where there is a reasonable belief that these customers have been, are being, or will be subject to financial exploitation. (File No. SR-FINRA-2016-039).

In addition to the federal regulatory efforts, on Jan. 20, 2017, members of Congress introduced Senate Bill 178, the Elder Abuse Prevention and Prosecution Act. This bill, which serves to provide additional support to federal cases involving elder abuse, would require, among other things, the U.S. Attorney General to designate an Elder Justice Coordinator in each federal judicial district responsible for prosecuting elder abuse cases and conducting public outreach relating to elder abuse. S.B. 178 would also require federal interagency coordination, data collection and reporting for cases involving elder abuse.

On January 24, 2017, members of Congress introduced Senate Bill 223, known as the "Senior$afe Act of 2017." This proposal would provide immunity from civil liability to individuals working within the banking and financial services industries who disclose potential examples of financial exploitation of senior citizens to certain government agencies or law enforcement, provided the disclosures were made in good faith and with reasonable care.

Ohio House Bill 78 Introduced

Ohio Representative Wes Retherford (R-Hamilton) introduced House Bill 78 on Feb. 22, 2017, which replaces House Bill 24 introduced last session. If passed, HB 78 would provide more care for the elderly by making it mandatory for various groups to report suspected financial exploitation or abuse. The bill would expand the list of professionals required to report suspected financial exploitation to the appropriate county department of job and family services. As proposed, those financial professionals affected by the new mandatory reporting would include certified public accountants, bank employees, financial planners accredited by a national accreditation agency, and investment advisers as defined in Ohio Revised Code 1707.01.

Although an Adult Protective Services advocate may visit with an elderly member of their community to provide services, it may be the investment adviser, accountant, lawyer or a bank teller who personally witnesses a person making troubling financial decisions.

The proposed state and federal bills, if passed, will change the way many groups handle suspected abuse of the elderly. Although these efforts are necessary, it is also important for all Division licensees to conduct business ethically, and keep vigilant when noticing and witnessing changes in clients that raise red flags of financial exploitation.

The Growing Problem of Elder Financial Victimization

In November 2016, the number of seniors living in the U.S reached over 50 million, the first time in U.S. history. It is estimated that by 2050 the senior population will reach 83 million. http://www.seniorcare.com/featured/aging-america/

continued on page 7

Protecting Seniors continued from page 6

According to the National Adult Protective Services Association (NAPSA), financial exploitation occurs when a person misuses or takes the assets of vulnerable adults for their own benefit. The most commonly reported types of financial exploitation perpetrated against the elderly include theft, fraud, Ponzi schemes, and investment fraud. http://www.napsa-now.org/policy-advocacy/exploitation/

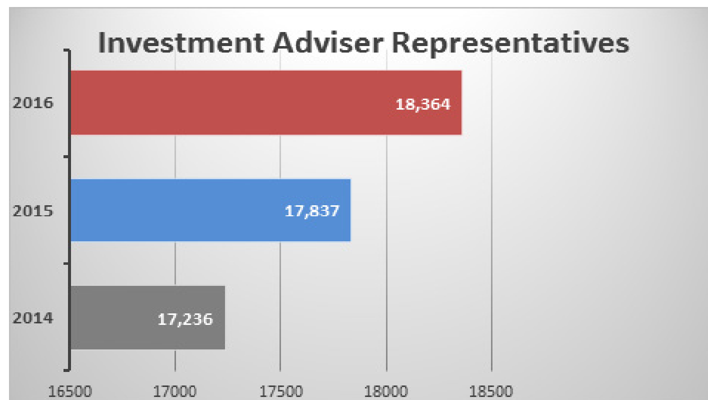
Ohio's Efforts to Combat Elder Abuse

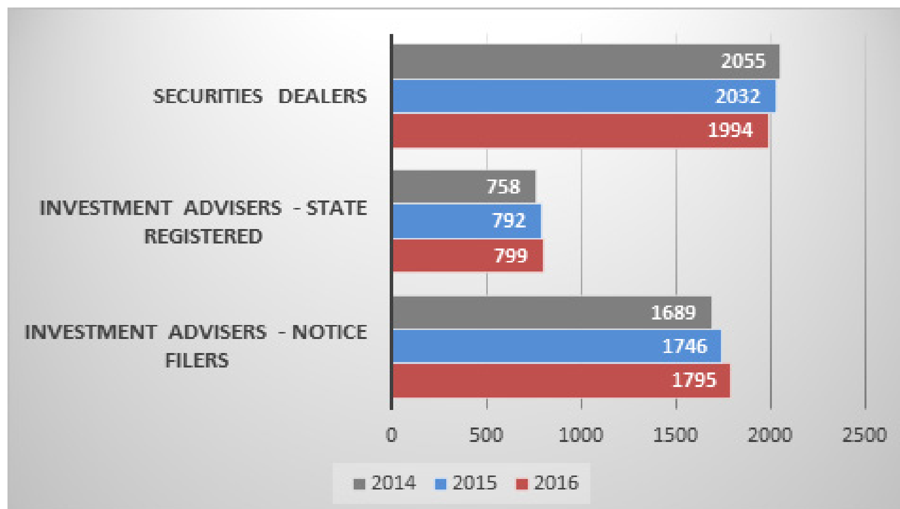
According to research from the Scripps Gerontology Center at Miami University, Ohio's population of adults age 60 and older will grow 30 percent from 2010 to 2020, and 50 percent by 2040. Elderly Ohioans are not immune from the potential increase in financial exploitation, which is devastating to its victims.

To address the growing problem of elder abuse in Ohio, the Ohio Attorney General's Office created the Elder Abuse Task Force in 2005 to raise awareness, improve education and boost the level of research. The other key issues addressed were the lack of adequate funding, strict policy making and new programming in place for the elderly community. In 2009, the Task Force became part of the Elder Abuse Commission, a partnership among various state agencies to address the totality of abuses directed toward older Ohioans. The Commission currently is supported and staffed by the Attorney General's Consumer Protection Section.

The Division of Securities is represented on the Commission because of our focus on elderly abuse as it relates to financial exploitation. The Division continues to respond to securities fraud perpetuated against all Ohioans, including the vulnerable group of senior citizens in Ohio.

2016 Year-End Licensing Statistics





Enforcement Section Update

The Division's Enforcement Section is a criminal justice agency authorized to investigate and report on all complaints and alleged violations of the Ohio Securities Act and related rules. The Enforcement Section attorneys represent the Division in prosecutions and other matters arising from such complaints and alleged violations.

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ADMINISTRATIVE HEARINGS

TAP Management, Inc. *et al.*
Division Notice Order No. 15-022
Pending Final Order

CRIMINAL HEARINGS

For additional information regarding the cases below, please see: Bulletin2016ThirdQuarter , Bulletin2016FourthQuarter

State v. Bruce Durr
Case No. 16 CR I 07-0368
Delaware County Court of Common Pleas
April 3, 2017 (sentencing)

State v. Mary Hackney; Philip Curtis; Lovell Jones
Case No. 16 CR 004771
Franklin County Court of Common Pleas
April 3, 2017 (pre-trial conference)

State v. Jeremy Moser
Case No. 16 CR 502
Miami County Court of Common Pleas
April 10, 2017 (sentencing)

State v. Harold Campbell
Case No. 2017 CR 00280
Montgomery County Court of Common Pleas
March 23, 2017 (scheduling conference)

State v. Christopher Hodge
Case No. CR 16 10 0288
Logan County Court of Common Pleas
April 4, 2017 (status conference)

State v. Michael D. Mathew
Case No. CR2016-0415
Muskingum County Court of Common Pleas
May 16, 2017 (trial)

State v. Keith Elsesser
2017 CR 02 0041
Tuscarawas County Court of Common Pleas
March 30, 2017 (arraignment)

State v. Jeremy Moser
Case No. 16 CR 502
Miami County Court of Common Pleas

On February 2, 2017, following a criminal referral from the Ohio Division of Securities and a grand jury indictment, Jeremy Moser, a Troy resident, entered a plea of guilty and was convicted of felony-level inchoate securities charges. Moser solicited and received $10,000 from an Ohio resident to invest in a startup business, Integrated Tech Solutions ("ITS"), based in part on misrepresentations that ITS was affiliated with an established business. ITS was never incorporated, and the indictment alleges the investor funds were used for personal expenses. The sentencing hearing is scheduled for April 10, 2017. This case is being prosecuted by the Office of the Miami County Prosecutor, Anthony E. Kendell.

State v. Harold Campbell
Case No. 2017 CR 00280
Montgomery County Court of Common Pleas

On January 25, 2017, following a criminal referral from the Ohio Division of Securities, Harold Campbell was indicted on one count of theft from an elderly adult. The indictment is based on allegations that Campbell convinced his elderly aunt to invest $80,000 with him based on a guaranteed return of 5% annually. The indictment alleges that Campbell did not invest the money, but instead use the funds to pay his personal expenses. A scheduling conference is scheduled for March 23, 2017.

continued on page 9

Criminal Hearings continued from page 8

State v. Michael D. Mathew
Case No. CR2016-0415
Muskingum County Court of Common Pleas

On December 21, 2016, following a referral from the Ohio Division of Securities and a joint investigation by the Division and the Muskingum County Sheriff's office, Michael Mathew was indicted on 65 criminal counts, including securities fraud, misrepresentations in the sale of a security, publishing false information as to value of securities, engaging in unlicensed activity and theft.

The indictment is based, in part, on allegations that, during the period from August 8, 2014 through September 8, 2015, fifteen (15) investors invested approximately $493,335.87 with Michael Mathew d/b/a Mathew Investments, LLC based on false assurances that their investment would be held in trust and traded in various positions in the stock market and that their principal was guaranteed not to lose more than 30% through an insurance contract with Goldman Sachs. The trial is scheduled to begin May 16, 2017. This case is being prosecuted by the Office of Hon. D. Michael Haddox, Muskingum County Prosecutor.

State v. Keith Elsesser
Case No. 2017 CR 02 0041
Tuscarawas County Court of Common Pleas

On February 17, 2017, following a criminal referral from the Ohio Division of Securities and a joint investigation between the Division and New Philadelphia Police Department, Keith Elsesser, 50, was indicted on 31 felony charges related to the fraudulent sale of securities, including 29 counts of unlawful securities practices and two counts of grand theft. The indictment is based on allegations that Elsesser sold phony securities to two Tuscarawas County investors between 2011 and 2013. Elsesser is accused of leading the victims to believe that they were investing in an energy drink venture, but he allegedly spent the victims' investments on himself. The loss to both victims is a total of approximately $90,000. Elsesser was previously convicted on federal charges in North Carolina in connection with a similar scheme. This case is being prosecuted by Attorney General DeWine's Special Prosecutions Section.

ADMINISTRATIVE ACTIONS

Division Order Nos. 16-029/17-003
Rajesh Lahoti; Wyred, LLC; Find Fred
Columbus, Ohio

On December 1, 2016, the Division issued Notice Order 16-029 against Rajesh Lahoti, Wyred, LLC, and Find Fred based on allegations that they misrepresented material facts to an Ohio investor and engaged in fraudulent activity related to the sale of securities issued by Wyred, LLC, doing business as Find Fred. The Ohio investor paid, in total, $750,000 to the Respondents for investment in an online dating website which is now defunct. An administrative hearing was not requested. On January 31, 2017, the Division issued Order No. 17-003, a final Cease and Desist Order in this matter.

Division Order No. 16-030
The James Pier Company, Inc. CRD No. 160140
James Pier CRD No. 1723350
Fairview Park, Ohio

On December 22, 2016, the Division issued Order No. 16-030 approving and adopting the findings of fact, conclusions of law and the recommendation of the hearing officer and revoking the Ohio investment adviser license of The James Pier Company and the Ohio investment adviser representative license of James Pier. The Report and Recommendation included findings that the former licensees refused to comply with a lawful order or requirement by the Division, failed to furnish information requested by the Division, and were not of good business repute based on their lack of response to repeated requests for an on-site examination by the Division. The administrative hearing was conducted pursuant to the holding in Goldman v. State Med. Bd. of Ohio, 110 Ohio App.3d 124 (1996).

continued on page 10

Enforcement Section Update

Administrative Actions continued from page 9

Division Order No. 17-001
ULU Capital, LLC CRD No. 173351
Andrew Niehus CRD No. 4406399
Fairfield, Ohio

On January 11, 2017, the Division issued Division Order No. 17-001 terminating Division Order No. 16-019 based on a finding that termination was in the best interest for the effective administration of the Ohio Securities Act. On December 31, 2016, the investment adviser license of ULU Capital, LLC, and the investment adviser representative license of Andrew Niehus expired with the Division based upon their failure to renew.

Division Order No. 17-002
Gustafson Baxter Financial Services, Inc. CRD No. 110289
Bruce Baxter CRD No. 1315705
Powell, Ohio

On January 26, 2017, the Division issued Order No. 17-002 approving and adopting the findings of fact, conclusions of law and the recommendation of the hearing officer and revoking the Ohio investment adviser license of Gustafson Baxter Financial Services, Inc. and the Ohio investment adviser representative license of Bruce Baxter. The Report and Recommendation included findings that the former licensees refused to comply with a lawful order or requirement by the Division, failed to furnish information requested by the Division, and were not of good business repute based on their lack of response to repeated requests for an on-site examination by the Division. The administrative hearing was conducted pursuant to the holding in Goldman v. State Med. Bd. of Ohio, 110 Ohio App.3d 124 (1996).

Division Order No. 17-004
NBI Financial Services
Barker & Daugthers, Inc. D/B/A New Beginnings
Seven Hills, Ohio

On January 31, 2017, the Division issued a final Cease and Desist Order against NBI Financial Services, Barker & Daughters, Inc. d/b/a New Beginnings after they failed to request an administrative hearing in response to Division Notice Order Number 16-020. The Division found that the Respondents sold investment contracts to an Ohio investor in exchange for an aggregate investment amount of $35,600 through assurances that the money would be invested “like a mutual fund” and that the investor would receive returns of 400%. The Division alleges that the investor funds were used for personal use, including food, utilities, and other miscellaneous expenditures.

Division Order No. 17-005
Robert Eugene Hanes D/B/A Earth Resources
Pittsburgh, Pennsylvania

On February 2, 2017, the Division issued a final Cease and Desist Order against Robert Eugene Hayes d/b/a Earth Resources after he failed to request an administrative hearing in response to Division Notice Order Number 16-024. The Division found that Respondent cold-called an Ohio investor and sold him a working interest in an oil well in Haskell County, Texas, in exchange for $22,375. Instead of applying the investor funds to the oil well, the Division alleges that Mr. Hanes used the funds for airline tickets, hotels and meals at casino resorts.

continued on page 11

Administrative Actions continued from page 10

Division Order No. 17-006
Binary Trading Experts
Mason, Ohio

On February 6, 2017, the Division issued a final Cease and Desist Order against Binary Trading Experts after the company failed to request an administrative hearing in response to Division Notice Order Number 16-026. The Division found that Binary Trading Experts engaged in fraudulent activity and made material misrepresentations related to the sale of securities through their internet-based trading platform at www.binarytradingexperts.com ("Website"). The Website guarantees a daily profit of $250 without providing any material disclosures related to the risk of investment.

Division Order No. 17-007
Michael W. Wiesemann, Sr. CRD No. 4918499
MAH Investment Management, LLC CRD No. 155092
Prime Conservative Fund, LP
Brookville, Indiana

On February 17, 2017, the Division issued a final Cease and Desist Order with Consent against Michael W. Wiesemann, Sr. ("Wiesemann"), MAH Investment Management, LLC ("MAH"), and Prime Conservative Fund, LP. The Consent Order found that the Respondents engaged in fraudulent, deceptive or manipulative conduct, breached their fiduciary duty to their investment advisory clients, and improperly commingled client funds with personal assets. As part of the Consent Agreement, Wiesemann and MAH Investment Management, LLC, voluntarily surrendered their Ohio investment advisory licenses and agreed to a lifetime ban on acting in the capacity of an investment adviser, investment adviser representative, securities dealer, securities salesperson or a securities issuer in or from the State of Ohio. As further part of the Consent Agreement, Respondents paid back $817,810.19 to Ohio investors who were clients of the firm and investors in Prime Conservative Fund, LP.

Division Order No. 17-008
SPOTFN.com, LLC
SPOT FN, Ltd.
Ft. Lauderdale, Florida
London, United Kingdom

On February 21, 2017, the Division issued a Notice of Opportunity and Notice of Intent to Issue a Cease and Desist Order against SPOTFN.com, LLC and SPOT FN, Ltd. based on allegations that they operated an internet-based trading platform at spotfn.com and engaged in unlicensed securities dealer or investment advisory services, made misrepresentations of material facts and engaged in securities fraud through their website and through cold calls to a disabled Ohio resident. The Notice Order alleges that the Ohio resident invested $5,000 through his debit card based on assurances that the investment was insured and that he would receive a weekly distribution of $1,500. The website states that investors can earn "up to 88% every 15 minutes" through their investments on the platform. The Notice Order further alleges that the disabled Ohio investor received weekly calls for a period of time from "brokers" with SPOT FN after he invested, including one call at 2:30 a.m. SPOT FN failed to return the Ohio investor's funds after he requested liquidation.

Lights, Camera, Action!

As part of a new campaign to help Ohioans invest wisely, Janice Hitzeman, our Chief Enforcement Attorney, participated in a video filmed in our offices that will be shown as part of the revised "When I'm 65" documentary series produced by Detroit Public Television. Janice shared some common investment myths and gave tips for how to make solid financial choices. You can view Janice's segment on YouTube: https://www.youtube.com/watch?v=UPk7jrg-6Fo&feature=youtu.be

Corrective Filing Requirements for Certain Ohio Exempt Transactions

By Jessica Brown, Corporation Finance Counsel

When any securities are offered or sold in reliance upon an exemption under Ohio Revised Code ("R.C.") sections 1707.03(Q), 1707.03(W)*, or 1707.03(Y), a respective form must be filed with the Division within 60 days of the date of the first sale in Ohio for 1707.03(Q) (Form 3-Q), at least five business days before the sale for 1707.03(W) (Form 3-W) and not later than 15 days after the sale for 1707.03(Y) (Form 3-Y). If such form is filed after the statutorily prescribed time period, it is considered to not be timely filed and the issuer must make a corrective filing. The type of corrective filing required depends on how long after the prescribed time period that a filing was made.

Ohio Administrative Code rules 1303:6-3-39.1(B)(1)-(3) and (D) allow for a corrective filing due to "excusable neglect" to be made within six months from the date of the first sale. This requires filing a Form 391 and all required attachments, plus paying an additional fee. Thus, if a Form 3-Q filing is made after 60 days from the date of the first sale, but within six months of the date of first sale, an issuer can file a Form 391 to remedy the late filing.

However, if a filing is made after six months from the date of first sale in Ohio, an issuer is required to make a corrective filing pursuant to R.C. section 1707.39 by filing a Form 39 and all required attachments, plus paying an additional fee. Pursuant to R.C. section 1707.39, the Division may retroactively register the securities if it finds that no person has been defrauded, prejudiced, or damaged by such noncompliance or sale and that no person will be defrauded, prejudiced, or damaged by such registration.

The Division may further require the issuer to send a Rescission Offer Explanatory Statement / Non-Prejudice Statement (the form is available on the Division's website at: http://www.com.state.oh.us/documents/np.pdf) to each purchaser that notifies such purchasers of the violation and gives them the option of receiving their investment back. If required purchasers sign such statement acknowledging they were not harmed by the late filing, or are given their investment back (depending on the option each purchaser choses), the Division may then retroactively register the securities.

If an issuer finds itself in a position of needing a corrective filing, the Division recommends reviewing R.C. section 1707.03 in order to reassess if any exemptions are available to the issuer. As a reminder, pursuant to R.C. section 1707.45, the burden of proof is on the issuer to show that a proposed transaction qualifies for an exemption.

**In October of 2016 the Securities and Exchange Commission adopted certain rules related to intrastate and small-business offerings. One of the changes to the rules repealed the federal exemption under Rule 505 of Regulation D. R.C. section 1707.03(W) is Ohio's companion exemption to Rule 505. The repeal of Rule 505 will become effective 180 days after publication in the Federal Register and thus 1707.03(W) will no longer be available as an Ohio exemption when the repeal goes into effect.*

Jessica Brown is an attorney for the Division of Securities, responsible for reviewing registration filings and responding to inquiries on securities and exemption matters.

Ohio Manual Exemption

As a follow-up to the manual exemption update published in the second quarter edition of the Ohio Securities Bulletin (2016, page 7), the Division would like to alert licensed dealers that OTC Markets Group has taken the position that OTCQX and OTCQB are recognized securities manuals, which the Division and other states have accepted. OTC Markets Group Inc. (OTCQX: OTCM) operates the OTCQX Best Market and the OTCQB Venture Market.

To recap, licensed dealers may rely on an exemption under R.C. Section 1707.03(M)(3)(a) for the sale of securities listed in recognized securities manuals. As always, the burden of proof with an exemption is upon the person selling the securities pursuant to R.C. Section 1707.45.

The Ohio Division of Securities will begin accepting electronic Notice Filings in the near future. For more information, check out our **website** or contact the Division at 614-644-7381 or **securitiesgeneral.questions@com.state.oh.us**

Division News

Colleen Brown Retires

Colleen Brown, the long-time executive assistant to Commissioner Andrea Seidt, retired in February after 10 years of state service, eight of them with the Division. Before coming to the Department of Commerce, Colleen worked at the Jones Day law firm and in the office of the Ohio Attorney General.

We owe Colleen a great deal of thanks for her many years of dedicated service and her jovial sense of humor that made the Division a more enjoyable place to work. The staff are already missing her but wish her a long and fulfilling retirement.

Jason Shawver Joins Enforcement Staff

Jason Shawver joined the Division in March as our new investigator. He will research and investigate complaints of possible violations of the Ohio Securities Act, including conducting interviews with related parties, scheduling and reviewing financial account records, preparing preliminary investigative reports, as well as requesting and serving subpoenas. Jason was previously with the Ohio State Highway Patrol as an enforcement agent in the investigative unit.

Industry News

Shortening the Settlement Cycle for Most U.S. Securities

The Securities Industry and Financial Markets Association (SIFMA) recently announced that on Sept. 5, 2017, the financial industry intends to shorten the settlement cycle process that underlies a significant volume of U.S. financial transaction activity. Specifically, the settlement cycle for most transactions in U.S. securities would shorten from three business days after the trade date ("T+3") to two business days after the trade date ("T+2").

According to Marin Gibson, SIFMA's managing director and associate general counsel for State Government Affairs, this change would reduce a number of risks for individual investors and the financial markets as a whole, including credit risk, market risk, and liquidity risk and, as a result, systemic risk.

"Because risk is a function of time, the greater the time between a trade execution and the settlement of that trade, the greater the risk to the parties that something will occur that may complicate or, in extremely rare cases, prevent settlement," said Gibson. "The shorter the settlement cycle time, the smaller the risk to buyers and sellers, including individual investors, and the market generally."

Gibson added that with the large daily volume of trading in the U.S. financial markets, "the change from T+3 to T+2 would increase the safety and soundness of our financial system and directly benefit investors and other market participants. In addition, the U.S. move to T+2 would align U.S. settlement cycles with the settlement cycle in major international markets, as most European Union member states and major markets in the Asia-Pacific region have already adopted a two-day securities settlement cycle."

T+2 Plain Language Document

Click on Plain Language T+2 Doc - SGA to read a document designed to explain the Shortened Settlement Cycle in plain language for use by financial firms in socializing and educating impacted customers and other market participants.

Industry Resources

Materials to assist financial firms in completing the move to a shortened settlement cycle are available at: ust2.com.
Industry participants who are affected by this change can download a comprehensive implementation playbook at: ust2.com/pdfs.

The Ohio Securities Exchange provides a platform where views and opinions related to the securities industry can be shared from sources outside the Division of Securities. The Division encourages members of the securities community to submit articles pertaining to Ohio securities law and regulations.

If you are interested in submitting an article, contact the Editor, Dan Orzano, Daniel.Orzano@com.state.oh.us for the publication schedule and submission requirements. The Division reserves the right to edit submitted articles for publication.

Disclaimer
The views and opinions expressed in the Ohio Securities Exchange solely represent those of the contributors. The Division of Securities takes no position on the material presented.

The Dodd-Frank Act, Security-Based Swaps And…. "Fantasy Sports For Stocks?"

By Robert N. Rapp

In a recently settled U.S. Securities and Exchange Commission (SEC) administrative enforcement proceeding the operator of a mobile telephone game, dubbed by some as "Fantasy Sports for Stocks," in which players could win cash prizes by predicting the order in which 10 stocks or exchange-traded funds (ETFs) would perform relative to each other over the course of a week, agreed to a cease and desist order and a $50,000 civil money penalty for violating the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd Frank Act").

Without admitting or denying SEC findings, the game operator, Forcerank LLC ("Forcerank") consented to the sanctions based on an SEC determination that by running the game in which players generally paid a $5.00 entry fee, Forcerank had offered and sold "security-based swaps" to players in violation of the Dodd-Frank Act. Security-based swaps are forms of "derivatives" that were targeted for regulation as having significantly contributed to the 2008-2009 global financial crisis. Adding security-based swaps to the statutory definitions of "security" in the federal securities laws, the Dodd-Frank Act brought these particular swaps within the regulatory purview of the SEC as part of a new regulatory and market structure that, among other things, permits offers and sales only to "eligible contract participants" – individuals meeting stringent invested assets criteria – unless a registration statement covering the offering is effective, and to mandate that sales be effected through a national securities exchange or registered "security-based swap execution facility" ("SBSEF"), and be "cleared" through a registered clearing agency.

In the Forcerank game the players, none of whom were eligible contract participants, ranked 10 stocks or ETFs chosen by Forcerank from one to 10 based on the expected percentage change in the market price in the upcoming week. Players predicted for each stock or ETF where it would rank, from best to worst performing. Points were awarded for each player's 10 predictions based on the correct prediction or degree of closeness. Players with the most aggregate points received cash prizes at the end of the competition. Over the five month period in which the game ran, there were 240 contests in which 337 players paid a total of $16,885 in entry fees (generally $5.00 per contest charged to a credit card), and ultimately shared in approximately $15,196 of prize money. For operating the game, Forcerank kept 10% of players' entry fees. There was, however, a broader incentive for running the game. The contests enabled an affiliate of Forcerank to collect data – "crowdsourced predictions" – about securities and trading, and to use that data to create aggregate predictions that could be sold to hedge funds and other investors.

According to the SEC, the Forcerank players paid an entry fee for the opportunity to enter into an agreement allowing for the payment of points and cash winnings "dependent upon the occurrence, or the extent of the occurrence, of an event or contingency associated with a potential financial, economic, or commercial consequence involving the market price of an individual security," namely, how it actually performed over the course of a week relative to nine others. Without regard to context or particular circumstances, this is the simple definition of a "security-based swap," as that term and a new regulatory and market structure built around it were added to the federal securities laws by the Dodd-Frank Act. Forcerank players were not "eligible contract participants." Forcerank set no requirements that players own any amount of assets or otherwise satisfy any wealth-related qualifying criteria, and nothing involved in the game touched the facilities of any national securities exchange or SBSEF, much less any clearing facility.

Extending the reach of the Dodd-Frank Act regulatory structure for swaps generally, and security-based swaps in particular, to the Forcerank $5.00 game seems odd in the larger scheme of the derivatives regulatory and market structure created by the Dodd-Frank Act.

continued on page 15

"Fantasy Sports For Stocks?" continued from page 14

It can safely be said that what Congress had in mind when ushering in a new regulatory and market structure for complex derivatives which were tagged as contributing to systemic risk and the financial crisis was not a $5.00 mobile telephone game involving the weekly ranking of securities. That said, however, when it took on the Forcerank game, the SEC was not writing on a clean slate regarding the Dodd-Frank Act, security-based swaps, and "fantasy stock trading."

In June 2015, the SEC Office of Investor Education and Advocacy issued an Investor Alert to warn investors that "pay-to-play 'fantasy' trading competitions" or other "virtual games" referencing securities could involve securities-based swaps. The Investor Alert counseled that although one may think terms like "swap," "security-based swap," and "derivative" include only complicated financial instruments used by sophisticated financial institutions, the definitions are much broader. These terms encompass any contract, agreement or transaction whose value is based upon – derives from – the value or performance of some other financial product, event, or characteristic. Each entry in the Forcerank game constituted a security-based swap because: (1) the participant paid to enter into an agreement with Forcerank providing for the payment of points and cash dependent upon the player's prediction about the price performance of individual securities being compared to actual performance; and (2) each swap was based on the value of single securities. In these circumstances, said the SEC, investor protection is a paramount objective.

The object of investor protection in any setting is an investment decision. The Dodd-Frank Act added security-based swaps to the laundry list of instruments, things or relationships expressly defined in the federal securities laws to be a "security." Things comprising the list are presumed to have certain characteristics that create true investment risk, and at the top of the list of investor protections afforded by securities laws is full and fair disclosure of information upon which to make an informed investment decision. It is also true that the definition of security is in each instance qualified in it is entirety by the header "unless the context otherwise requires." The SEC Investor Alert on security-based swaps itself makes the point that any actual situation would need to be analyzed based on the particular facts and circumstances involved to determine whether security-based swaps are actually involved. As an administrative proceeding settled by consent, Forcerank included no such analysis, although it did recognize that the Forcerank website itself expressly disclaimed the creation of any security or security-based swap by its game, thus suggesting, according to the SEC, that players "might be concerned" the contests violated laws related to the purchase and sale of security-based swaps.

The simple reality was that the Forcerank players' $5.00 entry fee allowed them to predict the market price of each of 10 securities at the end of a week, to rank them from expected best to expected worse performance, and to win points and cash based on how their predictions actually turned out. To be sure, the game referenced securities, and SEC Investor Alert makes specific note of "virtual games referencing securities" which charge people an entry fee to participate in a fantasy trading game or competition that would create the type of financial exposure the regulatory regime for security-based swaps is designed to address. But Forcerank game players did not engage in virtual trading, or enter a stock trading competition, or become exposed to risks associated with derivatives in making a wrong prediction how 10 securities would perform relative to each other in the course of a week. Forcerank begs the question whether the objective in establishing a regulatory and market structure for security-based swaps under the Dodd-Frank Act in the wake of the financial crisis, or the objective of investor protection generally, is furthered by its application to a weekly $5.00 chance to predict the performance of 10 securities and win money as a result of wisdom in doing so, or just plain luck.

What is certain, however, is that with the addition of security-based swaps to the definition of security in the federal securities laws, coupled with the broad definition of security-based swap itself that is incorporated into that definition and the basic prohibitions of the Dodd-Frank Act, the scope of SEC enforcement authority now extends into the uncertain realm of transactions presenting the opportunity to realize some economic value linked to, or simply "referencing" an event or occurrence involving another security. Complex "derivatives" may have played a major role in the global financial crisis, but for practitioners in a more mundane securities regulation setting "security-based swap" must now be a part of their lexicon and understanding, as they may appear in odd places bereft of investment characteristics and true investment risk.

Robert N. Rapp is Senior Counsel with Calfee, Halter & Griswold LLP, in Cleveland, Ohio, and is Distinguished Practitioner In Residence at the Case Western Reserve University School of Law. He earned his B.A. and J.D. from Case Western Reserve University, and his M.B.A. from Cleveland State University.