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Ohio Department of Commerce Division of Securities

Securities Bulletin

Ohio Department of Commerce, Division of Securities

Bankruptcy After a Securities Violation: How the Securities Claim Exemption Helps Ohio Investors

By *Analiese Hinchcliffe, Enforcement Attorney*

The Ohio Division of Securities receives complaints from investors daily. While Division enforcement attorneys are responsible for investigating whether violations of the Ohio Securities Act have occurred, the primary concern of investors usually is the recoupment of their funds. The Ohio Securities Act grants the Division the ability to seek civil restitution under Ohio Revised Code ("R.C.") §1707.261 if a court of common pleas has issued an injunction.[1] If criminal convictions for violations of the Ohio Securities Act are obtained, restitution may also be ordered.[2] However, the Division is not currently able to order restitution outside of administrative consent orders.[3] The victims of such violations may bring individual or class civil actions for violations under R.C. Chapter 17.[4] Once restitution or judgement orders are issued against a person who violates the Ohio Securities Act, a violator of the Ohio Securities Act may consider filing for bankruptcy in an attempt to avoid paying restitution.

Fortunately, in the wake of numerous financial frauds in the late 1990s and early 2000s, Congress expanded the debts statutorily excepted from discharge under 11 U.S.C §523 to included debts arising from violations of securities laws with the enactment of the Sarbanes-Oxley Act of 2002.[5] Section 523 previously exempted debts arising from fraudulent activity under paragraph (a)(2).[6] However, federal rules require a creditor to file an objection to the debt discharge within 60 days of the debtor's bankruptcy petition to apply the fraud exemption.[7] Failure to file may cause the creditor to forever waive a challenge to the discharge of the debt.[8] Before the amendments prescribed in the Sarbanes-Oxley Act of 2002, investor-creditors were limited to the use of the general fraud exemption and its tight timeframe.

Under the Sarbanes-Oxley Act of 2002, Congress explicitly excepted the discharge of debts arising from securities law violations with the amendment of 11 U.S.C. §523(a) to include paragraph (19),[9] which states:

§ 523. Exceptions to discharge

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title [11 USCS § 727, 1141, 1228(a), 1228(b), or 1328(b)] does not discharge an individual debtor from any debt—

(19) that—

(A) is for—

(i) the violation of any of the Federal securities laws (as that term is defined in section 3(a)(47) of the Securities Exchange Act of 1934 [15 USCS § 78c(a)(47)]), any of the State securities laws, or any regulation or order issued under such Federal or State securities laws; or

(ii) common law fraud, deceit, or manipulation in connection with the purchase or sale of any security; and

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[1] Ohio Rev. Code §1707.261(A).
[2] *See* Ohio Rev. Code §1707.99 (felony guidelines for violations of §1707.042 or §1707.44). *See also* Ohio Rev. Code §2929.18 (financial sanctions for felony convictions).
[3] *See* Ohio Rev. Code §1707.261(C).
[4] *See* generally Ohio Rev. Code §§1707.40-1707.43.
[5] *See* Sarbanes-Oxley Act of 2002 §803, 116 Stat. 745, 801. *See generally* Sarbanes-Oxley Act of 2002 Legislative History, 107 CIS Legis. Hist. P.L. 204.
[6] 11 U.S.C. §523(a)(2).
[7] *See* Fed. R. Bankr. P. 4077(C).
[8] *See id. See also* Nelson S. Ebaugh, The Securities Claim Exemption in Bankruptcy: The Good, the Bad, and the Ugly, 19 A.B.A. Sec. Litig. J. 1, 14-15 (2008).
[9] *See* Sarbanes-Oxley Act of 2002 §803.

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(B) results, before, on, or after the date on which the petition was filed, from--

(i) any judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceeding;

(ii) any settlement agreement entered into by the debtor; or

(iii) any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor.[10]

Congress further revised this "securities claim exemption" by the addition of the language "before, on, or after the date on which the petition was filed" to subparagraph (B).[11] This amendment, contained in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, extended the discharge exemption to debts that arose from a violation of securities laws even if a judgement has not been ordered prior to the date that the debtor files for bankruptcy.[12]

While the Division may not order restitution paid to investors through an administrative order, the United States Bankruptcy Court for the Northern District of Ohio held that a default cease and desist order issued by the Division can qualify for the securities claim exemption in *Frost v. Civiello.*[13] The Division found that the insurance agent debtor violated R.C. 1707.44(A)(1), unlicensed sale of securities, and R.C. 1707.44(C)(1), sale of unregistered securities.[14] The debtor was properly served a Notice of Opportunity of Hearing and did not request a hearing under R.C. Chapter 119, therefore the Division issued a default order.[15] The Court identified a two-pronged test that a debt must meet in order to qualify for the securities claim exemption:

> As Collier's explains, in order to be excepted from discharge, two conditions must be met:
>
> (1) The debt is for the violation of certain federal securities laws, state securities laws or regulations under the federal or state securities laws or is for "common law fraud, deceit, or manipulation in connection with the purchase or sale of any security"; and –
>
> (2) The debt results from a judgment, order, consent order or decree in an [sic] federal or state judicial or administrative proceeding or any settlement agreement entered by the debtor or any court or administrative order for the payment of damages, a fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee cost or other payment owed by the debtor.[16]

The Court held the default order qualifies as a "valid adjudication wrought by an administrative agency empowered to enforce Ohio securities law" in satisfaction of the first condition, a violation of federal or state securities laws.[17] For the second prong, the Court determined that the debt did not "result from" the cease and desist order as required by the second element as the "cease and desist order does not memorialize the debt".[18] However, the cease and desist order determined the debtor violated R.C. 1707.44, and R.C. 1707.43(A), which provides a basis for relief for violations of the Ohio Securities Act.[19]

Section 1707.43(A) allows a purchaser to elect to void a sale or contract for sale made in violation of R.C. 1707.[20] The statute imposes joint and several liability for the full amount paid by the purchaser as well as all taxable court costs on "[t]he person making such sale or contract for sale, and every person that has participated in or aided the seller in any way in making such sale or contract for sale".[21] Therefore, the Court held that the violation of the Ohio Securities Act itself provides the basis for remedy.[22] The investor-creditors were still bound by the statute of limitations found in R.C. 1707.43(B), but the action before the Court was filed well within two years of their discovery that the debtor's actions were illegal.[23] As the debt satisfied both elements of the test, the Court held the debt was not dischargeable under 11 U.S.C. §523(a)(19).[24] Therefore, creditors can object to the discharge debts related to violations of the Ohio

[10] 11 U.S.C. §523(a)(19).
[11] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 §1404(a), 119 Stat. 23, 215.
[12] *Id. See also* Ebaugh at 14, 15.
[13] *See Frost v. Civiello* (*In re* Civiello), 348 B.R. 459, 467 (Bankr. N.D. Ohio 2006).
[14] *See id.* at 461-462.
[15] *See id.* at 462.
[16] *Id.* at 464, (quoting 15 Collier on Bankruptcy §523.24B (15th ed. 2006)).
[17] *Id.* at 465.
[18] *Id.* at 466.
[19] *Id.*
[20] Ohio Rev. Code §1707.43(A).
[21] *Id. See also* Frost at 466.
[22] *See Frost* at 466
[23] *See id.* at 467. *See also* Ohio Rev. Code §1707.43(B).
[24] *See Frost* at 467.

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Securities Act, even if administrative action by the Division is the sole cause of action brought against the debtor. As long as the Division properly follows the statutory guidelines in R.C. Chapter 110, a cease and desist order, even if it is a default order, for violations of R.C. 1707 qualifies under 11 U.S.C. §523(a)(19).[25]

Of important note to Ohio investors who are considering an objection to a bankruptcy debt discharge using the securities claim exemption, it will only apply to individual debtors.[26] A corporation can discharge its debts without concern that the securities claim exemption will grant investors a basis to object.[27] Individual debtors may also be able to avoid the application of the securities claim exemption if they file bankruptcy under Chapter 13. "In a Chapter 13 bankruptcy, the debtor is required to make payments to his creditors over a period of three to five years. If the Chapter 13 debtor fails to make all payments, only then would the securities claim exemption apply." [28] In this case, as opposed to a corporate debtor, the investor creditor can still object using a fraud exemption with its 60-day time frame.[29]

In conclusion, an investor seeking to recoup funds lost due to a violation of the Ohio Securities Act may utilize the securities claim exemption, 11 U.S.C. §523(a)(19), to prevent the discharge of related debt in bankruptcy. Even in actions where the Division is powerless to order restitution, the securities claim exemption may be available for use by aggrieved investors. Investors can use civil judgements, restitution ordered from civil or criminal action taken by the Division, and Division orders, including default orders, to challenge discharge by securities bad actors in bankruptcy.

[25] *See Frost* at 465.
[26] *See Ebaugh* at 15 (citing *In re* WorldCom, Inc., 329 B.R.10, 13 (Bankr. S.D.N.Y. 2005))
[27] *Id.*
[28] *Id.* at 15 (citing 11 U.S.C. §1328(b)).
[29] *Id.*

2017 Ohio Securities Conference Focuses on Balancing Technology with Investor Protection

The Digital Age has brought about new challenges to the securities industry as a whole, and so the theme of this year's Ohio Securities Conference is "Technical Innovation & Investor Protection; Finding the Right Balance." The conference is Friday, October 27, at a new location, the Westin Hotel in downtown Columbus.

The Ohio Division of Securities and the University of Toledo College of Law will present an entire day of presentations geared around technology and the issues that affect our industry. Covered topics include: Cybersecurity and Risk Management Tools for the Practitioner; Fighting Internet Fraud and the Impact on Regulation, Compliance and Enforcement; FINRA Guidelines for Advertisements and the Use of Social Media; and a point/counterpoint discussion regarding the Regulation vs. Deregulation of Internet Offerings.

We have another excellent lineup of speakers for this year's conference, including:

- John Kennedy, Assistant Vice President, Nationwide Insurance
- Justin Root, Of Counsel, Dickinson Wright, LLC
- John Reed Stark, President, John Reed Stark Consulting, LLC
- Jake van der Laan, Director of Enforcement and Chief Information Officer, New Brunswick Financial and Consumer Services Commission
- Mark Henderson, Security Specialist, Online Fraud Detection and Prevention, Internal Revenue Service
- Amy Sochard, Senior Director, Advertising Regulation, FINRA
- Erin Siegfried, Partner, Porter Wright Morris & Arthur, LLP
- Eric Chaffee, Professor of Law, University of Toledo College of Law
- Joan Hemingway, Professor of Law, University of Tennessee College of Law
- Charlie Korsmo, Associate Professor of Law, Case Western Reserve University School of Law

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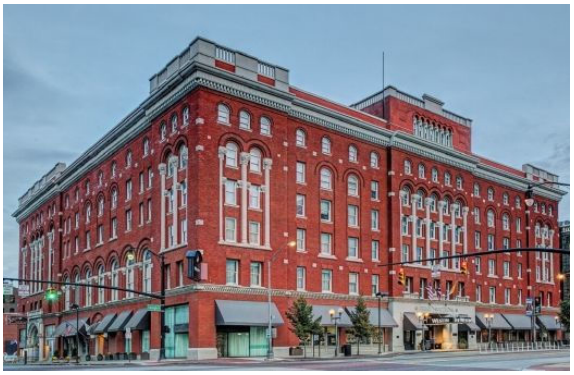

2017 Securities Conference is at the Westin Hotel

In addition, each Division section will host its annual Advisory Committee regulatory update. Speakers include Registration Chief Counsel Mark Heuerman, Licensing Chief Counsel Anne Followell, and Enforcement Chief and Attorney Inspector Janice Hitzeman.

The annual conference is the only continuing legal education program dedicated exclusively to Ohio securities law. Six hours of continuing education will be applied for Ohio attorneys, Certified Public Accountants, Certified Financial Planners and Certified Fraud Examiners. Additional details including registration information and deadlines will available on the Division of Securities website in August, and updates will be provided through regular mailings and emails.

Administrative Proceedings and Double Jeopardy

By *D. Michael Quinn, Division Counsel*

The Double Jeopardy Clause of the Fifth Amendment to the United States Constitution provides that "no person shall *** be subject for the same offense to be twice put in jeopardy of life or limb," and Section 10, Article I of the Ohio Constitution provides that "no person shall be twice put in jeopardy for the same offense." "The Double Jeopardy Clause of each constitution prohibits (1) a second prosecution for the same offense after acquittal, (2) a second prosecution for the same offense after conviction, and (3) multiple punishments for the same offense." *State v. Gustafson,* 76 Ohio St. 3d 425, 432 (1996) (citations omitted). The Ohio Securities Act (RC Chapter 1707) contains administrative sanctions (license revocations and administrative orders) and criminal punishments (RC 1707.99). This article visits why the imposition of administrative actions does not preclude the state taking a criminal action – or the reverse.

The beginning of the analysis requires an examination whether the action by the state gave rise to a criminal prosecution. "In sum, insofar as the Double Jeopardy Clause precludes successive criminal prosecutions, the proscription is against a second criminal trial after jeopardy has attached in a first criminal trial." *State v. Gustafson*, supra, 435 (emphasis sic). See also: *Shelby Aerie 0763 Fraternal Eagles v. Ohio Liquor Control Comm'n*, 2003-Ohio-823 (Ct. App.). The risk to which the [Double Jeopardy] Clause refers is not present in proceedings that are not "essentially criminal." *Breed v. Jones*, 421 U.S. 519 (1975).

In addition to the language of the statute indicating the legislature's intent for the state action to be considered administrative (or civil) or criminal, the Supreme Court of the United States has set out factors to consider when making such a judgement.

> In making this latter determination, the factors listed in *Kennedy v. Mendoza-Martinez*, 372 U.S. 144, 168-169, 9 L. Ed. 2d 644, 83 S. Ct. 554 (1963), provide useful guideposts, including: (1) "whether the sanction involves an affirmative disability or restraint"; (2) "whether it has historically been regarded as a punishment"; (3) "whether it comes into play only on a finding of scienter"; (4) "whether its operation will promote the traditional aims of punishment -- retribution and deterrence"; (5) "whether the behavior to which it applies is already a crime"; (6) "whether an alternative purpose to which it may rationally be connected is assignable for it"; and (7) "whether it appears excessive in relation to the alternative purpose assigned." It is important to note, however, that "these factors must be considered in relation to the statute on its face," id. at 169, and "only the clearest proof" will suffice to override legislative intent and transform what has been denominated a civil remedy into a criminal penalty, Ward, supra, at 249.

Hudson v. United States, 522 U.S. 93, 99 (1997)

In concluding that the criminal case in Hudson was not precluded by the earlier Office of the Comptroller administrative action to impose monetary penalties and occupational debarment, the U.S. Supreme Court: "… long recognized that the Double Jeopardy Clause does not prohibit the imposition of any additional sanction that could, "'in common parlance,'" be described as punishment." *Id*. 98-99 *(citations omitted).*

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Administrative Proceedings continued from page 4

The courts throughout the country have articulated a distinction between criminal prosecutions and administrative actions designed to control the person or business engaged in activities regulated by the state. In *Mullet v. Miller,* 168 Ariz. 594, 596, 816 P.2d 251, 253 (Ct. App. 1991) the Arizona court decided that: "We do not believe that it was the intent of the Supreme Court in Grady to extend the protection against double jeopardy to nonjudicial proceedings by an administrative body charged with regulating business." (Citation omitted.) See also: *State v. Kirby,* 133 N.M. 782, 784 (2003); *State v. Bushman*, 2010 UT App 120 (2010); *In re Bilzerian*, 153 F.3d 1278, 1283 (11th Cir. 1998).

However, any civil or administrative sanctions must be intended to serve as a civil remedy in order to not be perceived as an additional criminal punishment.

> Whether a particular punishment is criminal or civil is, at least initially, a matter of statutory construction. A court must first ask whether the legislature, "in establishing the penalizing mechanism, indicated either expressly or impliedly a preference for one label or the other." Even in those cases where the legislature "has indicated an intention to establish a civil penalty, we have inquired further whether the statutory scheme was so punitive either in purpose or effect," as to "transform what was clearly intended as a civil remedy into a criminal penalty," *(citations omitted)*

Hudson, supra, at 99.

As a general principal, an administrative sanction will not be viewed as a criminal punishment, triggering double jeopardy, provided the administrative sanction is perceived to be remedial in nature. A sanction to protect the public, imposed by an administrative body, will be treated as non-criminal in nature unless so excessive that it could only be characterized as punishment for a crime. *SEC v. O'Hagan,* 901 F. Supp. 1461, 1462 (D. Minn. 1995) (The SEC sought to disgorge only the illegal profits derived from the criminal's securities violations.); *United States SEC v. Blackwell,* 477 F. Supp. 2d 891, 916 (S.D. Ohio 2007) (It is well established that disgorgement orders are remedial, and not punitive; as such, federal courts have, on many occasions, rejected the argument that disgorgement orders violate the Double Jeopardy Clause) (Citations omitted); *Kornman v. SEC*, 389 U.S. App. D.C. 120, 135-36, 592 F.3d 173, 188-89 (2010) (As the Commission observed, Kornman's sanction is remedial in nature because it "is designed to protect the public, and the sanction is not historically viewed as punishment,…")(Citation omitted); *United States v. Furlett*, 781 F. Supp. 536, 537 (N.D. Ill. 1991) (The prior sanctions imposed upon defendants reasonably were interpreted as remedial measures rather than punitive. Accordingly, jeopardy did not attach to the administrative proceeding and the criminal prosecution was not barred by the Double Jeopardy Clause.); *United States v. Melvin,* 2015 U.S. Dist. LEXIS 152732, at 45 (N.D. Ga. May 27, 2015) ("[T]he [C]ourt concludes that, like the sanctions in *Hudson*, the sanctions imposed in the [SEC] civil action [including monetary penalties, professional debarment, and disgorgement] do not implicate double jeopardy.") *(citations omitted).*

The Court in *SEC v. Gordon,* 822 F. Supp. 2d 1144 (N.D. Okla. 2011) explored the SEC's disgorgement order after a criminal conviction. In that case, the SEC filed a motion for summary judgment, arguing that all factual issues necessary to resolve its claims in its civil enforcement were conclusively resolved against Gordon in the criminal case. In granting the SEC's motion, and the resulting civil disgorgement order, the court noted:

> Gordon has not shown that the SEC is seeking disgorgement solely to punish him. Defendant has cited no authority suggesting that a prior criminal conviction for insider trading violations precludes the later imposition of a civil award of disgorgement, and the Court finds that an award of disgorgement based on the amount of a defendant's illegal profits may not be considered a second punishment triggering application of the Double Jeopardy Clause.

Id. at 1160.

Thus, absent the administrative sanctions being so disproportionate to the societal purpose for which the sanctions are stated to be imposed, there would not be two criminal actions. Double jeopardy will not attach regardless whether the criminal prosecution precedes or succeeds the administrative action.

A to Z with L & E

Quarterly Question

Do I need a sponsor in order to take the Series 63, 65 or 66 exams? If so, will the Division serve as the "sponsor" for me?

You do not need a sponsor to sit for the Series 63, 65 or 66 examinations, like you currently do for all FINRA qualification examinations (e.g., Series 6, 7, 24, etc.). Unsponsored candidates who are not currently affiliated with a firm through FINRA's Web CRD system should use Form U10 to request and pay for the Series 63, 65 or 66 exams, and should indicate "N/A" where the form asks for the Sponsoring Firm Name.

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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Possible Changes Ahead for FINRA Qualification Exams

On April 10, 2017, the SEC announced in the Federal Register, FINRA's proposed rule changes to re-structure the qualification examination program. As to the motivation for the rule changes, FINRA described:

> *"Over time, the examination program has increased in complexity to address the introduction of new products and functions, and related regulatory concerns and requirements. As a result, today, there are a large number of examinations, considerable content overlap across the representative-level examinations and requirements for individuals in various segments of the industry to pass multiple examinations."* [1]

Under the proposed rule, the current representative-level examination program would be replaced with a two-part examination structure:

1) A general knowledge examination known as the "Securities Industry Essentials" (SIE) exam, and
2) A tailored, specialized knowledge examination based on the type of activity the individual will be engaging in.[2]

The individual would then be able to take additional specialized examinations as their business roles expand or change, without having to take the SIE exam again. FINRA indicates that this examination restructure will eliminate duplicative testing of general securities knowledge, since the general knowledge questions contained in the SIE would not be repeated on the specialized knowledge examinations.

The proposed FINRA rule would also allow individuals who are **not** associated with a FINRA member firm to sit for the SIE exam (i.e., eliminating the sponsorship requirement).[3] However, full registration could not be obtained without successfully passing one of the specialized examinations, and an individual would not be eligible to take a specialized exam without a sponsoring FINRA-member firm.

To date, there have been over 15 comment letters filed in response to the FINRA proposal, and FINRA extended the time for Commission action to July 7, 2017.

[1] Notice of Filing of a Proposed Rule Change to Adopt Consolidated FINRA Registration Rules, Restructure the Representative-Level Qualification Examination Program and Amend the Continuing Education Requirements, Release No. 34-80371; File No. SR-FINRA-2017-007, Federal Register, Vol. 82, No. 67, at 17336-37 (April 10, 2017).

[2] *See id* at 17339. The text of the proposed rule change is available on FINRA's website.

[3] *See* Release No. 34-80371, at 17339.

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UPDATE: Protecting Seniors from Financial Exploitation Federally and in Ohio

The Division monitors federal and state initiatives aimed at protecting seniors from financial exploitation. There is legislation pending that may affect the duties of securities licensed professionals to report Elder Financial Abuse when there is reasonable cause to believe abuse is occurring.

Ohio Legislative Proposals

Ohio House Bill 78, known as "Revised Adult Protective Services Laws" (see Q1 2017 Bulletin for additional details).
On February 28, 2017, House Bill 78 was referred to the Aging and Long Term Care Committee.

Update: It's important to note that language substantially similar to House Bill 78 was included in Am. Sub. H.B. No. 49 (the FY 2018-2019 Operating Budget Bill), which was signed by Governor Kasich on June 30, 2017. This legislation, amending RC 5101.62 – RC 5101.631, provides in part:

- Certain individuals who have "reasonable cause to believe" that an adult is being abused, neglected or exploited shall immediately report the suspected abuse, neglect or exploitation to the county department of job and family services.
- The list of mandatory reporters was expanded to include "an investment adviser, as defined in section 1707.01 of the Revised Code;" and "a financial planner accredited by a national accreditation agency" among other professionals.
- Such reports may be oral or in writing.
- Provides for civil and criminal immunity for the reporter, unless the person has acted in bad faith or with malicious purpose.
- Requires the Department of Job and Family Services to develop and make available educational materials to assist mandatory reporters in identifying situations of abuse, neglect and exploitation.
- Requires entities that employ or are responsible for licensing/regulating mandatory reporters to have access to the education materials described above.

On May 25, 2017, Ohio Senate Bill 158, titled "Combat Elder Fraud and Exploitation" was introduced.
Update: On June 15, SB 158 was referred to the Senate Judiciary Committee. A Committee Hearing was held on June 20 and continued. SB 158 differs from HB 78 in several important ways:

- If adopted as introduced, this legislation would require collaboration among across several state agencies and professional organizations to develop best practices and standards for preventing elder fraud and financial exploitation.
- Would require that criminal offenders committing certain crimes involving theft, deception, identity theft and forgery against elderly persons pay full restitution to their victims and a fine up to $50,000.
- Finally, SB 158 would expand the list of those who are required to make reports to county departments of job and family services to include: CPAs, financial planners accredited by a national recognized accreditation agency, securities dealers, investment advisers, salespersons, investment adviser representatives, and employees of a bank, savings and loan association, savings bank, or credit union.
- The professional must immediately make an oral or written report to the county job and family services office when they have "reasonable cause to believe that an adult is being abused, neglected, or exploited, or is in a condition which is the result of abuse, neglect or exploitation."
- A professional making such report in good faith and in compliance with these laws would be immune from civil or criminal liability.

Federal Legislative Proposals (see Q1 2017 Bulletin for additional details)

- U.S. Senate Bill 178, known as the "Elder Abuse Prevention and Prosecution Act"
  - o **Update**: On March 23, 2017, Senate Bill 178 was reviewed and reported on by the Senate Judiciary Committee, recommending passage without amendment.
- U.S. Senate Bill 223, known as the "Senior$afe Act of 2017"
  - o **Update:** Referred to the Committee on Banking, Housing, and Urban Affairs.

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Spotlight on Stephanie Talib

Stephanie has been our Licensing Administrator since July 2015. She's been with the Division since 2005 and employed in State government for almost 30 years. She is a graduate of Franklin University as well as the Ohio Certified Public Manager Program. As the Licensing Administrator, Stephanie reviews incoming applications for those seeking licensure in Ohio as Securities Salespersons (Registered Representatives) and Investment Adviser Representatives. Additionally, Stephanie manages applications for Broker Dealer and Investment Adviser firms, assuring they've followed the proper administrative rules and laws. Stephanie said what she enjoys most about her work is "being a part of the Licensing team. I feel we have an important role in the Division - we help to protect Ohio Investors." Stephanie's hobbies include exercising, watching football, and going to the movies with her husband, Derek.

Senate Aging Committee Releases 2017 Fraud Book

Top 10 scams outlined in new report

The U.S. Senate's Special Committee on Aging recently released its updated Fraud Book 2017, outlining the top ten most commonly reported scams to its toll-free Fraud Hotline over the past year. Of the 2,282 calls received – 35 of them came from Ohioans – calls pertaining to the top ten scams featured in the 2017 Fraud Book accounted for more than 90 percent of all complaints.

The Top 10 Senior Scams

1. IRS Impersonation Scams
2. Sweepstakes Scams
3. Robocalls/Unwanted Phone Calls
4. Computer Scams
5. Elder Financial Abuse
6. Grandparent Scams
7. Romance Scams/Confidence Fraud
8. Government Grant Scams
9. Counterfeit Check Scams
10. Identity Theft

The number of calls to the Senate Aging Committee's Fraud Hotline more than doubled in 2016, a stark reminder that con artists continue to stop at nothing to rob unsuspecting seniors of their hard-earned money.

The report goes into greater detail about each of these scams, including actual examples of seniors being defrauded. The report also provides tips from the FBI, the Federal Trade Commission and other agencies to combat senior fraud.

ADMINISTRATIVE HEARINGS

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

Thomas P. Gilmartin, Jr. and Capital Finance Group, LLC
Division Order No. 16-021
Pending Final Order

Gary L. Rathbun - CRD No. 1084721
Division Order No. 17-012
Douglas S. Miller - CRD No. 1946240
Division Order No. 17-013
August 14-15, 2017 (joint administrative hearing)

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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CRIMINAL HEARINGS

For additional information regarding the cases below, please see:
•Bulletin2017FirstQuarter
•Bulletin2016FourthQuarter

State v. Harold Campbell
Case No. 2017 CR 00280
Montgomery County Court of Common Pleas
July 6, 2017 (sentencing)

State v. Michael D. Mathew
Case No. CR2016-0415
Muskingum County Court of Common Pleas
July 10, 2017 (sentencing)

State v. Jeffrey W. Johnson
Case No. 17CR020
Holmes County Court of Common Pleas
July 17, 2017 (jury trial)

State v. Mary Hackney; Philip Curtis; Lovell Jones
Case No. 16 CR 004771
Franklin County Court of Common Pleas
July 19, 2017 (jury trial)

Catherine Schaper
Case No. CR2015-03-0495
Butler County Court of Common Pleas
August 7, 2017 (sentencing)

State v. Keith Elsesser
2017 CR 02 0041
Tuscarawas County Court of Common Pleas
September 18-19, 2017 (final pre-trial and trial)

John Richard Blazer
2:16-CR-233
U.S. District Court S.D. Ohio
TBD (sentencing)

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John Richard Blazer
2:16-cr-233
U.S. District Court S.D. Ohio

On May 4, 2017, a Consent Order of Forfeiture was entered against John Richard Blazer based on the terms of a plea agreement establishing that he solicited and received investment funds in the amount of $937,425.96 and whereby Blazer pled guilty to one count of money laundering and one count of wire fraud. Through his guilty plea, Blazer admitted that he had willfully and knowingly devised an investment fraud scheme in which he told clients that their monies would be invested in a gold-mining operation in Africa or a real estate fund. Blazer told investors that the real estate investment funds would be used to purchase and rehabilitate residential properties in central Ohio. Rather than invest victim funds as he had promised, Blazer diverted the funds to pay his own personal and business expenses, as well as to re-pay earlier investor clients with monies solicited and received from later investor clients. The sentencing hearing originally scheduled for May 4, 2017, has been continued to a date to be determined.

Donna S. Brown
Budget Finance Company
U.S. District Court N.D. West Virginia

On April 18, 2017, an amended order was entered against Donna S. Brown, sentencing her to 121 months in federal prison after she pled guilty to one count of wire fraud, one count of mail fraud and one count of money laundering. Brown was further ordered to pay restitution in the amount of $20,702,055.26. Brown owned and operated Budget Finance Company which was both a licensed consumer loan company and an unlicensed investment company. Between 2005 and 2015, she lured potential investors into investing funds with Budget Finance by promising annual returns of between 8 and 12 percent. Brown mailed checks to investors located in West Virginia and Ohio who requested periodic payments and sent them fraudulent quarterly investment statements reflecting their account balances and interest paid. She also mailed investors IRS 1099 forms, but never sent those forms to the IRS. No substantial investment source existed to account for well over 800 investment accounts with investments exceeding $31 million and the money from new investors was used to pay previous investors in Ponzi-like fashion. Budget Finance closed suddenly in November 2015.

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

On July 6, 2017, Harold G. Campbell, 66, of Richmond, Kentucky, was sentenced to one to five years of probation and ordered to pay restitution to his elderly victim in the amount of $74,413.15 after pleading guilty to one count of theft from the elderly. Campbell was ordered to pay back his victim in monthly amounts not less than $650 per month. Failure to abide by the terms of the sentence could send Campbell to prison for up to three years. The conviction and sentence stems from the theft of funds from an elderly relative, who is a Montgomery County resident. Campbell solicited the relative to invest money with him, with a guaranteed return of 5% annually. Instead of investing the money, Campbell used it to pay personal expenses and for other personal payments.

Bruce Durr
Case No. 16CR11-07-0368
Delaware County Court of Common Pleas

On April 3, 2017, Bruce Durr, Jr. of Westerville, was sentenced to the Delaware County jail for 30 days and five years of community control after he pled guilty to four counts of theft. Durr was ordered to pay restitution to the victims in the amount of $69,400 in installments of $400 per month and further ordered to perform 240 hours of community service. If Durr makes the required monthly restitution payments as ordered, the community service hours will be suspended. If the above conditions are not met, Durr could be sentenced for up to six years in jail (18 months for each of the four counts) to run consecutively. The conviction stems from allegations that Durr solicited and received $69,400 from four Ohio residents to invest in The Denture Place, a new company touted as a denture manufacturer. Instead of investing the money as promised, Durr used the funds for personal expenses. The denture company never opened and investors were not refunded.

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Criminal Hearings continued from page 10

Christopher O. Hodge
Case No. CR 16 10 0288
Logan County Court of Common Pleas

On May 30, 2017, Christopher Hodge of Phoenix, Arizona, was sentenced to five years of community control after he pled guilty to telecommunications fraud, a felony of the third degree. Hodge was ordered to pay the costs of prosecution and was further ordered to pay $10,000 in restitution to his victim. As part of the sentencing order, Hodge is prohibited from selling securities in or from Ohio for life. The conviction stems from Hodge's sale of interest in a company called Intellicore Solutions to an Ohio resident. Instead of using the money for investment purposes, Hodge used investor funds for personal expenses.

Jeffrey W. Johnson
Case No. 17CR020
Holmes County Court of Common Pleas

On April 10, 2017, Jeffrey W. Johnson was indicted on two counts of theft, two counts of securities fraud, two counts of misrepresentations in the sale of a security and two counts of selling unregistered securities. The indictment is based on allegations that Johnson solicited an Ohio resident to invest in stock in M & J Sales Corporation. A jury trial is scheduled to begin July 17, 2017.

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

On July 10, 2017, Michael D. Mathew, 35, of Pataskala, was sentenced to 21½ years in jail and ordered to pay restitution in the amount of $493,335.87 after pleading guilty to 36 felonies, including 14 counts of misrepresentation in the sale of a security, two counts of theft from the elderly, three counts of attempted misrepresentation in the sale of a security, nine counts of securities fraud, three counts of attempted securities fraud and five counts of publishing a false statement as to the value of a security. From August 8, 2014, through September 8, 2015, 15 investors invested $493,335.87 with Mathew, who operated an unlicensed investment adviser business under the name Mathew Investments, LLC from a business address in Dresden, Ohio. The investors' money was solicited under the guise that their investment would be held in trust and traded in various positions in the stock market. Mathew enticed investors by falsely stating that a portion of their investment was guaranteed and by issuing false statements showing inflated portfolio balances.

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

On April 10, 2017, Jeremy Moser was sentenced to three years of community control after paying full restitution in the amount of $10,000 to his victim. If the terms of his community control are violated, Moser could face up to 18 months in prison on each of the criminal conviction counts. Moser was ordered to complete 100 hours of community service, to complete the course "Thinking for a Change," and to pay court costs and probation fees. Moser previously 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.

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Criminal Hearings continued from page 11

North Shore Energy, LLC
Case No. CR2015-03-0496
William Troy West
Case No. CR2015-03-0497
Robert "Bob" McManus
Case No. CR2014-10-1598
Catherine Schaper
Case No. CR2015-03-0495
Butler County Court of Common Pleas

On June 5, 2017, William Troy West was sentenced to six years in prison and ordered to pay the costs of prosecution. North Shore Energy, LLC, located in Austin, Texas, and its principle, Troy West, were also ordered to pay restitution to investors in the amount of $1,942,239.79. Both West and the company pled guilty to one count of securities fraud and one count of the sale of unregistered securities, both felonies of the second degree. Company solicitor Robert "Bob" McManus, of West Chester, Ohio, was also sentenced to five years in prison and ordered to pay restitution to the victims. All three defendants are jointly and severally liable to pay the full restitution amount of $1,942,239.79. The convictions stem from the sale of promissory notes issued by North Shore Energy, LLC, to at least 18 investors residing in Ohio, Indiana and Kentucky in 2010 and 2011 for the purpose of investing in oil and gas drilling operations in Texas. A second principle of North Shore Energy, LLC, Catherine M. Schaper, is scheduled to be sentenced on August 7, 2017.

ADMINISTRATIVE ACTIONS

Division Order No. 17-011
Frisby Construction, LLC
Frisby Roofing Company
Milford, Ohio

On May 18, 2017, the Division issued Notice Order 17-011 alleging that Frisby Construction, LLC, and Frisby Roofing Company had engaged in the sale of unregistered securities by mailing in excess of 8,000 investment circulars offering private investment opportunities in Frisby Roofing Company and offering returns between 11 and 20 percent.

Division Order No. 17-012
Gary L. Rathbun - CRD No. 1084721
Wauseon, Ohio

On May 26, 2017, the Division issued a Notice of Intent to Suspend or Revoke the Ohio Investment Adviser Representative License of Gary L. Rathbun. The Notice Order alleges that Rathbun is not of good business repute and conducts business in violation of Ohio rules and regulations based, in part, on FINRA Case Number 2014041919401, which alleges that Rathbun participated in the sale of investments in six related limited liability companies to 187 clients of his employing investment adviser firm in the amount of $25.5 million without prior firm approval. The Notice Order further alleges that Rathbun failed to disclose to clients that he was compensated $500 per hour by some of the issuers for consulting activities. The FINRA case was settled through an Acceptance, Waiver, and Consent with findings that Rathbun violated NASD Rules 2010 and 3720 and a bar from associating with any FINRA member firm in any capacity. A hearing was requested in this matter and is currently scheduled for August 14-15, 2017.

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Division Order No. 17-013

Douglas S. Miller - CRD No. 1946240

Bowling Green, Ohio

On May 26, 2017, the Division issued a Notice of Intent to Suspend or Revoke the Ohio Investment Adviser Representative License of Douglas S. Miller. The Notice Order alleges that Miller is not of good business repute and conducts business in violation of Ohio rules and regulations based, in part, on FINRA Case Number 2014041919401 which alleges that Miller participated in the sale of investments in six related limited liability companies to 187 clients of his employing investment adviser firm in the amount of $25.5 million without prior firm approval. The Notice Order further alleges that Miller failed to disclose to clients that he was compensated $500 per hour by some of the issuers for consulting activities. The FINRA case was settled through an Acceptance, Waiver, and Consent with findings that Miller violated NASD Rules 2010 and 3720 and a bar from associating with and FINRA member firm in any capacity. A hearing was requested in this matter and is currently scheduled for August 14-15, 2017.

Division Order No. 17-014

Texas Energy Mutual, LLC

Rodney L. Pope

Chet Inglis

Matthew J. Manley-Leaverton

Cory J. Rothwell

Grapevine, Texas

On June 2, 2017, the Division issued a Notice of Opportunity and Notice of Intent to Issue a Cease and Desist Order against Texas Energy Mutual, LLC, Rodney L. Pope, Chet Inglis, Mathew J. Manley Leaverton, and Cory J. Rothwell (collectedly “Respondents”) based on allegations that the Respondents engaged in the sale of unregistered securities through cold calls to at least one Ohio investor. The Notice Order alleges that the Respondents misrepresented material facts in the sale of securities and engaged in securities fraud. Prior administrative orders were filed against one or more of the Respondents by the Financial and Consumer Services Tribunal in New Brunswick, Canada; the Arkansas Securities Commission and the California Department of Business Oversight. The Division Notice Order alleges that an Ohio investor was induced to retire and invest $230,000 in offerings by Texas Energy Mutual, LLC, based on statements that the investor would earn between $3,500 and $8,000 per month on the investments. The Notice Order alleges that the investor proceeds were not used for the purposes stated and up to 30 percent of the investment was used to pay commissions to unlicensed individuals.

Jurisdictional Analysis of Internet Fraud

By *Janice Hitzeman, Attorney Inspector*

Due to the accessibility of the “World Wide Web,” users can conduct business throughout the world using only a laptop computer. Unfortunately, this ability also allows fraud artists to use the internet specifically to cloak their identity and location to evade discovery and process. Securities regulators who wish to proactively stop internet fraud will wrestle with issues related to jurisdiction. Regulators must determine that proper jurisdiction exists to initiate action in their jurisdiction based on the laws of their state and the Due Process Clause within the 14th Amendment to the U.S. Constitution. A jurisdictional review must include both subject matter (“in rem”) jurisdiction and personal (“in personam”) jurisdiction.

This analysis focuses on issues related to asserting in personam jurisdiction over individuals or entities operating through the internet when there is no physical office located in a particular state. In comparison to the history of jurisprudence, the widespread availability and use of the internet for commercial purposes is recent. The law of personal jurisdiction based solely on internet activity is murky and a developing area of jurisprudence.

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Jurisdictional Analysis continued from page 13

The seminal case setting forth the federal standard for personal jurisdiction is *International Shoe v. Washington*, in which the U.S. Supreme Court held that "due process requires only that in order to subject a defendant to a judgment in personam, if he be not present within the territory of the forum, he have certain minimum contacts with it such that the maintenance of the suit does not offend 'traditional notions of fair play and substantial justice.'" [1] The holding in *International Shoe* has been pervasively cited and applied in both federal and state courts. However, in applying the minimum contacts standard to internet-based cases, two major lines of jurisprudence have evolved.

The first line of cases emanates from an early attempt to address in personam jurisdiction over internet-based commerce found in *Zippo Manufacturing Co. v. Zippo Dot Com, Inc.*, 952 F. Supp. 1119 (W.D. Pa. 1997). In *Zippo*, the federal district court crafted a "sliding scale" test based upon the relative interactivity and the commercial nature of a website. [2] The sliding scale places websites into three categories. The first category, where jurisdiction is proper, includes websites that enter into contracts over the internet with individuals located in the forum state. The third category, where jurisdiction is not proper, includes websites that merely provide information passively. In the second, or middle, category are websites where users exchange information with the website host, but no commercial transaction occurs. [3] The *Zippo* court described this middle category by stating, "the likelihood that personal jurisdiction can be constitutionally exercised is directly proportionate to the nature and quality of commercial activity that an entity conducts over the internet." [4]

Although widely applied, courts recognize that the *Zippo* test is merely an application of the minimum contacts standard set forth in *International Shoe*.[5]

A second line of cases concerns the degree to which a foreign party has "targeted" the forum state.[6] In *Burger King Corp. v. Rudzewicz*, the U.S. Supreme Court upheld a lower court's decision that a Florida court could assert personal jurisdiction over a Burger King franchisee operating solely in Michigan, and opined, "So long as a commercial actor's efforts are 'purposefully directed' toward residents of another State, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there." [7] In this line of cases, courts find personal jurisdiction where the defendant purposely targeted residents of the forum state. When applying this standard, courts look at both the activities and the intent of the foreign parties within a state. However, the "purposefully direct" standard fails to recognize that bad actors cast a wide net in to attract as many victims as possible. A regulator could argue that the expansive definition of "sale," [8] which includes both offers and solicitations, provides a basis for personal jurisdiction over any party who generally solicits securities over the internet.

[1] 326 U.S. 310, 316 (1945) (citing *Milliken v. Meyer,* 311 U.S. 457, 463 (1940)).
[2] *Zippo*, 952 F.Supp. at 1123-24.
[3] Daniel Steuer, *The Shoe Fits and the Lighter Is Out of Gas: The Continuing Utility of International Shoe and the Misuse and Ineffectiveness of Zippo*, 74 U. Colo. L. Rev. 319 (2003).
[4] *Zippo*, 952 F.Supp. at 1124.
[5] *See generally Illinois v. Hemi Group LLC,* 622 F.3d 754, 758-59 (7th Cir. 2010) (citing *Tamburo v. Dworkin*, 601 F.3d 693, 703 n. 7 (7th Cir. 2010)); *Innovative Garage Door Co.* v. High Ranking Domains, LLC, 981 N.E.2d 488, 495-96 (Ill. App. Ct. 2012).
[6] *See, e.g., ALS Scan, Inc. v. Digital Service Consultants, Inc.*, 293 F.3d 707, 714 (4th Cir. 2002); *uBID, Inc. v. GoDaddy Grp., Inc.*, 623 F.3d 421, 427-429 (7th Cir. 2010); *Illinois v. Hemi Grp. LLC*, 622 F.3d 754, 758 (7th Cir. 2010) *Chloé v. Queen Bee of Beverly Hills, LLC*, 616 F.3d 158, 171 (2d Cir. 2010); *Rio Properties, Inc. v. Rio Int'l Interlink*, 284 F.3d 1007, 1020 (9th Cir. 2002); *Capitol Records, LLC v. VideoEgg, Inc.*, 611 F.Supp.2d 349, 360–61 (S.D.N.Y.2009); *Gather, Inc. v. Gatheroo, LLC*, 443 F.Supp.2d 108, 115-16 (D.Mass.2006); *Snowney v. Harrah's Entertainment, Inc.*, 112 P.3d 28, 34 (Cal. 2005). *See also be2 LLC v. Ivanov*, 642 F.3d 555, 558-59 (7th Cir. 2011) (holding "Courts should be careful in resolving questions about personal jurisdiction involving online contacts to ensure that a defendant is not haled into court simply because the defendant owns or operates a website that is accessible in the forum state, even if that site is 'interactive.' [citation omitted]. Beyond simply operating an interactive website that is accessible from the forum state, a defendant must in some way *target* the forum state's market. If the defendant merely operates a website, even a "highly interactive" website, that is accessible from, but does not target, the forum state, then the defendant may not be hauled into court in that state without offending the Constitution.")
[7] 471 U.S. 462, 476 (1985).
[8] 15 U.S.C. § 77b(3); 15 U.S.C.A. § 78c (14); UNIF. SEC. ACT OF 2002 § 102(26)

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Jurisdictional Analysis continued from page 14

However, courts may be reluctant to find personal jurisdiction based solely on the wide accessibility of a website without specific contact with residents of the particular state.[9]

The path continues to be forged for determinations concerning in personam jurisdiction for cases involving commercial internet activity. In cases involving actual sales or loss to victims, personal jurisdiction in a particular state is uncontroverted. The ability of a securities regulator to initiate a preemptive strike against an individual or entity selling securities through a website before a victim loses money in their respective state is less clear.[10]

Since Jan. 1, 2016, the Division has initiated three administrative actions based on fraudulent conduct mediated through the internet, which caused losses to Ohio investors. The Division is seeing a rise in the number of complaints involving investments in online platforms and offerings. If you or your clients become aware of potential fraud or unlicensed activity occurring on the internet, please refer this information to the Ohio Division of Securities, Enforcement Section.

Janice Hitzeman is the Attorney Inspector and Chief of Enforcement for the Division of Securities. She represents the Division on the NASAA Internet Fraud Investigations Project Group and the Advanced Litigation Training Project Group. She is also Chair of the Division's Enforcement Advisory Committee.

[9] In *In re Blue Flame Energy Corp.*, 871 N.E.2d 1227, 1238 (Ohio Ct. App. 2006), the Ohio Division of Securities argued that the broad definition of "sale" within the Ohio Securities Act provides basis for personal jurisdiction against parties who advertise securities on their website. In rejecting the Division's argument, the court stated, "If we were to accept the Division's argument that advertising a security through a website constitutes a "sale" in Ohio, then the Division would have jurisdiction over every issuer who maintains a promotional website, regardless of whether the issuer actually sells or intends to sell securities in Ohio. Personal jurisdiction exists only in forums in which a party has purposeful, deliberate contact, not random contact occasioned by the wide accessibility of the internet." It is important to note that the dismissed party in *Blue Flame* did not have a mechanism for a user to exchange information with the company through their website. The court found jurisdiction was proper for the remaining four Respondents.

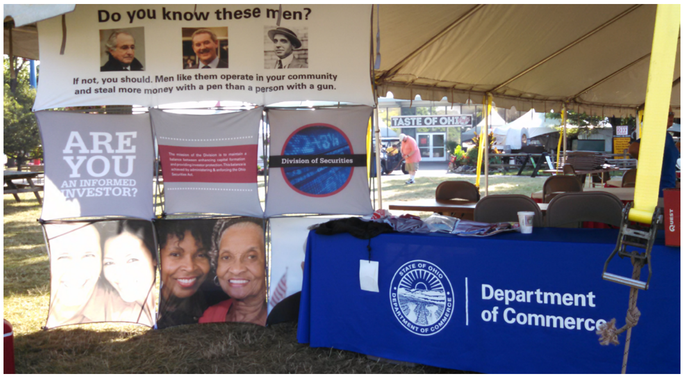
[10] One option, for those states with enforcement authority to do so, would be to use an undercover persona to create a dialogue as a potential investor with the website purveyors in order to solidify an argument for personal jurisdiction. In some cases, the website is hosted through a proxy and the true identity of the bad actors is unknown. In those cases, service of process also becomes an issue as a true address may be unknown or non-existent.

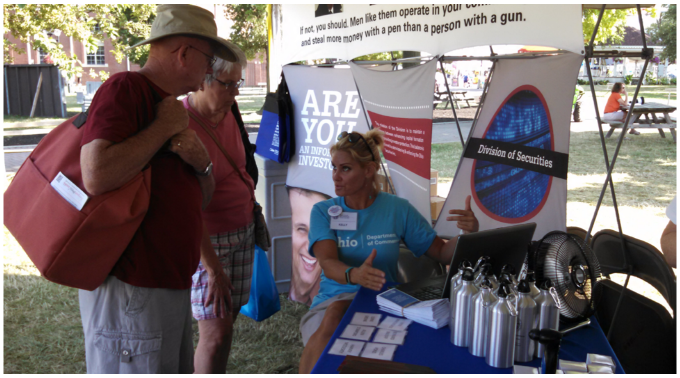
[11] *See* In re: SpotFN.com, LLC *et al*, Division NOH Order No. 17-008; In re: Binary Trading Experts, Division Cease and Desist Order No. 17-006; In re: Waldemar Kazana, Division Cease and Desist Order No. 16-009;

Educating Ohioans

The Division's Outreach and Education program raises awareness about investment fraud so that criminals can't steal Ohioans' life savings. We educate thousands of people each year through speaking engagements, training seminars, and exhibiting at events. Because seniors are especially vulnerable to con artists, we work with organizations such as the Ohio Association of Areas Agencies on Aging, the Coalition of Adult Protective Services and other groups to educate seniors and their advocates.

Another example of educating seniors is our participation in Senior Day at the Ohio State Fair. If you plan to attend this year's fair on August 1, look for the Ohio Department of Aging's Senior Expo tent and stop by our booth from 10 a.m. to 4 p.m.





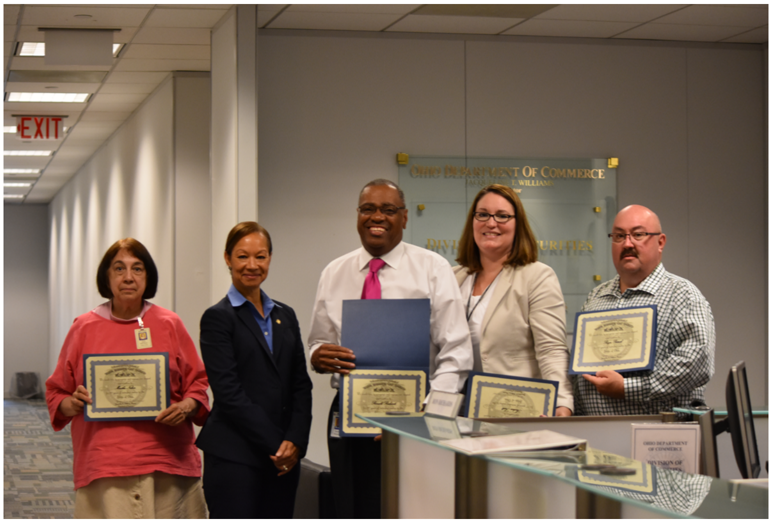
Division News

Welcome New Staff Members

Alex Brown joined the Division in May as our new investigator. He researches and investigates complaints of possible violations of the Ohio Securities Act, including conducting interviews, reviewing financial records, preparing investigative reports, as well as requesting and serving subpoenas. Alex was previously with the Hocking County Sheriff's Office, assigned to the County Drug Task Force.

Shaunna Barnett started in June as our new office assistant, where she is responsible for handling a variety of daily office duties and supporting various Division administrative functions. Prior to joining Securities, she worked at the State Fire Marshal's office supporting their Code Enforcement Bureau.

Jacob Capretta is our summer intern supporting the Enforcement team. He is providing preliminary research on open cases and investigations, assisting with witness interviews, and participating in several aspects of the administrative, civil and criminal proceedings. Jacob is a senior from Columbus attending Kent State University, where he's majoring in Criminology.



Staff Members Reach Service Milestones

Commerce Director Jacqueline Williams, second from left, honored our Division employees who reached significant service milestones. From left, Chris Nelson, 20 years; Director Williams; Ron Richards, 20 years; Andrea Seidt, 10 years; Roger Patrick, 15 years. Not pictured: Tanez Jackson, 10 years.

Congratulations to the Division's PEER Award Winners

From left: Roger Patrick, Partnership Award; Anne Followell, Janice Hitzeman, David Biemel, Professionalism Award; Laura Littlejohn, Rising Star Award; Ray Glenn, Perseverance Award. Not pictured, Karen Blakeley, Professionalism Award; Mark Ballenger, Spirit Award.

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NASAA Adopts Policy Regarding Electronically Delivered Offering Documents, Electronic Signatures
Ohio Division of Securities Will Follow New Policy

On May 8, 2017, the North American Securities Administrators Association (NASAA) adopted a statement of policy regarding the use of electronic offering documents and electronic signatures (the "Policy"). http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2017/05/Electronic-Offering-Documents-and-Electronic-Signatures-Statement-of-Policy.pdf

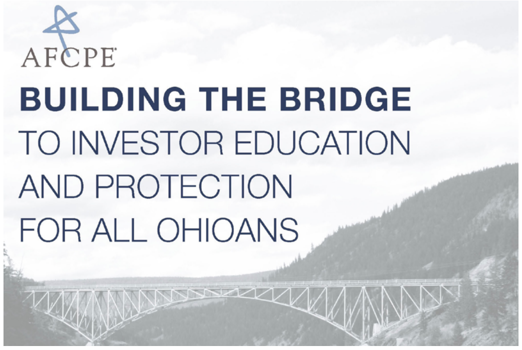
The Policy permits issuers to deliver Offering Documents[1] electronically, provided that certain conditions are met. For example, the Policy prescribes that the Offering Documents must be prepared in a manner consistent with federal and state securities laws, and be presented in such a way that the recipient can store, retrieve and print the documents. The Policy also sets forth rules for the use of electronic signatures by issuers, including the requirement that such issuers establish adequate authentication and security procedures.

The Policy emphasizes the need for Issuers to receive an investor's informed consent prior to using electronic documents or electronic signatures. For example, Section I.A.2.a requires that the issuer receive an investor's informed consent; Sections I.B.1 and I.B.2 require that an issuer establish measures to ensure that prospective investors review documents (including required disclosures) in their entirety prior to signing them; and Section II.A.2 states that electronic signatures may only be used if an investor affirmatively elects to use them.

In Ohio, the Division intends to follow this newly adopted Policy. The Division may suspend registration of an offering of securities if the Division finds that such securities are being disposed of or purchased on "grossly unfair terms, in such manner as to deceive or defraud or as to tend to deceive or defraud purchasers or sellers." [2] Accordingly, issuers who wish to use electronic documents and/or electronic signatures must ensure that the use of such methods is done in a way that preserves the ability of prospective investors to thoroughly evaluate the offering, including the risks.

[1] Definitions for "Offering Documents" at III.A.1. includes subscription agreements.
[2] ORC 1707.13 (emphasis added).

New Financial Education Program Launched



The Division of Securities is partnering with the Association for Financial Counseling & Planning Education® (AFCPE®) on a new statewide program called "Building the Bridge to Investor Education and Protection for Ohioans." The program is supported by the Division through a grant from the Investor Protection Trust.

The program includes several elements:
- A statewide survey of Ohio adults about saving and investing for retirement (see sidebar article).
- A series of three, half-day events where the public can learn about various aspects of financial literacy, including saving and investing.
- Pro-bono financial counseling and planning services provided by Accredited Financial Counselor® (AFC®) and CERTIFIED FINANCIAL PLANNER™ (CFP®) professionals.
- A revised documentary series, "When I'm 65," produced by Detroit Public Television. The documentary will be broadcast on various dates this year, so check your local listings for the PBS station near you.

Two additional videos – which can be viewed on Detroit Public Television's YouTube channel – were developed for Ohio, including one on fraud prevention and another one on retirement planning for freelance workers.

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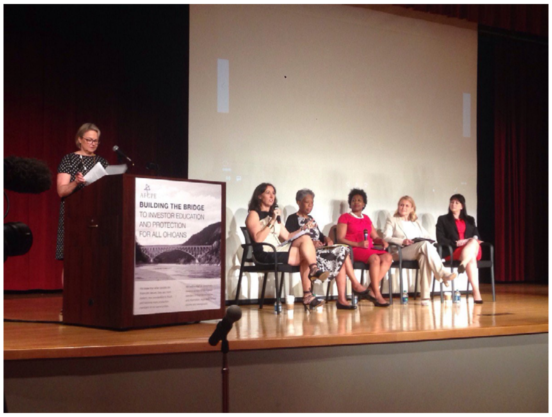
The first event was held May 19 in Columbus at the Fawcett Center at Ohio State hosted by WOSU Public Media. The other two events are scheduled in Dayton on July 20 and Cleveland on September 14.

The events – which are free and include a continental breakfast – are designed to provide Ohioans with information and resources for overcoming the challenges of saving for retirement. Be sure to register now to secure your seat.

The Division of Securities' message in this campaign focuses on helping consumers avoid making mistakes that could lead to potential investment fraud.



"Building the Bridge" panelists share their expertise during the Columbus event.

"Our role as Ohio's securities regulator is to help investors research investment advisers, stockbrokers and investment products before they invest their money," said Ohio Securities Commissioner Andrea Seidt. "One of our goals as a state agency is to build awareness among investors about safe financial behavior to help prevent investment fraud. Education is the best defense against Ohioans losing their hard-earned savings to fraudsters. We're proud to be a supporter of this program because it ties in perfectly with our efforts to educate Ohioans about safe investing."

Westerville, Ohio-based AFCPE would like to replicate the Ohio program in other states by working with state securities agencies around the country to bring the events to their citizens.

As part of the "Building the Bridge" project, a statewide survey was conducted earlier this year by Public Policy Polling. Some interesting statistics came out of the study, but specifically for Securities:

• Ohio residents rely more on word of mouth than checking out the background of a financial professional. Of those Ohio adults using a financial professional to help with their investments, 61 percent made their decision based on a recommendation from a relative, friend, co-worker or neighbor versus 24 percent who did their own research into the professional's background and services. While 76 percent said they checked to see if the person was licensed to do business in Ohio, only 17 percent actually contacted the Ohio Department of Commerce - Securities Division.

• Younger investors in Ohio may be more inclined than their elders to check out financial professionals. 54 percent of 18-29 year olds said they contacted the Ohio Department of Commerce - Securities Division, versus just 8 percent of 46-65 year olds. Only 32 percent of all Ohio adults with financial professionals said they used the FINRA BrokerCheck system to see background information on their financial professional. Another age gap was evident here: 66 percent of 18-29 year olds said they used BrokerCheck versus just 27 percent of 46-65 year olds.

• For those Ohio adults without a financial plan, lack of money, knowledge and trust are major factors. Of those in Ohio without a financial plan, 34 percent think they don't have enough money to save or invest for retirement (this is true of 45 percent of 18-29 year olds and only 9 percent of 45-60 year olds), 23 percent don't know enough "to feel comfortable" saving and investing or retirement (the gap here between African Americans and whites is 16 percent versus 34 percent), and 25 percent plan to live on Social Security or other resources. Men are far more likely than women to cite distrust of the markets and financial professionals as their No. 1 reason not to have a plan by a margin of 14 percent versus 3 percent.

• Bad information and lack of knowledge may keep Ohioans from seeking financial help. 57 percent of Ohioans surveyed think it "costs a lot" of use a financial counselor planner. Two in five do not understand the difference between a "financial planner" and a "financial counselor."

Industry News

SEC Fills Several Senior-Staff Positions

Shortly after Jay Clayton was sworn in to lead the U.S. Securities and Exchange Commission in early May, the federal agency announced several key positions had been filled. They include:

- Lucas Moskowitz, Chief of Staff. Moskowitz was a managing director at Patomak Global Partners LLC where he provided consulting services to financial services firms and public companies on regulatory and compliance issues. He previously worked at the SEC as a counsel to former Commissioner Daniel Gallagher. He also served as an attorney in the Division of Enforcement.
- Sean Memon, Deputy Chief of Staff. Memon was an associate at Sullivan & Cromwell LLP's Washington, D.C., office where he focused on transactional and regulatory matters. He previously worked in the finance and acquisitions department of Time Warner and was an investment banking analyst at Raymond James & Associates Inc. and Morgan Stanley.
- Jaime Klima, Chief Counsel. Klima was co-chief of staff under acting Chairman Michael Piwowar. Before serving as co-chief of staff she was counsel to Piwowar and former Commissioner Troy Paredes. She also was a lawyer at WilmerHale LLP.
- Robert Stebbins, General Counsel. Stebbins was a partner at Willkie Farr & Gallagher LLP where he focused on mergers and acquisitions, SEC compliance and corporate governance. His clients included Morgan Stanley, Fiat Chrysler and Major League Baseball.
- William Hinman, Director, Division of Corporation Finance. Hinman had retired as a partner at Simpson Thacher & Bartlett LLP in Silicon Valley, where he advised public and private companies in corporate finance matters. Prior to joining Simpson Thacher as a partner in 2000, he was the managing partner of Shearman & Sterling's San Francisco and Menlo Park office.

Exempt Offerings After the JOBS Act

By: *Andrea Seidt, Securities Commissioner*

Back in March, I served as faculty for a CLE seminar presented by the American Law Institute, a popular annual session focused on "Regulation D Offerings and Private Placements." In preparation, I reviewed existing research on offerings emanating from the 2012 JOBS Act to see which federal registration exemptions were being used.[1] I compiled my observations into a paper, entitled "A Sideline View of Exempt Offerings," available from ALI as course material. The paper notes how much our securities markets have changed over the course of the last decade, taking special note of the marked change observed in 2012 – not simply because that was the year in which the JOBS Act passed, but rather, because 2012 was the year in which private offerings had for the first time demonstrably overtaken public offerings in the amount of new capital raised in the United States before the JOBS Act passed.[2]

I was curious about the impact that the registration exemptions created (or expanded) by the JOBS Act had on the shifting market and whether these exemptions – the alternative "public" Regulation D offering, the expanded plus (+) version of Regulation A, and altogether new Regulation Crowdfunding – were successfully fueling capital formation for small businesses as desired to achieve the legislation's chief aim of job creation.[3] I spent some time in my paper walking through the data and analysis publicly reported from the SEC's Division of Economic & Risk Analysis (DERA) the past few years, as well as unofficial crowdfunding industry data (in the absence of DERA data) to shed light on this question.[4] The bottom line, based on my review, was that most exempt offerings following the JOBS Act so far have been made pursuant to old Rule 506(b) of Regulation D rather than the new or reworked JOBS Act exemptions.

[1] The Jumpstarts Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306, 313 (Apr. 5, 2012).
[2] Vladimir Ivanov & Scott Bauguess, *Capital Raising in the U.S.: An Analysis of Unregistered Offerings Using the Regulation D Exemption, 2009-2012: An update of the February 2012 study*, SEC: Div. of Econ. & Risk Analysis (DERA) (July 2013) (noting that, "[i]n 2012, registered offerings accounted for $1.2 trillion of new capital compared to $1.7 trillion raised through all private offering channels.").
[3] It should be noted that the term "private offering" itself has evolved into a misnomer as a significant percentage of private deals are publicly offered to investors with whom an issuer has no preexisting relationship.
[4] Ivanov & Bauguess, supra note 1; Scott Bauguess et al., *Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2014*, SEC: DERA (October 2015) (reviewing filings made between September 23, 2012 to December 31, 2014); Anzhela Knyazeva, "Regulation A+: What do we know so far?" SEC: DERA (November 2016); Sherwood Neiss, *Here's How Regulation Crowdfunding Performed in 2016*, Venture Beat (Jan. 11, 2017), http://venturebeat.com/2017/01/11/heres-how-regulation-crowdfunding-performed-in-2016/).

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More specifically, as of the date of my paper:

- More than 24,500 Rule 506(b) filings had been made pursuant to pre-existing Rule 506(b) of Regulation D, generating $1.52 trillion in new capital raised.[5]
- The JOBS Act's new Regulation D alternative, Rule 506(c), brought in less than 10 percent of that number for a total of 2,117 filings made, for a significantly smaller aggregate raise of $32.5 billion.[6] "On a relative basis, issuances claiming the new Rule 506(c) exemption have accounted for only 2.1% of the reported capital raised pursuant to Rule 506 since becoming effective in September 2014." [7]
- The new Regulation A+ exemption experienced even weaker filing rates. Excluding 29 filings that were withdrawn, only 147 filings were made during the first 16 months that the exemption was available for an aggregate maximum raise of approximately $2.6 billion in capital.[8] As of the date of the relevant SEC report, only a little more than half (81) of the offerings had been qualified, limiting authorized sales to a total of $1.5 billion, of which a small fraction ($190 million) had been reported as raised.[9]
- Lastly, the greatly anticipated new Regulation Crowdfunding exemption had been used by only 186 companies in its first calendar year 2016 (available only during the last 7.5 months of the year).[10] Seventy-nine (42%) of those companies had reached minimum funding targets totaling $17.9 million. The average campaign raise was $226,578 and the average fee paid to the platform for a funded campaign was $11,329 (4.8% of average raise).[11]

What does this early filing data tell us when it comes to gauging the success of these JOBS Act offering exemptions in providing new avenues for small businesses capital formation? Looking at the glass half full, I would say that the data shows thousands of businesses successfully utilizing the new exemptions – Rule 506(c) with the greatest frequency – to raise billions of dollars in much needed capital. Women- and minority-owned businesses, in particular, have strategically leveraged the exemptions to connect with their investor base.[12] That said, it is clear that the filing response has not been as robust as many expected and the old tried and true Rule 506(b) exemption continues to dominate the exempt offering scene.

My paper posited that perhaps the pre-existing relationship, investor sophistication, and due diligence dynamics witnessed in the angel and venture capital space are, organically, necessary components to bridge the information asymmetry that might discourage investors from these new breeds of small, private offerings. In the banking context, "[s]mall business borrowers tend to be more 'informationally opaque' than their larger counterparts and thus pose greater challenges for lenders." Karen Gordon Mills & Braden McCarthy, *The State of Small Business Lending: Innovation and Technology and the Implications for Regulation*, Working Paper 17-042, Harvard Business Review at 35-36 (November 2016) (http://www.hbs.edu/faculty/Publication%20Files/17-042_30393d52-3c61-41cb-a78a-ebbe3e040e55.pdf). "Studies by Petersen and Rajan (1994) and Berger and Udell (1995) have underscored that the informational opacity of small businesses has often given community banks an edge in small business lending, as local banks invest the time and personnel to build dense relationships with borrowers, which then makes it easier for them to assess a borrower's creditworthiness." *Id.*

Then again, perhaps the story is much simpler and the real difference between the traditional private offering space and the new offering exemptions is just pure household economics. While venture capitalists and angel investors may have the financial wherewithal and appetite to invest in riskier, early stage companies – and do so in spades as the foregoing Rule 506(b) data bears out, retail investors may lack those resources and/or risk profile. To be sure, many Americans are living paycheck to paycheck and choose to invest whatever they can afford in safer, more traditional products. As the new JOBS Act exemptions mature, it will be interesting to see what filing types ultimately give small businesses the biggest bang for their buck and, in turn, create much needed jobs for our recovering U.S. economy.

[5] Bauguess, supra note 4 at 14 & Table 3.
[6] *Id.* at 12-13.
[7] *Id.* at 2.
8Knyazeva, supra note 4 at 5.
[9] *Id.*
[10] Neiss, supra note 4.
[11] *Id.*
[12] *Crowdfunding Powers Women in Tech*, The Guardian.com, https://www.theguardian.com/hiscox-partner-zone/2016/dec/05/crowdfunding-powers-women-in-tech (citing Andreea Gorbatai & Laura Nelson, *The Narrative Advantage: Gender and the Language of Crowdfunding,* Univ. of Berkeley, California (August 2015) (http://faculty.haas.berkeley.edu/gorbatai/working%20papers%20and%20word/Crowdfunding-GenderGorbataiNelson.pdf)).

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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.

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Is a Best Interest Standard the Future of Broker-Dealer Regulation?

By *Andrew Hartnett*

Many commentators have suggested that the idea of some kind of best interest standard applicable to broker-dealers is here to stay, even as the election of President Donald J. Trump created uncertainty about whether the Department of Labor's (DOL) fiduciary rule would be implemented. Developments related to the DOL fiduciary rule, at the Securities and Exchange Commission (SEC), in Nevada, and at the Certified Financial Planner Board over the past several months strongly support the idea that a best interest standard is the future of broker-dealer regulation. It remains very uncertain what that standard will look like, however, and whether there will be one best interest standard or several.

Department of Labor Fiduciary Rule

Shortly after President Trump was elected, the DOL fiduciary rule appeared to be on the chopping block. Gary Cohn, the director of the National Economic Council, suggested that the rule would be eliminated, calling it "a bad rule for consumers." In a memorandum issued Feb. 3, 2017, the president directed the DOL to "prepare an updated economic and legal analysis" of the rule and, if supported by the new analysis, to revise or rescind the rule. [1]

The DOL sought to delay the rule's April 10 effective date to give it time to conduct this new analysis. When the final rule delaying the effective date came out, however, it indicated that certain parts of the rule would become effective June 9, a curveball that prompted the Wall Street Journal to describe the DOL's bureaucracy as being "in open rebellion" against the president.[2]

Where most observers had expected the entire rule and all of the associated prohibited transaction exemptions (PTEs) to be delayed indefinitely, the fiduciary rule (i.e. the new fiduciary definition) became applicable on June 9 and the Best Interest Contract and Principal Transaction exemptions also became available on June 9. The exemptions, however, only require fiduciaries to adhere to certain Impartial Conduct Standards:

(1) providing advice in retirement investors' best interest;
(2) charging no more than reasonable compensation; and
(3) avoiding misleading statements.

The applicability of other requirements of those exemptions, such as representations of fiduciary compliance, contracts and warranties about firm's policies and procedures, is delayed until Jan. 1, 2018, while the DOL performs the review mandated by the president.

Some had hoped that the confirmation of DOL Secretary Alexander Acosta would provide a reprieve from the June 9 partial applicability date. However, Acosta announced in a Wall Street Journal op-ed published roughly three weeks before June 9 that he would not change the date, writing, "We have carefully considered the record in this case, and the requirements of the Administrative Procedure Act, and have found no principled legal basis to change the June 9 date while we seek public input. Respect for the rule of law leads us to the conclusion that this date cannot be postponed."

On June 29, the DOL announced that it was releasing a new request for information, with a 15-day comment period regarding whether to delay the Jan. 1, 2018, applicability date of the rest of the exemptions and a 30-day comment period regarding a variety of other questions, including questions about innovations in the marketplace, such as clean shares and fee-based annuities, since the rule was initially filed.[3]

[1] Fiduciary Duty Rule, 82 Fed. Reg. 9675 (February 7, 2017).
[2] Definition of the Term Fiduciary, 66 Fed. Reg. 16902 (April 7, 2017) (to be codified at 29 C.F.R. pt 2510).
[3] Request for Information Regarding the Fiduciary Rule and Prohibited Transaction Exemptions, 82 Fed. Reg. 31278 (July 6, 2017).

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SEC Request for Information

Roughly 10 days after Acosta's op-ed, SEC Chairman Jay Clayton announced that the SEC is soliciting input on the standards of conduct for investment advisers and broker-dealers.

Noting that the SEC had reviewed the issue in 2006, from 2010-11, and again in 2013, Clayton said that developments in the marketplace since 2013, including "financial innovations, changes to investment adviser and broker-dealer business models, and regulatory developments — including the issuance and pending applicability of the Department of Labor's Fiduciary Rule" necessitate the updated analysis.

In addition to seeking general comments on what the appropriate advice standard is, the SEC announcement poses a series of specific questions, including, among other topics:

- whether investor confusion remains about the types of professionals providing advice,
- whether conflicts of interest have been appropriately addressed,
- how the DOL fiduciary rule has affected the marketplace,
- who should be considered a retail investor, and
- how "investment advice" should be defined.

The SEC request for information confirmed what had come to seem increasingly likely. The first hint that the SEC might be preparing to consider a fiduciary rule came when Commissioner Michael Piwowar, then the SEC's acting chairman, said in April that the SEC should "reassert its role" in setting advice standards. This statement was notably absent from remarks he made in early March at the Investment Adviser Association compliance conference. There, he blasted the DOL rule but seemed skeptical about the SEC promulgating a fiduciary rule: "It is a really, really, really hard issue to deal with."

Piwowar went on to talk about trying to mitigate investor confusion about the different advice standards applicable to brokers and to investment advisers. Notably, this issue is the first of the 17 bullet points of questions posed by the SEC.

Nevada Statute

Nevada is also implementing a fiduciary standard applicable to broker-dealers. Senate Bill 383, which Nevada Gov. Brian Sandoval signed June 2, revises the Nevada Securities Act to mandate that any "broker-dealer, sales representative, investment adviser or representative of an investment adviser shall not violate the fiduciary duty toward a client" imposed in a separate statute.

That statute, NRS 628A.020, imposes the "duty of a fiduciary" on all financial planners.[4] Senate Bill 383 also modifies the definition of "financial planner" to remove from the exclusion for broker-dealers, their representatives, investment advisers, and their representatives.

Senate Bill 383 does not clarify exactly what this fiduciary standard entails. First, it gives the Nevada securities administrator the authority to write rules defining the standard, though no regulations have yet been proposed. Second, NRS 628A.020 contains two specific requirements: (1) disclose any gain the financial planner receives if the advice is followed and (2) ensure the planner understands, on an ongoing basis, the client's financial condition. The new statute is effective on July 1, 2017.

[4] Nev. Rev. Stat. § 628A.020 (2015).

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CFP Board Draft Revisions

On June 20, the Certified Financial Planner Board issued a request for public comment on revisions to its Standards of Professional Conduct that expanded the scope of when a CFP professional would have to act in a fiduciary capacity. The revised Standards of Professional Conduct require that CFP professionals act as fiduciaries whenever they are providing financial advice to clients, whereas the currently applicable standards only require that a CFP professional act as a fiduciary when preparing a financial plan. The comment period ends August 21.

Conclusion

In short, the DOL has partially imposed its fiduciary duty rule while it considers revising additional parts of it; the SEC has solicited public comment on whether to impose a fiduciary standard; Nevada has imposed a fiduciary standard, though clarifying regulations remain to be implemented; and the Certified Financial Planner Board is seeking comments on expanding the applicability of its fiduciary duty to whenever a CFP professional is giving financial advice. Taken together, these developments seem to make clear that a best interest standard – or standards – is coming.

Whether these developments end with one standard, coordinated standards, or multiple standards remains very uncertain. In Secretary Acosta's op-ed, he explicitly invited the SEC to work with the DOL as it works to revise the fiduciary rule: "[T]he SEC has critical expertise in this area. I hope in this administration the SEC will be a full participant." Clayton noted in his announcement that he "welcome[s] the Department of Labor's invitation to engage constructively" as the commission analyzes a fiduciary rule. Clayton subsequently noted in a budget hearing before the Senate Appropriations Committee's Subcommittee on Financial Services and General Government that he intended to move forward with his fiduciary analysis "in a way that is coordinated" and that he was confident the agencies would cooperate with each other. Acosta similarly reiterated his desire that the SEC "be a part of the conversation" in a Senate hearing. Of course, this coordination will get thornier and more complicated given the different regulatory regimes and that the DOL has a partially implemented rule and a (likely-to-be-delayed) applicability date in six months while the SEC has just begun soliciting information.

In addition to the uncertainty surrounding the SEC and the DOL's efforts to coordinate, it is unclear where Nevada's rulemaking will end up, and the CFP Board rulemaking remains a draft. What seems clear, though, from all of these initiatives is that some sort of best interest standard is coming. The precise requirements of such a standard, and whether one standard or multiple standards results, remains to be seen. Hopefully, a coordinated, uniform standard can emerge, as this would be in the best interest of both investors and financial advisors.

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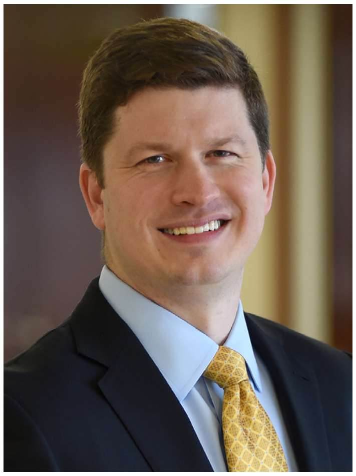

As Missouri's Commissioner of Securities from 2013 to 2016, Mr. Hartnett directed the Missouri Securities Division and helped formulate policy nationwide through his work at the North American Securities Administrators Association (NASAA). He led the team that created the cybersecurity program now used by most state regulators and chaired the Broker-Dealer Section and the Enforcement Section for NASAA, as well as committees focused on cybersecurity, technology, and federal legislation. He has spoken at events nationwide on topics including state securities regulations, cybersecurity, and protection for senior investors.

Prior to his time as Commissioner of Securities, Mr. Hartnett served as Chief of Staff to then-Missouri Attorney General Chris Koster and as an Assistant Attorney General in the Consumer Protection Division, handling all aspects of consumer protection, antitrust and securities investigations and litigation. He began his career in private practice in St. Louis and is a graduate of Saint Louis University School of Law.

The Resurgence of "Selling Away"

By: *Brian P. Nally*

With the market performing well in the last several years, there has been a resurgence of "selling away" claims. Selling away occurs when an investment professional sells securities not held, offered, or approved by his or her broker-dealer. This type of activity causes problems because broker-dealers, often unaware of these offerings, are unable to perform the due diligence necessary to protect investors. These investments are often unregistered securities, which means important disclosure requirements do not apply and investors often rely on the salesperson for relevant information.

Further, selling away often occurs with private placement opportunities and other limited investment offerings such that information about the investment (and the investment professional's affiliation with the investment) is not readily available to broker-dealers or the potential investors. This article attempts to address the applicable requirements for investment professionals and the supervisory obligations of broker-dealers relating to selling away activities.

Supervisory Duty of Broker-Dealers

The Financial Industry Regulatory Authority ("FINRA") is the self-regulatory agency charged with enforcing regulations in accordance with federal law. FINRA Rule 3110 governs a broker-dealer's supervisory obligations and provides that a firm has a duty to establish, implement, and maintain a system to supervise the activities of each registered representative and that the system be reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules.

The duty to supervise includes, among other things, a duty to perform certain activities that would potentially detect undisclosed outside business activities of firm representatives. *McGraw v. Wachovia Sec., L.L.C.*, 756 F. Supp. 2d 1053, 1074 (N.D. Iowa 2009).

A broker-dealer's duty to supervise, however, is measured by a "reasonableness standard" and is not a matter of strict liability. Courts have stated that a brokerage firm is "not an insurer for its representatives" and "not necessarily liable for all actions taken by its registered representative[.]" *Asplund v. Selected Investments in Financial Equities, Inc.*, 86 Cal.App.4th 26, 42 (Cal. App. 2000).

Indeed, a broker-dealer can establish a good faith defense to a negligent supervision claim if it can establish that it "maintained and enforced a reasonable and proper system of supervision and internal controls." *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1576 (9th Cir. 1990). In this regard, Section 15(b) of the 1934 Act defines reasonable supervision as: "[E]stablished procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any ... violation [of the Act] by [an associated person]." 15 U.S.C. § 78o(b)(4)(E)(i). A firm's supervisory system must comply with these standards but cannot guarantee firm-wide compliance with all applicable laws and regulation and FINRA rules. *See* FINRA Notice 14-10, fn. 4.

Supervision of Outside Business Activities and Private Securities Transactions

Pursuant to FINRA Rules 3270 and 3280 (formerly NASD Rules 303 and 3040), firms are responsible for educating representatives and associated persons about outside business activities and private securities transactions, as well as for implementing supervisory and compliance procedures to address these activities. *McGraw*, 756 F. Supp. 2d at 1074. "Outside activities" are employment or compensation of a representative by any person other than the employing brokerage firm as a result of any business activity outside the scope of the representative's relationship with his employer firm. *See Id.*; FINRA Rule 3270.

A representative engaged in any kind of business activity away from the brokerage firm must provide the firm with prompt written notice of such activity, and a representative's failure to do so is a violation of FINRA rules. FINRA Rule 3270. When reviewing written notices submitted under FINRA Rule 3270, members must consider:

1. Whether the activity will "interfere with or otherwise compromise the registered person's responsibilities to the member and/or the member's customers;"
2. Whether the activity will "be viewed by customers or the public as part of the member's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered."

See Supplementary Material, FINRA Rule 3270.

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If a brokerage firm denies this written request, the registered person may not engage in the outside business activity.

"Private securities transactions" are any securities transactions outside the regular course or scope of a representative's employment with a brokerage firm, which includes new and unregistered offerings. FINRA Rule 3280(d). Prior to participating in any private securities transaction, a representative must provide written notice to the brokerage firm describing in detail the proposed transaction and the person's proposed role in it and stating whether he or she has received or may receive selling compensation in connection with the transaction. *See* FINRA Rule 3280(b). The representative is prohibited from selling any security away from the brokerage firm unless that firm has authorized the associated person to make the sale. *See* NASD Notice to Members 01-79.

Brokerage firms generally are not responsible for supervising any outside business activities or private securities transactions engaged in by their representatives unless they have received notice of or have approved those activities. *McGraw*, 756 F.Supp.2d 1053, 1075 (2010). Firms, however, still have a duty monitor and investigate activities for which they have had no proper notice in an effort to detect "red flags" that would alert the brokerage firm to the possibility of undisclosed outside activities. Id. "Red flags" that would alert a firm to the possibility of undisclosed activities, and consequently give rise to a duty to monitor and investigate those activities, include:

(i) correspondence from customers or other individuals addressed to the broker at the firm's address referring to investments that are not reflected on the records of the brokerage firm;
(ii) inquiries from customers or other individuals to supervisory or administrative personnel relating to investments not reflected on the records of the brokerage firm; and
(iii) sales literature received in the firm's office or found in the broker's office relating to investments not approved for sale by the firm. In this regard, a firm's supervisory policies and procedures should be tailored according to these considerations and to the type of business in which the firm engages.

Selling Away in Ohio

Ohio maintains its own legislation and enforcement structure designed to protect investors and to provide clear guidance to investment professionals. Many of the selling away activities involve investments made through promissory notes. While generally thought of as simple debt obligations, Ohio law includes promissory notes within the definition of "security" such that engaging in this type of transaction may subject a registered representative and his or her broker to liability for selling away. *See* Ohio Revised Code § 1707.01(B); *see also Williams v. Guarnieri*, 2005-Ohio-4044, ¶ 21 (Ohio App. 11th Dist. Aug. 5, 2005) (if sold, a promissory note must be registered as it is a security and not merely a debt obligation); Williams v. Waves, Cuts, Colour & Tanning, 92 Ohio App. 3d 224, 230 (1st Dist. 1994) (promissory note providing for the issuance of stock in satisfaction of a debt is a sale of a security and must be registered even if no shares are issued).

Under R.C. § 1707.01(B), which discusses a real estate exemption, a promissory note may not always constitute a security under Ohio law, although any such analysis begins with the presumption that a promissory note is a security. *See* Bank One, N.A. v. Demmler, 2009-Ohio-3848 (Ohio App. 5th Dist. Aug. 3, 2009) (noting that R.C. § 1707.01(B) exempts real estate transactions from security legislation); *Perrysburg Twp. v City of Rossford*, 2004-Ohio-4362, ¶ 12 (2004) citing *Reves v. Ernst & Young*, 494, U.S. 56, 65-66 (1990).

Specifically, the following factors tend to demonstrate that a promissory note is a security in Ohio:

1) if the parties refer to the note as an investment or intend for the note to be an investment;
2) if the note is long-term;
3) if the note is not a collateralized loan;
4) if the note was intended to generate capital and/or business development; and
5) if the note carries high risk. *See Perrysburg Twp. v. Rossford Arena Amphitheater Auth.*, 175 Ohio App.3d 549, 559 (6th Dist. 2008).

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The Ohio Department of Commerce, Division of Securities has brought enforcement actions against investment professionals for "selling away" activities. *See e.g., In the Matter of Michael J. Rudolph*, Division Order No. 02-029; *In the Matter of John E. Prokop*, Division Order 02-037; *In the Matter of Bari L. Courts*, Division Order 02-035; *In the Matter of Kevin R. Ostrowski*, Division Order 00-479.

In addition to civil and professional penalties, investment professionals may face criminal charges in connection with "selling away" activities. *See State v. Ostrowski,* Case No. 02CR059706 (Lorain C.P. 2002) (sentenced to three years community control for false representation under 1707.44(B)(4)); *State v. Nemchik*, 2000 Ohio App. LEXIS 836 (9th Dist. 2000) (12 years in prison and restitution for grand theft by deception, false representation under 1707.44(B), selling unregistered securities under 1707.44(C), and selling away).

However, both of these Ohio legislative provisions impute a knowledge requirement on the investment professional such that analogous to federal law, if an investment professional possesses a good faith belief that he or she is acting in accordance with applicable laws and regulations, no criminal punishment will be instituted. *See e.g. Williams v. Guarnieri*, 2005-Ohio-4044, ¶ 21 (Ohio App. 11th Dist. Aug. 5, 2005) (registered representative sold unregistered promissory note but actions were in reliance on other professionals and without knowledge that promissory notes were required to be registered as securities).

Conclusion

The risk of selling away should be understood by everyone in the investment industry. Broker-dealers and investment professionals must work together to ensure all investments, even promissory note offerings, are properly classified as "securities" and processed through the appropriate entity. In the end, this will help protect the investing public, as well as help protect members of the investment industry from adverse regulatory action and private litigation.

Brian Nally is a Partner out of the Cleveland and Indianapolis offices of Reminger Co., L.P.A. He focuses his practice on securities litigation and arbitration, and has experience representing clients in state and federal court, as well as arbitration before the Financial Industry Regulatory Authority (FINRA) and American Arbitration Association (AAA). Brian also has experience representing clients in government regulatory investigations and enforcement actions brought by FINRA, the Securities and Exchange Commission, professional boards (e.g., the CFP Board), state departments of securities, and state departments of insurance. For three consecutive years (2014, 2015 and 2016), Brian has been recognized as a "Rising Star" by Ohio Super Lawyers Magazine, a recognition given to less than 2.5% of lawyers in the State of Ohio.