

Ohio Securities Bulletin



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Governor

KENNETH R. COX
Director of Commerce

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Acting Commissioner of Securities

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Pencheff v. Adams

(Editor's Note: On June 15, 1983, the Ohio Supreme Court decided the case of *Pencheff v. Adams*. The Division of Securities believes this to be an important decision under the Ohio Securities Act. Plaintiff-appellant Peter M. Pencheff, an attorney, signed a subscription and stock purchase agreement on April 6, 1979, to purchase shares in Columbus Financial Planning Agency, Inc. That subscription agreement recited that the shares being purchased had not yet been registered with the Division under Revised Code Chapter 1707. Four months later, Columbus Financial Planning Agency, Inc. filed a registration by description under Section 1707.06(A)(1). In the interim, funds had changed hands and certificates had been issued. Counsel for Columbus Financial Planning Agency, Inc. argued that the failure to register this transaction, known to Pencheff at the time of purchase, was not the kind of violation that "materially affected the protection contemplated by the violated provision" under section 1707.43 of the Revised Code. The Division of Securities, through the office of the Attorney General of Ohio, filed an *amicus curiae* brief, and through former Assistant Attorney General Barry Moses, appeared before the Ohio Supreme Court, arguing that sales made in violation of the registration provisions of Chapter 1707 did materially affect the contemplated protection and that such sales were voidable by the purchaser. The unanimous decision of the Ohio Supreme Court appears below in its entirety.)

Pencheff v. Adams, 5 Ohio St. 3d 153 (1983). APPEAL from the Court of Appeals for Franklin County.

On April 6, 1979, plaintiff-appellant, Peter M. Pencheff, entered into a Subscription and Stock Purchase Agreement ("agreement") with the defendants-appellees, Columbus Financial Planning Agency, Inc. ("Planning"), and its president, Thomas G. Adams. Pursuant to the terms of the agreement, Pencheff purchased from Planning one hundred shares of securities that were neither registered with the Ohio Division of Securities ("Division") nor exempt from registration with the Division. Thereafter, Pencheff sought a rescission of the agreement and a refund of the purchase price. Appellees refused to refund Pencheff's purchase price of \$150,000.

As a result, Pencheff filed a complaint against appellees in the Court of Common Pleas of Franklin County. Pencheff alleged that Planning's sale of unregistered and non-exempt securities constituted a violation of the Ohio Securities Act (R.C. Chapter 1707). Pencheff claimed that he was entitled, as a matter of law, to rescission and damages.

Accordingly, Pencheff filed a motion for summary judgment, to which appellees responded. At a later date, appel-

lees filed an answer and counter-claim. Based on the supporting document, affidavits, and pleadings, the trial court then proceeded to enter judgment against appellees in the sum of \$150,000 plus interest.

On appeal, the court of appeals concurred with the trial court's finding that appellees had violated R.C. Chapter 1707, but remanded that case for a determination of whether the violation materially affected the protection contemplated by the violated provisions. The court of appeals also remanded the case to the trial court for a resolution of appellees' claims that had not been disposed of by the summary judgment.

The cause is now before this court pursuant to the allowance of a motion to certify the record.

Fry and Waller Co., L.P.A., Mr. Carl B. Fry, Mr. Barry A. Waller, and Mr. Rick L. Brunner, for appellant.

Messrs. Scott, Walker, and Kuehnle, and Mr. George Nickerson, for appellees.

Mr. Anthony J. Celebrezze, Jr., attorney general, and Mr. Barry W. Moses, urging reversal for *amicus curiae*, Department of Commerce, Division of Securities.

J.P. Celebrezze, J. The record clearly shows that appellees violated the provisions of R.C. 1707.44(C)(1) in the sale of unregistered securities to appellant. Consequently, the sole issue before this court is whether the violation materially affected the protection contemplated by the violated provision.

This very issue (sale of unregistered securities) was addressed and resolved by this court in *Bronaugh v. R. & E. Dredging Co.* (1968), 16 Ohio St. 2d 35 (45 O.O.2d 321). At the outset, we decided that a determination of this issue was a question of law that could properly be resolved by this court. *Id.* at 40. We then said:

"[T]he purpose behind the violated provision (R.C. 1707.44(C)(1)) is to prevent those persons willing to market worthless or unnecessary risky securities from soliciting the purchasing public without first subjecting themselves and their securities to reasonable licensing and registration requirements designed to protect the public from its own stupidity, gullibility and avariciousness." *Id.* at 40-41.

Accordingly, we decided that the violation of R.C. 1707.44(C)(1) did materially affect the protection contemplated by said provision. Any contrary determination would

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only serve to undermine the most fundamental purpose of the statute—protection of the public from the sale of unregistered securities.

Based upon the foregoing, we hold as a matter of law that appellees' failure to comply with R.C. 1707.44(C)(1) materially affect the protection contemplated by that provision and entitles appellant to the relief provided under R.C. 1707.43.

Accordingly, the judgment of the court of appeals as to the issue of the determination of materiality is reversed, and the cause is remanded to the trial court for further proceedings consistent with this opinion. Judgment accordingly.

CELEBREZZE, C.J. KEEFE, SWEENEY, LOCHER, HOLMES, and C. BROWN, JJ., concur.

KEEFE, J., of the First Appellate District, sitting for W. BROWN, J.

Commissioner's Greetings

This edition of the Ohio Securities Bulletin marks the return of the publication after a three-year hiatus. It will be published four times this year and on a quarterly basis thereafter. We intend to cover various topics in Securities law, enforcement, registration, and broker-dealer licensing at the Division, personnel changes and any other matters brought to our attention that need addressing. We welcome comments and suggestions concerning the functioning of the Division, that need to be clarified, resolved, or discussed.

As many of you know, there has been a rapid turnover in the commissioner's office lately with Rodger Marting leaving on January 20, 1986 to pursue a career as a promoter, and Acting Commissioner Phillip Lehmkuhl moving on to take a position with Squire, Sanders & Dempsey on April 28, 1986. I have been designated Acting Commission in the interim and will strive to insure that the Division does not lose continuity in its functioning.

Mark V. Holderman

Enforcement

Wozniak v. Department of Commerce, Division of Securities, (Franklin Co. Ct. of Common Pleas, Case No. 83-CV-031603), (5/22/84), (Tyack, J.).

This case was an appeal from an order of the Division of Securities, characterized by the court as a "consent decree." This consent decree order had been issued by the Division pursuant to negotiations by which appellant withdrew his request for an administrative hearing, thereby waiving his right to administrative appeal.

In a private civil action in federal court, it was found that the appellant's conduct in question did not violate Revised Code sections 1707.14 or 1707.43. The Court of Common Pleas however, limited its review to the administrative record, and did not consider the evidence presented in the federal civil action. From that record it found that 1) it was clear that a consent decree was entered by both parties, 2) that appellant received a number of benefits he sought, and 3) that appellant withdrew his request for a hearing. Pursuant to these facts, the court found the consent order to be in accordance with law. The appeal was dismissed by Judge Tyack.

The Division finds this opinion to be important for several reasons. First, it establishes the power of the Division to enter into negotiated orders; second, it upholds the validity of those orders; and third, it upholds such an order even in the face of a full adjudication that the Securities Act has not been violated.

Richard J. Cashman—Potato Processors International Corp.

On March 30, 1984, Richard J. Cashman and Potato Processors International Corp. entered into a consent injunction, in which Mr. Cashman was permanently barred from participating in the public sale of securities, or from becoming an officer, director, or controlling person in any publicly-held company.

In its complaint, the Division of Securities alleged violations of the fraud, licensing, and registration provisions of the Ohio Securities Act in the sale of stock by Potato Processors International Corp. of Columbus.

The injunction resulted from an investigation into the company and Mr. Cashman by former Assistant Attorney Inspector James Lummanick and Investigator Cy Sedlacko.

Robert R. Hills

On March 21, 1984, Robert R. Hills pleaded no contest to one count of selling unregistered securities. Seventeen other counts of unregistered sales, securities fraud, and theft by deception were dismissed by the Franklin County Prosecuting Attorney in exchange for the plea.

Mr. Hills had been indicted in August, 1983, as a result of sales of interests in a limited partnership, Magus, Ltd. The stated purpose of the venture was to acquire assets of other oil and gas producing entities, including assets held by Bethel Resources, Inc., Fenex, Inc., and H.M.W. Co., Inc., all three of which were controlled by Mr. Hills. The interests in Magus, Ltd., were not registered with the Division of Securities and Magus, Ltd. acquired no assets.

Mr. Hills was sentenced by Judge Rader on one count of unregistered sales to one and one half years at Chillicothe Correctional Institute.

The indictment and plea resulted from a lengthy investigation into Mr. Hills and the businesses he controlled by Division Investigator Karen L. Terhune, former Assistant Attorney Inspector James Lummanick, and former Staff Attorney Nancy Ivers Ferguson.

Robert C. Wills, William E. Brame

On November 4, 1983, Robert C. Wills and William E. Brame were sentenced to prison, following their conviction in the Common Pleas Court of Licking County, Ohio, on securities and theft charges. Mr. Wills, who was convicted on thirteen counts of violating Revised Code section 1707.44(G) and thirteen counts of theft by deception, was sentenced to nineteen and one half years in prison and fined \$32,500.00. Mr. Brame, convicted on eight counts of theft by deception, was sentenced to four and one half years in prison. A third defendant, Mark Wing, was acquitted of all charges during the two-week jury trial. (See, Ohio Securities Bulletin, Issue 1, 1983.)

James Maxwell, Jr.

On May 2, 1984, James Maxwell, Jr., former Attorney Inspector of the Ohio Division of Securities, consented to an injunction filed in the Court of Common Pleas of Franklin County, Ohio. Under the terms of the Entry, James Maxwell, Jr. consented to be restrained and enjoined from, *inter alia*: 1) either direct or indirect participation in the sale in Ohio of securities sold pursuant to Ohio Revised Code section 1707.03(O) or 1707.03(Q); 2) selling any security except in full compliance with the Ohio Securities Act; 3) serving as officer, director, general partner, or more than five per-cent shareholder of any coal mining or oil and gas drilling ventures in Ohio for a period of four years, except in those ventures in which he now holds such position or those ventures in which he holds 100% of the equity.

The complaint for the injunction sought pursuant to Ohio Revised Code section 1707.26 resulted from an investigation, conducted by Tina K. Manning, Staff Attorney, and Karen L. Terhune, Investigator, of Blue Max Coal Company of which Mr. Maxwell served as secretary-treasurer.

Charles Carroll Peebles, Heritage Market Research, Inc., American Heritage Research, Inc.

On August 2, 1985, a permanent injunction was obtained by consent entry in the U.S. District Court for Southern Ohio by the Commodity Futures Trading Commission and the Ohio Division of Securities against Charles Carroll Peebles, American Heritage Research, Inc., and Heritage Market Research, Inc. prohibiting trading in off-exchange futures contracts and selling securities in violation of Ohio securities laws.

The complaint alleged that between June, 1984 and January, 1985, the defendants marketed strategic and precious metals investments through nationwide sales solicitations to customers from an office in Columbus, Ohio. This program involved the offering and selling of off-exchange futures contracts to the general public in violation of the Commodity Exchange Act.

A second investment program involved the sale of 5,000 units in a fund that would be pooled to purchase strategic and precious metals. The complaint alleged violations of the antifraud, licensing, and registration provisions of the Ohio Securities Act in this program. According to the suit, no such fund was ever set up.

A court-appointed receiver has taken over the assets of the corporate defendants and is supervising the return of defrauded customers' funds.

The injunction resulted from an investigation conducted by Karen Terhune.

Berwell Energy, Inc.

On April 17, 1986, the Division issued a final Cease and Desist Order against Berwell Energy, Inc., of 1880 MacKenzie Drive, Columbus, Ohio. The Division found that Berwell Energy, Inc. sold joint venture interests in violation of section 1707.44(C)(1) of the Ohio Revised Code. The Division also found that the cost projections on certain oil and gas wells, to be completed, were overstated.

Rules

The following is a summary of administrative rule changes from May, 1983, to present:

The Division amended rule 1301:6-3-01, defining the terms "having no readily determinable value" as used in Revised Code section 1707.01(K)(1) and "its securities" as used in Revised Code section 1707.03(K)(1).

The Division amended rule 1301:6-1-03 to eliminate those provisions that apply to areas of the Ohio Revised Code no longer regulated by the Division and to modify the notice provision for rule changes.

The Division amended rule 1301:6-3-03(M), pursuant to Revised Code section 1707.03(V), to exempt from registration the sale of interests in Government National Mortgage Association (GNMA) mortgage pools.

The Division amended rule 1301:6-3-03(N), pursuant to Revised Code section 1707.03(V), to exempt from registration many employee stock plans.

The Division amended rules 1301:6-3-03(E) and (J), to require that foreign applicants for claims of exemption pursuant to Revised Code section 1707.03(O) and (Q) file, along with such claims, a consent to service of process.

The Division amended rule 1301:6-3-03(M) to create an exemption for certain securities representing an interest in bank certificates of deposit which are themselves exempt pursuant to Revised Code section 1707.02(C) and enacted rule 1301:6-3-03(O) to create an exemption for warrants, subscription rights, and options to purchase securities which are exempt pursuant to Revised Code section 1707.02(E). In both cases the underlying security was exempt by statute.

The Division amended rule 1301:6-3-08 to increase the effective period for registrations by description from thirteen months to sixteen months.

The Division amended rule 1301:6-3-09 to segregate those rules which apply exclusively to investment companies. The changes to those paragraphs applicable to investment companies allow registration of several types of investment companies permitted under federal law but previously prohibited from registration in Ohio. The Division further amended rule 1301:6-3-09(G) governing registration of mutual funds and unit investment trusts to ease certain restrictions presently imposed on mutual funds, and to streamline the registration process for seasoned mutual funds and unit investment trust sponsors.

The Division amended rule 1301:6-3-09(B) to specifically permit the use of uniform forms in order to simplify the registration process and to require a cross reference sheet for real estate offerings in order to facilitate review.

The Division amended rule 1301:6-3-09(K) to permit the Division to require pre-sale delivery of disclosure documents in order that persons may avoid restrictions otherwise present in SEC Rule 504 Regulation D offerings, and to clarify language.

The Division amended rule 1301:6-3-091 to require applicants to provide the Division with the same information as filed with the SEC to specifically permit the use of uniform forms to clarify language and to change reference from commissioner to division to make the rule consistent with other rules of the Division.

The Division amended rule 1301:6-3-12 to more clearly define which Division records are available for public inspection, and to put into rule form the fees presently charged for copies of such records.

The Division promulgated rule 1301:6-3-13 to establish a procedure by which the Division may withdraw certain applications for registration and claims of exemption that have not been registered or approved within one year of filing.

The Division amended rule 1301:6-3-15 to require dealers to maintain a complaint file and to require the maintenance of certain books and records.

The Division amended rule 1301:6-3-15(C) to raise the passing rate for a dealer exam to ensure satisfactory dealer knowledge; to require that certified public accountants, acceptable appraisals, generally accepted auditing standards and accounting principles, and SEC rule 17a-5 be used in certain situations with regard to financial requirements of dealers in order to ensure a standard, accurate determination is made; to require dealers to designate branch officer supervisors with certain minimum qualifications, and to increase dealer-supervisor accountability in order to ensure responsibility, and to delete references to Revised Code section 1707.08.

The Division amended rule 1301:6-3-15(E) to allow broker-dealers to post a bond, letter of credit, or guarantee of liability in lieu of the present net worth requirement.

The Division amended rule 1301:6-3-15(F) to eliminate the license and renewal card display requirements.

The Division amended rule 1301:6-3-15(O) to better define "good business repute."

The Division amended rule 1301:6-3-16 to increase the passing score for securities salesmen and require retesting if not licensed within the last two years by the Division or if licensed in another state pursuant to that state's examination.

The Division adopted rule 1301:6-3-391 to implement the provisions of new statutory section Revised Code section 1707.391 by delineating the filing requirements and defining excusable neglect and failure to timely or properly file.

Editor's Notice:

Updated versions of the Ohio Securities Act and rules are available at the Division for \$17.50. The publication is in looseleaf form and the price includes automatic supplements for purchasers. Copies may be obtained by contacting the Ohio Division of Securities, Two Nationwide Plaza, Columbus, Ohio 43266-0548. The cost of mailing is \$2.40 for first class, \$1.66 for third class, and \$1.19 for book rate.

Registration

The following policies are among those that have been applied by the Division for the past three years. The Division has had numerous requests for publication and clarification of all of the guidelines it uses to determine whether a proposed offering of securities is being made on grossly unfair terms. The Division intends to review, publish for comment, and hold hearings on all guidelines in the near future.

Underwriter Compensation Policy

An offering is grossly unfair if the underwriting commission, discount, or other remuneration exceeds fifteen per cent of the proceeds of the offering. For purposes of this paragraph, "commission, discount, or other remuneration" shall at a minimum include the following:

- a. The amount designated as commission, discount, or other remuneration in the registration application;
- b. Any accountable or non-accountable expense allowance granted to the underwriter;
- c. Warrants granted to the underwriter;
- d. Any remuneration to the underwriter for financial advisory contracts or consulting contracts, unless the applicant can satisfy the Division that the contract requires specified duties to be performed at specified intervals and that such remuneration is not excessive;
- e. Future registration rights, rights of first refusal, and indemnification agreements.

The valuation of underwriters' warrants, future registration rights, rights of first refusal, and indemnification agreements shall be the valuation used by the National Association of Securities Dealers.

Pro Rata Policy

An offering that includes sales by selling shareholders is grossly unfair if the selling shareholders pay less than a pro rata portion of all expenses of issuance and distribution of the offering, except as follows:

- a. If the selling shareholders are selling more than ten per cent but less than fifty per cent of the total offering, the selling shareholders must pay a pro rata portion of all expenses of issuance and distribution of the offering, except the issuer's legal, accounting, and transfer agent fees.
- b. If the selling shareholders are selling ten per cent or less of the total offering, the selling shareholders must pay a pro rata portion of the underwriters' commission, discount, and remuneration.

As used in this policy, the term "selling shareholders" includes all selling security holders.

Subordinate Voting Rights Policy

A proposed public offering of equity securities to be made by an issuer, which has or proposes to have more than one class of equity securities outstanding after the offering, is presumed to be grossly unfair if the securities of the class to be offered for sale to the public do not have equal voting rights on all matters as to which a vote of the security holders is otherwise permitted by law or the charter documents, including the election of directors, unless the final offering circular of such issuer prominently discloses the

unequal voting terms of the class to be offered for sale to the public on the front cover page of the issuer's final offering circular.

Blank-Check Preferred Policy

A proposed public offering of securities to be made by an issuer which has or proposes to have preferred stock issued or issuable with rights, preferences, and privileges to be determined by the Board of Directors without further action by stockholders is presumed to be grossly unfair unless the final offering circular prominently discloses within the description of such preferred stock that "the Board of Directors without shareholders approval can issue preferred stock with voting and conversion rights which could adversely affect the voting power of the common shareholders."

Insider Loans Policy

A proposed public offering of securities is presumed to be grossly unfair to purchasers under this standard if:

- a. A loan of cash or property made by the issuer to one or more of its officers, directors, and five per cent shareholders is not (as of the date of the filing of the registration application) evidenced by a promissory note which names the issuer as the payee;
- b. The maturity date of any outstanding loan made by the issuer to one or more of its officers, directors, and five per cent shareholders (prior to the date the registration application is filed) extends beyond the end of the sixth (6th) month following the initial public offering date; or
- c. An issuer which has previously made loans of cash or property to one or more of its officers, directors, and five per cent shareholders (prior to the date the registration application is filed) does not include language within its final offering circular whereby the issuer guarantees that any future loans to any of its officers, directors, or five per cent shareholders will not occur unless approved by a majority of the disinterested Board of Directors and for a bona fide business purpose.

Insolvent Issuer Policy

Section 1707.44(F) of the Ohio Revised Code states that no person with intent to deceive shall sell or cause to be offered for sale any securities of an insolvent issuer, with knowledge that such issuer is insolvent in that the liabilities of such issuer exceeds its assets taken at their fair market value.

This standard shall be deemed violated unless the insolvency of an issuer as defined, and determined by issuer's most recent audited financial statement, is prominently disclosed on the front cover page of the final offering circular of such issuer.

<u>Broker-Dealer Section</u>	<u>March</u>	<u>April</u>
<u>Applications Received</u>		
Broker-Dealer (Form 15)	24	10
Foreign Real Estate		
Broker-Dealer (Form 331-A)	1	2
Salesman (Form 16)	195	182
Foreign Real Estate Salesman (Form 331-B)	5	20
<u>Licenses Issued</u>		
Form 15	17	12
Form 331-A	4	2
Form 16	101	107
Form 331-B	17	9
<u>Licenses Denied</u>		
Form 15	7	0
Form 331-A	0	0
Form 16	94	0
Form 331-B	8	0

Consumer Finance Section

<u>Applications Received</u>		
Small Loan	8	1
Second Mortgage	13	1
Insurance Premium Finance	0	4
Pawnbroker	1	1
<u>Licenses Issued</u>		
Small Loan	11	4
Second Mortgage	10	9
Insurance Premium Finance	0	0
Pawnbroker	0	1
<u>Licenses Denied</u>		
Small Loan	0	0
Second Mortgage	0	0
Insurance Premium Finance	0	0
Pawnbroker	1	0

<u>Enforcement Section</u>	<u>March</u>	<u>April</u>
<u>Inquiries</u>		
Received or Assigned	206	145
Terminated or Closed	208	135
<u>Active Cases</u>		
Received or Assigned	16	15
Terminated or Closed	4	11
Pending at the end of the Month	54	47
<u>Administrative Activities</u>		
Cease and Desist Orders	2	0
Subpoenas	0	0
Hearings	3	1
Investigative Interviews and Conferences	11	11

Credit Union Section

<u>Credit Unions Ordered Into</u>		
Liquidation	0	0
Hearings Held	0	0
Mergers Granted	2	1
Mergers Denied	1	0
New Charters Granted	1	0
Examination Fees	2,904.33	8,023.73
Xerox Fees	276.50	577.00
Supervisory Fees	69,428.79	8,058.72

Examination Section

<u>Credit Union</u>		
Number	89	67
Assets	120,046,490	104,388,370
<u>Consumer Finance</u>		
Small Loan	166	137
Second Mortgage	130	103
Pawnbroker	2	2
<u>Broker-Dealer</u>		
	10	9
<u>Registration</u>		
3-O's and 6's	11	10
9's	6	2
Other Securities	2	1

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