# OHIO SECURITIES BULLETIN

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# Investor Suitability

*The following article is a reprint (in part) of the April 1988* Investor Alert *entitled "Unsuitable Investments."* Investor Alert *is a joint project of the North American Securities Administrators Association (NASAA) and the Council of Better Business Bureaus, Inc. (BBB). Reprinted with permission.*

Thousands of inexperienced and unsophisticated investors who were placed by brokers into "unsuitable" investment strategies suffered devastating losses or, even worse, ended up deeply in debt to brokerage firms, in the wake of the "Black Monday" stock market crash of October 19th. The largest share of these complaints of inappropriate investments involved the new generation of ill-understood and extremely high-risk investment strategies, particularly index and option trading, including "naked" puts, which exposed many investors to losses not seen since the crash of 1929.

A North American Securities Administrators Association (NASAA) analysis of more than 2,500 stock market crash victims shows that much of the over $457 million dollars in losses suffered by the small investors whose circumstances were reviewed in the study might have been prevented if their brokers had observed proper sales practices *before* Black Monday.

Fueled by inadequate regulation, increasingly esoteric speculation strategies and the lure of high commissions, the No. 1 abusive sales practice complaint detected in the NASAA study was failure by brokers to observe the "know your customer" or, as it also is known, the "suitability" rule, which requires that the investment recommendations of a broker be appropriate for the financial and other circumstances of the individual investor. A substantial 40 percent of all the complaints of unsuitable investments had to do with options, often cases where investor losses were multiplied several times over as a result of buying with borrowed money, which is known as being on margin.

* * *

The [suitability] concept is simple: brokers are professionals who should understand the ins and outs of the securities markets. All too often individual investors have limited knowledge and little time to fully master the intricacies of the rapidly-expanding and increasingly complex world of investments. Therefore, a legal and ethical burden is placed squarely on the shoulders of the broker to act in the best interests of the investor in making and executing investment recommendations.

Brokers are bound by a "know your customer" rule, which forbids them to place an investor in an investment for which he or she is "unsuited" in terms of depth of investment experience, net worth, annual income, investment objectives, and other factors. In theory, suitability rules are particularly strict when options trading is contemplated. The information used to determine suitability is collected when an investor opens an account with a brokerage firm and should be updated as needed thereafter. Courts and arbitration panels have established that brokers are responsible for the suitability of recommendations made to inexperienced investors.

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The basic concept of suitability is set out in New York Stock Exchange Rule 405, known as the "know your customer" rule, which requires stockbrokers to "(u)se due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried" by their firms. The suitability standard is embodied in a provision of the National Association of Securities Dealers (NASD) Rule of Fair Practice. The Code of Ethics and Business Conduct of the Association of Investment Brokers, a trade group of registered representatives, states: "Encouraging financial transactions not commensurate with a client's resources, or suggesting highly speculative ventures without explaining the extent and nature of the risk involved, shall be considered unethical."

It is in this context that the "Manual for Registered Representatives" of the Securities Industry Association (SIA) notes that: "... common sense should rule out recommendations that are unsuitable to the customer's circumstances. There have been many lawsuits against securities firms and individual salesmen based upon the claim that recommendations made to particular customers were not suitable for the customer's accounts in violation of SEC and NASD rules. Recent court decisions have held the Registered Representative to a very high standard."

### SUITABILITY IN PRACTICE

Every customer who opens an account with a brokerage firm sits down with a sales representative and fills out a customer agreement form. This can also be done over the telephone. In the form, the prospective investor is required to provide such details as name, address, phone number, employer, social security number, citizenship, spouse's name and employer, and investment objectives and the degree of risk the applicant is willing to assume in his or her investment strategy. If an investor trades on margin there is at least one more form, usually referred to as a "margin" or "hypothecation" agreement, to be completed. In theory, it is through this combination of detailed questioning and form filing that brokerage firms satisfy the suitability requirements imposed upon them by the fiduciary nature of the relationships with clients.

Due to the extremely high risk involved, options trading requires investors to go through what is intended to be an even more rigorous review process. If all goes according to the rules, an investor interested in trading in options is asked more probing questions than those posed to an investor in common stock. The rules of the Chicago Board of Options Exchange (CBOE) require that brokers get specifics about the following:

- Investment objectives (safety of principal, income, growth, trading profits, speculation)
- Employment status
- Estimated annual income from all sources
- Estimated net worth (exclusive of family residence)
- Estimated liquid net worth (cash, securities, other)
- Marital status; number of dependents

- Age
- Investment experience and knowledge (number of years, size, frequency, and type of transactions for options, stocks and bonds, commodities, other).

The prospective options investor is required to acknowledge the receipt of a current Options Clearing Corporation prospectus, which is intended to spell out for the customer the potential risks of investing in options. The customer also must return within 15 days of receipt a signed options agreement and verify the data displayed by the broker on the new accounts form. Rule 9.9 of the CBOE states that no broker "shall recommend to a customer an option transaction in any option contract unless the person making the recommendation has a reasonable basis for believing at the time of the making the recommendation that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risk of the recommended transaction, and is financially able to bear the risk of the recommended position in the option."

## PROBLEM AREA: THE OPTIONS "DOUBLE WHAMMY"

The theory of "know your customer" rules and the reality of how customers actually are recruited by brokers for options trading sometimes bear little resemblance to one another. The NASAA Investor Hotline study found that while options accounted for only 14 percent of the total number of investments analyzed in the study, 40 percent of all suitability complaints involved options. In proportional terms, the NASAA study found more than three times as many unsuitability cases reported by investors in options than was true of investors in common stocks.

The disturbing prevalence of the abusive sales practice of brokers placing investors in unsuitable high-risk option strategies is compounded by the low margin requirements for options, which may be as little as 5 percent, compared to the Federal Reserve's requirement of 50 percent for common stock. The twin factors of low margin requirements and lack of investor sophistication about new and complex option investments combined in a "double whammy" effect, which was particularly evident in those cases where investors had been placed by brokers in "naked" puts, options not backed by securities. Investors heavily-margined in options were left with large losses in their accounts, made worse, in many cases, by hefty debit balances, often many times greater than the initial commitments of cash.

* * *

Individual investors who suffered 1929-scale financial losses on Black Monday most likely were heavily margined in unsuitable option strategies. The NASAA Investor Hotline study alone found dozens of cases of investors who had lost every penny they had saved for down payments on homes, retirement funds, and college educations for their children. Some found themselves hopelessly in debt, facing the prospect of financial ruin. In most of these cases, if brokers had exercised due diligence in applying the "know your customer" rule, these staggering losses would have been prevented.

## PROBLEM AREA: MARGIN ACCOUNTS

Margin accounts increase the potential for profit *and loss* for investors. In a margin account, an investor puts up half of the face value of a desired amount of stock, and then uses the purchased 50 percent of the securities as collateral for a loan which is extended by the brokerage firm to complete the sale of the balance. This leverage makes it possible to make twice the gross profit which otherwise would be achieved in a straight cash transaction, but the leverage also works in reverse, doubling the risk of loss.

If the value of the collateral falls below the 50 percent or an otherwise specified maintenance mark, the brokerage firm will demand additional deposits of collateral, usually in the form of cash or other securities, to resecure the margin loan. This is known as a "margin call."

Margin accounts were once the exclusive domain of aggressive sophisticated speculators who engaged in complex and risky investment strategies, such as naked call writing and spreads, which are restricted under federal regulation to margin transactions. In recent years, however, total margin debt held by U.S. investors has quadrupled, to the extent that the margin trading is so pervasive that it now reaches, under the guise of the highly touted "central assets accounts," into the ranks of middle-income, blue-collar investors. Nevertheless, margin accounts are of little use to the average investor. The borrowed funds are subject to interest charges, which reached 20 percent during the hyperinflation of the 1970s. Higher commission charges are also present, since the margin trader tends to make more frequent trades, which, under margin, are twice as large as if made outright with cash. And while margin account holders sign "margin" or "hypothecation" agreements, few seem to understand the potential downside of being on margin, particularly when it comes to an option strategy.

The NASAA Investor Hotline study found that margin-related problems accounted for the third largest category of all "Black Monday" complaints. Many investors stated that they were not aware that brokers have the "worse case" right under margin agreements to liquidate *without advance notice or approval* all or most of an investor's portfolio to satisfy margin account requirements. Some investors in margin accounts complained that they had the cash or other securities to meet the margin calls, but either were not contacted, or, when contacted, were given an unreasonably short period of time to satisfy the call. It was evident that most margin account investors, both large and small, did not understand the consequences of being on margin in a rapidly declining market.

# Commissioner's Letter

## SECURITIES CONFERENCE

The Division will be conducting a two-day conference in the fall on Thursday, November 17 and Friday,

November 18 at the Hyatt Regency on Capital Square in Columbus. The first day's agenda will consist of panel discussions in an educational format with emphasis on current developments. The Division will seek continuing legal education credit for lawyers who attend. The second day will consist of advisory committee meetings (see below), also to be held at the Hyatt Regency. The Division will be distributing a detailed agenda later when plans become finalized.

**ADVISORY COMMITTEES**

Through input from the practicing securities bar and industry, coupled with our own analysis of current securities topics, a list of advisory committees has been formulated. To make this structure work for everyone, we have given the committees broad charges. It will be each committee's function to address specific issues within its subject area. Some committees may be large in membership size and broad in scope. However, to prevent size and scope from paralyzing the committee into inaction, it is envisioned that sub or ad hoc committees may be formed. Each committee should explore changes and additions to policies, statutes, and rules, as well as providing a mechanism for the exchange of information.

The purpose of these committees is to provide a forum for communications among the practicing securities bar, industry, academicians and the Division. These communications necessarily must flow in both directions. Therefore, all committees are to be considered advisory. The Division will provide its input through its committee members just as the other members will make their positions known to the Division. Two Division staff members will be assigned to each committee. They will serve as facilitators for communication between the Division and committee members.

It will be necessary for interested individuals to complete the form included at the back of this bulletin or to contact Paul Tague indicating your committee of choice. Membership will be limited to one committee, but there will be no restrictions on committee size. The following is a list of the committees and examples of issues that could be relevant to each:

1. Takeovers:

   —Amendments to 041 to conform with recent court cases.

   —Promulgation of rules pursuant to Revised Code Sections 1707.041 and 1707.042.

2. Exemptions:

   —Coordination of Proposed Reg D changes with our Act.

   —Incorporation of quantitative and qualitative standards into the marketplace exemption (Section 1707.02(E)).

   —Exemption of Rule 701 employee benefit plans.

3. Registration:

   —Review and discussion of amendments to NASAA guidelines.

   —Review and discussion of blank check blind pool offerings.

4. Enforcement:

   —Discussion of corrective filings—39's and 391's.

   —Possible addition of penalty fines as an administrative sanction.

5. Licensing:

   —Discussions on mandatory arbitration.

   —Elimination of bonding as a substitute for satisfying net worth requirements.

The initial meeting of these committees will take place in conjunction with the fall securities conference.

# Interesting Reading

*Investor Alert! How to Protect Your Money from Schemes, Scams, and Frauds,* The North American Securities Administrators Association & The Council of Better Business Bureaus (1988).

*Ohio Securities Law & Practice,* Howard M. Friedman (1987).

*Fundamentals of Securities Regulation,* 2nd Edition, Louis Loss (1988).

# Personnel

Dan Malkoff resigned from the Division in June to accept a position as Assistant Attorney General with the Ohio Attorney General's Office. Dan had served as a staff attorney in the enforcement section for over two years. His securities expertise will not go untapped in that he will be representing the Division as a part of his responsibility in the A.G.'s Business and Governmental Regulation Section. The Division wishes him well in his new position.

Patricia McDonald, enforcement staff attorney, resigned effective June 17. The Division wishes her well in her future endeavors.

# Registration

**TRANSACTIONS REQUIRING REGISTRATION BY DESCRIPTION: HOW TO AVOID THE MOST COMMON MISTAKES**

This article summarizes solutions to common mistakes and provides answers to frequently asked questions relating to registration by description pursuant to Section 1707.06 of the Ohio Revised Code. Its purpose is to set forth practical information rather than expound on the philosophy of this section of law. All of the mistakes and questions outlined here have occurred with sufficient regularity to warrant discussion.

The most common mistake on Form 6 filings has been the applicant's assumption that the particular policies, statutory language, or requests for exhibits are not applicable to the filing being prepared. Information describing the issuer, the transaction and the securities will be requested if not supplied. A common error has been for the applicant to not take into consideration all the requirements relating to registration by description. These requirements may be found in the relevant statutes, in the Ohio Securities Bulletin, and in the CCH Blue Sky Reporter. Please read the requirements before calling the Division with questions.

The current registration form is on letter-sized paper. The Division recently revised its forms relating to Revised Code Section 1707.06 to this smaller size. The forms require two signatures, the latter of which must be notarized, and a filing fee of $50.

Each item on the form must be completed. If the question is "Not Applicable", or the answer is "None", type that response on the line.

The line requesting the statutory agent should be completed with the name and address of the statutory agent appointed by the corporate issuer as filed with the Ohio Secretary of State's Office, or, if not filed with the Secretary of State, then the address to whom process or other notices should be mailed if served upon the Secretary of State. An issuer not domiciled in Ohio must also submit an irrevocable Consent to Service of Process, appointing the Ohio Secretary of State as agent.

Each exhibit requested, or a statement as to why a particular exhibit is inapplicable, should be supplied. If the applicant desires to incorporate certain documents by reference, the language incorporating the documents must contain a reference to a specific Division file number.

The three per cent limitation discussed in Revised Code Section 1707.06(A)(1) refers to the entire offering, not just Ohio investments. The cap of 35 on the number of investors in Revised Code Sections 1707.06(A)(2) and 1707.06(A)(3) refers to the total number of investors, not just Ohio investors. The requirement in Revised Code Section 1707.06(A)(4) that an offering without an underwriter be limited to existing security holders refers to the entire offering and not just investors in Ohio.

Please compare the current Articles of Incorporation or Partnership Agreement with the amount of securities to be offered, to verify that the offering amount doesn't exceed the authorized but unissued securities. Also, if the charter document does not authorize a particular class or type (e.g., no par value; preferred; Class A limited partnership interests), they should not be listed as part of the securities already issued, nor as part of the offering.

If the total amount of the offering exceeds $250,000, an offering circular must be provided to investors. The circular must, AT A MINIMUM, comply with the requirements of Rule 1301:6-3-06(G) of the Ohio Administrative Code. Risk Factors must be discussed thoroughly. The Division legend (see CCH Blue Sky Reporter) should appear in bold print on the front cover of the offering circular.

A filing may be amended to correct an error or omission. If the change is of any other type—e.g., change of the offering terms—a new filing must be made and the old file terminated.

The Division has promulgated an extensive rule relating to Form 6's in order to provide clearer direction to the applicant. This rule, 1301:6-3-06 of the Ohio Administrative Code, describes requirements relating to sales and advertising material, amendments to a filing, exhibits and supplemental information, and the minimum standards for an offering circular. Of particular note is paragraph (C) of the rule, relating to procedural aspects of the filing. When a filing is received, the Division will process the fee, enter the filing on its records, and assign the file to an examiner who will review the form and exhibits for compliance with the statutes and rule. If questions or problems are found, the Division may proceed formally or informally.

Pursuant to Revised Code Section 1707.13, the Division has the authority to issue a suspension order if it finds that the issuer has violated any section of the Securities Act or any rule or order promulgated thereunder, has engaged in fraudulent conduct, has disposed of its securities on unfair terms, or has committed any of the other enumerated acts or practices. As an alternative to suspension, the Division may issue a request for an amendment or for supplemental information. The issuer must respond to a request for amendment or supplemental information within 30 days or the filing may be deemed ineligible for filing and/or a suspension order may be issued. (Note, if an amended form must be filed, for any reason, the filing is effective on the date the amended form is completed.) The request for an amendment and/or supplemental information may be oral or in writing. It is the Division's desire to resolve any issues as quickly as practicable, without the issuance of a suspension order.

Note that the Division retains continuing jurisdiction to issue a suspension order pursuant to Revised Code Section 1707.13. The grounds for suspension are listed therein.

M.Quinn

## REGISTRATION GUIDELINES—CHEAP STOCK

The following is the current Escrow and Subordination Agreement required in applicable offerings having cheap stock.

The term "cheap stock" refers to equity securities received for less than the proposed public offering price. The cheap stock issue is raised if the corporation has issued equity securities to promoters, insiders, officers, directors, or five percent shareholders for consideration which is less than the proposed offering price in the pending registration.

For a determination of applicable offerings requiring the escrow, see the Division's policy statement regarding cheap stock in the April 1987 Securities Bulletin.

### ESCROW AND SUBORDINATION AGREEMENT

This Agreement, dated _____, 198___, is entered into by and between _____ (Company),

_____ (Escrow Agent), and _____ (Shareholders).

The Company has filed a registration application (File No. _____) with the Ohio Division of Securities (Division) pursuant to Section 1707.___ of the Revised Code. As a condition for the approval of the registration application by the Division, Shareholders have agreed to escrow certain shares subject to the terms of this Agreement. The terms of this Agreement commence upon _____.

Therefore, Shareholders have deposited with the Escrow Agent certificates evidencing _____ shares of _____ stock and the Escrow Agent acknowledges receipt thereof. See Exhibit A, incorporated in and a part of this Agreement, which details the Escrowed Shares.

Therefore, with respect to the Escrowed Shares the parties to this Agreement agree as follows:

1. The Escrowed Share certificates shall bear the following legend:

   "These shares are subject to certain restrictions, including escrow and subordination, and may not be transferred without compliance with the Escrow and Subordination Agreement, dated _____, 198___. This legend may be removed only if the shares are released from escrow by the terms of the Agreement."

2. The Escrowed Shares shall not be assigned, sold, hypothecated, pledged, transferred, or otherwise disposed (except by will, descent, or operation of law) until released from escrow.

3. Except as otherwise provided by this Agreement, any dividend, cash, stock, or property paid or issued with respect to the Escrowed Shares and any dividend, cash, stock or property paid or issued with respect to the Escrowed Shares by reason of any exchange of shares, merger, consolidation, recapitalization, reorganization or similar business combination shall be subject to the terms of this Agreement.

4. In the event the Company makes a distribution to its shareholders in connection with the liquidation, dissolution, bankruptcy, receivership, or sale of all or substantially all of the Company assets, then before any distribution is made to Escrowed Shares, the Company shall make a ratable distribution to all non-escrowed shares in an amount up to $ _____ (Public Offering Price) per share. Any remaining proceeds shall be distributed ratably to all shares, including those held in escrow. If the distribution consists of shares or other non-cash items, the fair-market value of the shares or other non-cash items shall be valued by an independent appraiser.

5. In the case of a tender offer to purchase all or substantially all of the company's outstanding shares, merger, consolidation, or reorganization into an unaffiliated entity, the Escrowed Shares shall be released from escrow if:

   a. Two-thirds of the non-escrowed shares (excluding all shares owned or controlled directly or indirectly by any officer, director, or person subject to this Agreement) are voted in favor of such tender offer, merger, consolidation, or reorganization.

6. Other than as specified by this Agreement, the Shareholder shall have all beneficial rights of ownership of the Escrowed Shares, including the right to vote the Escrowed Shares for all purposes.

7. All calculations used in this Agreement shall be adjusted should the Company make a share dividend or distribution of shares, have a stock split, have a reverse stock split, or otherwise reclassify its shares.

8. All Escrowed Shares shall be released by the Escrow Agent when:

   a. The Company has provided to the Escrow Agent and the Commissioner of Securities audited financial statements (per United States Generally Accepted Accounting Principles consistently applied and signed by a Certified Public Accountant) showing fully-diluted net earnings, after taxes and exclusive of extraordinary items, for a period of four consecutive quarters of at least $ _____ per share (12% of Public Offering Price) or for each of two consecutive periods of four consecutive quarters of at least $ _____ per share (6% of Public Offering Price); and

   b. The Escrow Agent has not received written objection from the Commissioner of Securities within thirty days of receipt of such audited financial statements by the Commissioner of Securities.

9. If the Escrowed Shares are not released pursuant to the terms of paragraph (7) above, then twenty-five per cent of the total amount of shares originally escrowed shall be released automatically on each of the fifth, sixth, seventh, and eighth anniversaries of the effective date of the registration (File No. _____) in Ohio as stated in the Division Order granting effectiveness. Shares shall be released ratably to all shareholders subject to this Agreement.

10. In performing any of its duties, the Escrow Agent shall not incur any liability for any damages, losses, or expenses, except for willful default or negligence. It shall not incur any liability with respect to any action taken or omitted in good faith upon advice of counsel or counsel for the Company given with respect to the duties and responsibilities of the Escrow Agent under this Escrow Agreement. The Escrow Agent may in good faith rely on the truth and accuracy of any information signed and submitted by proper persons which conforms with the provisions of this Agreement.

11. The Company and the Shareholders jointly and severally agree to indemnify and hold harmless the Escrow Agent against any and all losses, claims, liabilities and expenses, including reasonable costs of investigation, counsel fees and disbursements, which may be imposed upon or incurred by the Escrow Agent in connection with its acceptance of appointment as Escrow Agent.

12. The Escrow Agent's fees for serving as Escrow Agent under this Agreement shall be paid by the Company.

13. This Escrow Agreement may be executed in any number of counterparts with the same force and effect as if all parties had signed the same document.

14. All notices, requests, instructions or other communications required or permitted to be given under this Agreement shall be given in writing and delivered by Certified Mail or hand-delivered to all parties to this Agreement.

15. If the Escrow Agent is unable to perform its duties, a new escrow agent shall be appointed, a new Escrow and Subordination Agreement (identical in all respects to this Agreement) shall be entered into, and notice shall be given to the Division. The Escrow Agent must be satisfactory to the Division.

16. This Agreement shall be governed by and construed and interpreted in accordance with the laws of _____.

(Signature lines for Company, Escrow Agent, and Shareholders)

*EXHIBIT A*

(Shareholder addresses and number of shares escrowed; Company name, address, and contact person; Escrow Agent name, address, and contact person)

### OUTLINE OF REQUIREMENTS FOR 3-O FILING AVAILABLE

The Division's registration section has prepared an outline of the requirements for completing and filing a Form 3-O pursuant to Ohio Revised Code Section 1707.03(O). The outline covers questions that are frequently asked regarding this claim of exemption and discusses the requirements of law as specified in Revised Code Section 1707.03(O) and Administrative Rule 1301:6-3-03. The outline is currently available from the Division by calling (614)644-7381.

### REGISTRATION FILINGS

| Form Type | Second Quarter 1988 | Year to Date 1988 |
|---|---|---|
| 2(B) | 246 | 482 |
| 3-O | 2,847 | 6,230 |
| 3-Q | 355 | 773 |
| 3-W | 59 | 93 |
| 04 | 1 | 2 |
| 041 | 1 | 3 |
| 041(B)(4) | 0 | 1 |
| 5(A) | 0 | 1 |
| 6(A)(1) | 101 | 161 |
| 6(A)(2) | 40 | 74 |
| 6(A)(3) | 16 | 31 |
| 6(A)(3)OG | 0 | 0 |
| 6(A)(4) | 27 | 51 |
| 09 | 342 | 674 |
| 09OG | 2 | 3 |
| 091 | 490 | 911 |
| 10 | 0 | 0 |
| 39 | 50 | 83 |
| 391/09 | 3 | 5 |
| 391/3-O | 190 | 379 |
| 391/3-Q | 43 | 109 |
| 391/3-W | 0 | 3 |
| 391/6(A)(1) | 1 | 2 |
| 391/6(A)(2) | 0 | 0 |
| 391/6(A)(3) | 0 | 1 |
| 391/6(A)(4) | 0 | 1 |
| TOTAL | 4,814 | 10,073 |

# Enforcement

### ADMINISTRATIVE ORDERS

The following are summaries of recent enforcement administrative orders of note. The orders have been issued by the Division after notice of the parties' opportunity for an administrative hearing in accordance with Ohio Revised Code Chapter 119. Orders which have been appealed to the court system are so noted.

*Alan Richard Holman*

On February 26, 1988, the securities salesman license of Alan Richard Holman of Los Angeles, California, was suspended for a period of sixty days. The Division found that an administrative action had been instituted by the Securities and Exchange Commission against Holman, which resulted in a revocation of his securities registration and a suspension from association with any broker-dealer, municipal securities dealer, investment company, or investment advisor for a period of one year. In consideration of the suspension and revocation action, the Division found that Holman was not of good business repute, as defined in Ohio Administrative Code Rule 1301:6-3-15(O) and in accordance with Ohio Revised Code Section 1707.16.

*The Cable House, Ltd.; Charles Hatfield*

On March 1, 1988, the Division issued a Cease and Desist Order against The Cable House, Ltd., and Charles L. Hatfield, both of Cincinnati, Ohio. The Division found that unregistered sales of limited partnership units were made and commissions were paid in connection with sales to individuals not licensed as dealers or salesmen, in violation of Ohio Revised Code Sections 1707.44(A) and 1707.44(C)(1).

*Leslie James Dus, Jr.*

On March 10, 1988, the application for licensing as a salesman of securities of Leslie James Dus, Jr. of North Ridgeville, Ohio, was refused. The Division found that Dus had pleaded guilty to one felony count of drug abuse and two felony counts of aggravated trafficking in drugs. The Director of Commerce found that the applicant was not of good business repute as required by Ohio Revised Code Section 1707.16. The Order was appealed in Lorain County on March 28, 1988.

*Ohio Kentucky Limited Partnership 1987-1; Ohio Kentucky Oil Corporation; Thomas J. Carpenter*

On April 19, 1988, the Division issued a Cease and Desist Order against Ohio Kentucky Limited Partnership, Ohio Kentucky Oil Corporation, and Thomas J. Carpenter of North Canton, Ohio. The Division found that the private placement memorandum used in connection with the sales of limited partnership units contained false representations and omissions of material and relevant facts concerning federal income tax aspects. Ohio Revised Code Section 1707.44(B)(4) was found to have been violated.

*Susan R. Sawyer*

On May 4, 1988, a Cease and Desist Order was issued against Susan R. Sawyer of Federal Way, Washington. The Division found that Sawyer sold securities to a Cincinnati resident while she was unlicensed to sell securities, in violation of Ohio Revised Code Section 1707.44(A).

*Ward C. Argust; Rich-Morrow Insurance Agency, Inc., dba Artcraft Iron Company; Rich-Morrow Realty Co., Inc.; Equitrust Investment Co.; Equitrust Cash Fund*

On May 27, 1988, a Cease and Desist Order was issued against Ward C. Argust, Rich-Morrow Insurance Agency, Inc., dba Artcraft Iron Company, Rich-Morrow Realty Co., Inc., Equitrust Investment Co, and Equitrust Cash Fund, all of Mansfield, Ohio. The Division found that Ward C. Argust sold unregistered securities through all of these entities to Mansfield, Ohio, investors while he was unlicensed to sell securities, in violation of Ohio Revised Code Sections 1707.44(A) and 1707.44(C)(1). Further, Argust's conduct was found to have operated as a fraud upon the investors, in violation of Ohio Revised Code Section 1707.44(G).

*Donald H. Coots; Donald H. Coots & Associates*

On May 27, 1988, a Cease and Desist Order was issued against Donald H. Coots and Donald H. Coots & Associates, both of Wooster, Ohio. The Division found that Donald H. Coots, acting on behalf of Donald H. Coots & Associates, caused to be offered for sale and/or sold unregistered promissory notes, referred to as "Certificates of Deposit" by Coots, while he was unlicensed to sell securities. In addition, the Division found that false representations were made, including that a national bank had issued the securities and that 10% annual interest would be paid on a monthly basis. Ohio Revised Code Sections 1707.44(A), 1707.44(B)(4), 1707.44(C)(1), and 1707.44(G) were violated.

*J.P. Falcon Management Company; Richard Pivovar*

On May 3, 1988, the Division issued a Cease and Desist Order against J.P. Falcon Management Company and Richard Pivovar of Westerville, Ohio. The Division found that Richard Pivovar, under the name of J.P. Falcon Management Company, formed partnerships which were committed to purchasing and operating single family homes. These partnerships were comprised of clients of Pivovar who entered into a property management agreement with Pivovar whereby Pivovar was appointed the exclusive agent to analyze the investment potential of the single family home and to operate and manage said property for the benefit of the partnerships. Pivovar received a percentage of the purchase price and of the monthly rental income in consideration of the financial planning and management services rendered by Pivovar on behalf of the partnerships. The sale of the unregistered, non-exempt investment scheme by Pivovar while he was unlicensed to sell securities constituted violations of Ohio Revised Code Sections 1707.44(A) and 1707.44(C)(1).

*Nick Woloszyn*

On May 19, 1988, a Cease and Desist Order was issued against Nick Woloszyn, of Warren, Ohio. The Division found that Woloszyn, a public accountant doing business under the name of 1040-Tax Man, Inc., entered into an agreement with a client whereby Woloszyn would use the client's funds for the purpose of purchasing and selling Texas Instruments options. The agreement further provided that a percentage of the profits would go to Woloszyn as a commission. Ohio Revised Code Sections 1707.44(A) and 1707.44(C)(1) were found to have been violated.

*New Kensington Tower Investments, Ltd.*

On May 23, 1988, the Division issued a Cease and Desist Order against New Kensington Tower Investments, Ltd., of Cleveland, Ohio. The Division found that incorrect dates of sale were reported on a Form 3-Q filing made with the Division on behalf of New Kensington Tower Investments, Ltd. Ohio Administrative Rule 1301:6-3-03(K) determines the date of sale to be the earlier of the date a subscription agreement or its equivalent is signed by the purchaser or the date the purchaser transfers or loses control of the purchase funds. Ohio Revised Code Sections 1707.44(A) and 1707.44(C)(1) were found to have been violated. The Division also declared null and void the Form 3-Q, File Number 329875, filed with the Division on behalf of New Kensington Tower Investments, Ltd., which reported incorrect dates of sale.

## SUSPENSION ORDERS

*Financial Service Group, Inc.*

Pursuant to Ohio Revised Code Section 1707.13, on March 2, 1988, the Division issued a Suspension Order to Financial Service Group, Inc., a Worthington based financial planning firm. The Division alleged that representatives of Financial Service Group had sold interests in a mortgage pool to Ohio residents without proper registration, in violation of Ohio Revised Code Section 1707.44(C)(1), and without being properly licensed, in violation of Ohio Revised Code Section 1707.44(A). Also named in the Suspension Order were Financial Service Associates, Inc., an affiliated firm, and Arthur P. Miller, Robert D. Hamilton, Stephen E. Tumblin, and Jerry W. Snyder, principals of the two companies.

In accordance with Revised Code Section 1707.13, a hearing on the confirmation or revocation of the Suspension Order was scheduled for March 14, 1988. Prior to the hearing, the Division entered into consent agreements with all of the parties whereby it was stipulated that the Suspension Order be confirmed and the rights of Financial Service Group, Inc. *et al.* to buy, sell or deal in the mortgage pool interests be suspended.

The Division's investigation into this matter is continuing.

## OTHER FINAL ADMINISTRATIVE ORDERS

| Respondent | Date Issued | Order No. | Action Taken/ Type of Order |
|---|---|---|---|
| 1600 Pasadena Offices, Ltd.; Terry E. Coone<br>South Pasadena, Florida | 2/28/88 | 88-024 | Cease & Desist |
| Jerry Lee Smith<br>Dayton, Ohio | 2/29/88 | 88-030 | Cease & Desist |
| Your Financial Community of Ohio, Inc.<br>Form 3-Q, File No. 330641<br>Worthington, Ohio | 3/1/88 | 88-031 | Null & Void<br>Cease & Desist |
| Terry L. Purdy dba Profit Phones<br>Columbus, Ohio | 3/11/88 | 88-040 | Cease & Desist |
| Georights, Inc.; E. Richard Brown<br>Westlake Village, California | 3/17/88 | 88-041 | Cease & Desist |
| Bond Services International Corporation; Mitchell Rymar<br>Hollywood, Florida | 3/21/88 | 88-044 | Cease & Desist |
| Strack Securities Service Corporation; Stan Hefferman<br>Spring, Texas | 3/24/88 | 88-047 | Cease & Desist |
| The Cleveland Film Associates; Pius A. Uzamere<br>Cleveland, Ohio | 3/31/88 | 88-051 | Cease & Desist |
| Donald E. McDowell dba 804 Enterprises<br>Form 3-Q, File No. 333678<br>New Carlisle, Ohio | 4/22/88 | 88-056 | Null & Void<br>Cease & Desist |
| Urology Limited Partnership<br>Form 3-Q, File No. 335028<br>Cincinnati, Ohio | 4/7/88 | 88-058 | Null & Void<br>Cease & Desist |
| Ronmar Energy 1984-1<br>Form 3-Q, File No. 326423<br>Akron, Ohio | 4/13/88 | 88-062 | Null & Void<br>Cease & Desist |
| Little Screamer Group Limited, Inc.; Gerald E. Roseberry<br>Mansfield, Ohio | 4/20/88 | 88-066 | Cease & Desist |
| Ronmar Energy 1984-2<br>Form 3-Q, File No. 326424<br>Akron, Ohio | 4/20/88 | 88-067 | Null & Void<br>Cease & Desist |
| Premium Equities Corporation<br>Form 3-Q, File No. 324149<br>Boardman, Ohio | 4/25/88 | 88-068 | Null & Void<br>Cease & Desist |
| Charles J. Garr<br>Boca Raton, Florida | 4/2/88 | 88-071 | Cease & Desist |
| Protext Biostatics, Inc.<br>Milford, Ohio;<br>Richard Kemper<br>Mariemont, Ohio;<br>Douglas Oberklaus<br>Cincinnati, Ohio | 5/3/88 | 88-072 | Cease & Desist |
| HHF Pacers-84<br>Grafton, Ohio | 5/19/88 | 88-085 | Cease & Desist |
| The New Grandview Inn, Inc.<br>Form 3-Q, File No. 323848<br>Columbus, Ohio | 5/5/88 | 88-089 | Null & Void<br>Cease & Desist |

**CRIMINAL CASES**

| Case Names | Jurisdiction/ Referring Staff Person | Action Taken | Comments |
|---|---|---|---|
| Mel J. Hartwell | Montgomery County/ referred by Corey Crognale | 1. Indicted on 3/4/88 for the following:<br>a. 29 counts of unlicensed sales of securities;<br>b. 29 counts of selling unregistered, non-exempt securities; and<br>c. 20 counts of theft. | Mel J. Hartwell raised approximately $360,000 from October 25, 1985, through June 6, 1986, by selling shares of Aerospace Management Sales, Inc., to Ohio investors, and misappropriated sale proceeds by placing the funds in his personal bank account. |
| Dennis Leary | Franklin County/ referred by Karen Terhune | 1. Pled guilty on 3/4/88 to one count of unlicensed sale of securities.<br>2. Sentenced on 4/13/88 to 18 months in prison. Imprisonment was suspended and probation of 6 months was imposed. | Dennis Leary, a former salesman for American Heritage Research, Inc., sold units in a nonexistent fund called the Aggressive Cash Management Fund. Investors were told that funds would be pooled to purchase strategic and precious metals. |
| Edward Cecutti | Hamilton County/ referred by Clyde Kahrl | 1. Indicted on 3/15/88 for the following:<br>a. 2 counts of unlicensed sales of securities;<br>b. 2 counts of selling unregistered, non-exempt securities;<br>c. 2 counts of non-disclosure of insolvency in the sale of securities. | Edward Cecutti operated Mutual Credit Services, Inc, a company which financed other business enterprises by selling "subordinated debentures" to the public. He was not licensed to sell securities, the debentures were not registered or exempted, and he had not disclosed that his companies were insolvent in taking investments as late as one month prior to declaring bankruptcy. Cecutti was on probation for mail fraud at the time. |
| Kim Little | Franklin County/ referred by Melanie Braithwaite | 1. Pled guilty on 4/18/88 to 15 felony counts of securities violations | Kim Little, former secretary-treasurer of Littlefield Oil Co., was a co-defendant in the Littlefield Oil Co. case. He was indicted on various counts of selling unregistered securities, selling securities without a license, misrepresentation in the sale of securities, and securities fraud. See the April 1988 Bulletin. |
| Paul Atterholt; Randolph Baker; Lavon Bailey; Eugene Tye | Franklin County/ referred by Melanie Braithwaite | 1. Pled guilty on 4/18/88 to misdemeanor counts of securities violations as follows:<br>a. Atterholt - 14 counts;<br>b. Baker - 3 counts;<br>c. Bailey - 1 count; and<br>d. Tye - 1 count. | These four co-defendants were salesmen for Fortune Securities, Inc., an affiliate of Littlefield Oil Co. See the April 1988 Bulletin. |

# Takeovers

*VEERE INC. v. THE FIRESTONE TIRE & RUBBER COMPANY, et al.*
(N.D. Ohio E.D.) Case No. C88-0571A; Judge Batchelder

3/7/88 * Veere Inc. commenced a tender offer for all of the shares of Firestone. On the same day, Veere initiated an action in federal court challenging the constitutionality of Revised Code Section 1707.041 (Take-Over Act); Revised Code Section 1707.042 (Takeover Anti-Fraud Statute); Revised Code Section 1701.831 (Control Share Acquisition Act); and Revised Code Chapter 1710 (Foreign Business Acquisition Act). Motion for a TRO to enjoin enforcement of the Take-Over Act and the Foreign Business Acquisition Act was denied.

3/8/88 * Veere filed a Schedule 14D-1/Form 041 with the Ohio Division of Securities.

3/14/88 * Hearing on Veere's motion for a preliminary injunction, seeking to have the Ohio Control Share Acquisition Act declared unconstitutional. The other statutes were not at issue in the hearing. The Take-Over Act and the Takeover Anti-Fraud Statute were not ripe for review. The State had agreed beforehand not to enforce the Foreign Business Acquisition Act.

3/16/88 * Decision by Judge Batchelder was issued. This decision noted that the Take-Over Act and Takeover Anti-Fraud statute were not ripe for review, and the opinion was limited to the Control Share Acquisition Act. The court analyzed the Ohio statute under the principles set forth in *CTS Corp. v. Dynamics Corp. of America*, 107 S.Ct. 1637 (1987), and held:

—Control Share Acquisition Act was held not to be directly preempted by the Williams Act because it is physically possible for bidders to comply with both statutes. Likewise, the state statute did not frustrate the purpose of the federal statute and therefore was not indirectly preempted; the "fact that under Ohio law the tender offeror must hold open his tender offer for longer than the minimum period provided by federal law in order to obtain acquisition of control shares" was not held to be fatal because it furthered the federal policy of investor protection.

—The Act did not directly burden interstate commerce because "the Ohio Act neither discriminates against interstate commerce nor subjects activities to inconsistent state regulation, since the Ohio Act also has the same effects on resident as non-resident offerors, and it also applies only to the control acquisition of corporations which Ohio has created." The court further held that there was no indirect burden because only domestic corporations were governed by the Act, and States have a legitimate interest in "allowing shareholders collectively to determine whether the take-over is advantageous to their interests." Finally, the court discussed the fact that the Ohio Act did not have a shareholder nexus requirement, and found that resident shareholder provision "is not essential to prevent the statute from creating an impermissible burden on interstate commerce."

3/22/88 * The Division issued an order stating that "upon review of all of the documents filed in this matter, pursuant to Ohio Revised Code Section 1707.041(B)(1)(a), no hearing is ordered by the Division of Securities."

*AB ELECTROLUX et al. v. THE MURRAY OHIO MANUFACTURING COMPANY*
(S.D. Ohio E.D.) Case No. C2-88-0568; Judge Graham

5/24/88 * A subsidiary of AB Electrolux commenced a tender offer for all of the outstanding shares of Murray Ohio. Late the preceding day, the bidder initiated an action in federal court challenging the constitutionality of Revised Code Section 1707.041 (Take-Over Act); Revised Code Section 1707.042 (Takeover Anti-Fraud Statute); and Revised Code Chapter 1710 (Foreign Business Acquisition Act); and sought to have Revised Code Section 1701.831 (Control Share Acquisition Act) declared inapplicable.

5/26/88 * A hearing was held on plaintiffs' request for a TRO. Based on the parties' assessment that agreements could be reached regarding the Ohio statutes, no TRO was issued.

5/31/88 * Plaintiffs and defendant Murray Ohio entered into an agreed order whereby Murray Ohio stipulated that the Ohio statutes were "either unconstitutional, inapplicable, or Murray does not intend to invoke their provisions." Also, plaintiffs filed the Form 14D-1/Form 041 with the Division of Securities.

6/1/88 * Plaintiffs and the State Defendants entered into a stipulation filed with the court that plaintiffs would file a Scheduled 14D-1 with the Division, thereby substantially complying with the requirements of Revised Code Section 1707.041, and that the Division would

give plaintiffs 24 hours notice prior to ordering any hearing under the statute. The parties also agreed that the State Defendants would not invoke the Foreign Business Acquisition Act, and that, based on the facts before it, the Control Share Acquisition Act did not apply to plaintiffs' tender offer.

6/10/88 * The Division issued an Order stating that "upon review of all of the documents filed in this matter, pursuant to Ohio Revised Code Section 1707.041(B)(1)(a), no hearing is ordered by the Division of Securities."

*FLEET AEROSPACE CORPORATION v. HOLDERMAN*

(6th Cir.) Case No. 86-3533/3536; Judges Kennedy, Wellford, and Peck

On June 6, 1988, the Sixth Circuit remanded the *Fleet* case to district court for further consideration. The appellate court held that the trial court was the proper tribunal to rule on whether the case is moot, and whether the district court's injunction of June 11, 1986, holding the Control Share Acquisition Act unconstitutional, had any "continuing vitality."

## FEDERATED TAKEOVER CHRONOLOGY

By popular demand, the following chronology is an appendage to the Federated Takeover Chronology printed in the last issue of the *Bulletin* (88:1).

3/17/88 * SEC staff recommends that Campeau bid be extended until five days after Campeau announces definitive financing, but rejects Macy's request for a twenty-day extension to the Campeau bid.

3/18/88 * The New York federal court upholds the legality of the Federated "poison pill." Campeau will thus be forced to extend its offer until Federated deletes its poison pill in order to allow the Macy's bid to go forward.

* Macy's clears all remaining antitrust hurdles.

3/22/88 * Campeau raises its bid to $73 per share conditioned upon the removal of Federated's "poison pill," thus making this offer the largest non-oil takeover ever.

3/30/88 * Campeau and Macy's both submit raised bids to the Federated Directors with Campeau emerging as the apparent front-runner with an offer of $74 per share.

3/31/88 * Macy's raises its bid to $78.92 for 80% of Federated, plus $60 in cash or stock for the remainder.

4/3/88 * Federated agrees to be acquired by Campeau for $73.50 a share or $6.6 billion. The poison pill is withdrawn. Macy's drops its bid in return for the right to buy Federated's I Magnin and Bullock's-Bullock's Wilshire divisions for $1.1 billion. Campeau will also pay $60 million of Macy's expenses from the battle.

4/88 through 5/88 * Following the agreement among the parties, over 90% of the shares of Federated were tendered to Campeau, thereby allowing Campeau to later complete a "short form" merger.

**SECURITIES COMMITTEE SELECTION FORM**

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