OHIO SECURITIES BULLETIN

John R. Kasich
Governor of Ohio

Andre T. Porter
Director of Commerce

Andrea Seidt
Commissioner of Securities

SUITABILITY REQUIREMENTS IN DIRECT PARTICIPATION PROGRAMS

Department of Commerce
Division of Securities

Investor Protection Hotline
1-877-N-VEST-411
1-877-683-7841
TTY/TDD - 1-800-750-0750
http://www.com.ohio.gov/secu

Ohio Securities Bulletin

Issue 2013: 2

Table of Contents

OHIO

DEPARTMENT OF
COMMERCE
DIVISION OF
SECURITIES

The Division has received several inquiries in recent months regarding the 10% concentration limit applicable to Direct Participation Program ("DPP") offerings, such as non-traded real estate investment trusts ("REITs"), business development companies, oil and gas drilling programs, equipment leasing programs, and commodity pools. Direct Participation Programs are complex securities offerings, with disclosure documents often in excess of 300-400 pages. DPPs involve substantial risks, including severe restrictions on liquidity that may lock-in investors indefinitely, complicated corporate structures that pose potential conflicts of interest for management, upfront fees and expenses ranging between 12% - 18% of the initial offering price and substantial on-going fees thereafter, leverage ratios that may exceed 300% of net assets, and distributions to shareholders paid from borrowings or a return of the shareholder's investment after deducting fees paid to insiders. Broker-dealers are highly incentivized to sell these products by the 7% - 10% commissions commonly charged to investors, some of the highest selling commissions of any investment product available.

Due to the complex and risky nature of DPPs, the Division and other regulators have set suitability standards to ensure the products are being marketed and sold to appropriate investors. Suitability is a legal obligation of the person or persons selling or recommending a security or investment strategy to determine that the security or strategy is appropriate for the person to whom it is being sold or recommended. One of the common suitability standards for DPPs is a concentration limit that encourages diversification in investor portfolios by limiting the percentage of the portfolio that may be allocated to a specified investment, sponsor, or asset class. The limit seeks to protect all investors, particularly elderly investors to whom DPPs are often marketed, from over-concentrating their portfolios in illiquid DPPs.

REGULATORY SUITABILITY – FINRA RULE 2111, NASAA GUIDELINES, AND OHIO ADMINISTRATIVE CODE

Suitability standards applicable to DPPs, like the concentration limit, come from several sources. FINRA Rule 2111[1] applies to all FINRA-member broker-dealer firms and representatives, and was discussed in detail in the first quarter 2013 edition of the Ohio Securities Bulletin. FINRA Rule 2111 sets out a number of factors that a broker-dealer should consider when determining suitability, including: but not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose.

The Division's dealer suitability rule is set out in O.A.C. section 1301:6-3-19(A)(5).[2] The Division interprets the "reasonable grounds…reasonable inquiry" requirement of O.A.C. section 1301:6-3-19(A)(5) to include all of the factors identified in FINRA Rule 2111 as well as the North American

continued page 4

Comments from Commissioner Andrea Seidt

Happy Spring (finally) to all Securities Bulletin subscribers. The Division participated in the North American Securities Administrators Association's Annual Spring Conference at the Mayflower Hotel in Washington, D.C. on April 15-16. I moderated a panel at the Conference focused on the timely subject of cost-benefit analysis in the context of SEC rulemaking. Speakers for my panel included Vanessa Countryman, Deputy Chief Counsel for the SEC's Office of Risk and Financial Strategy and Innovation; Mercer Bullard, Associate Professor of Law at the University of Mississippi School of Law; and Eugene Scalia, Partner at Gibson, Dunn & Crutcher. The panel received rave reviews for providing a lively but informative debate on the importance of economic analysis in the rulemaking process. I will certainly bring back what I learned to enhance our own rulemaking analyses here in the Division.

The Division staff and I are fortunate to have participated in other important events since our last Bulletin. One such stand-out event was the 2012 Corporate Law Symposium hosted by Professor Barbara Black and the University of Cincinnati College of Law on March 15. The focus of this year's symposium was "Addressing the Challenges of Protecting the Public: Enforcement Practices and Policies in the Post-Financial Crisis Era." The staff and I learned so much from the impressive line-up of speakers that day and I was honored to speak in the final panel regarding all of the great work that my staff has performed this past year to protect Ohio investors. The Division has had a particularly busy year on the criminal front and sharing the fruits of the Enforcement Section's labor was very relevant to the conference theme.

On to operations: As previously reported, the Division is in full swing deployment of its new securities database system known as STAR. The Division went live on the internal side of the application the second week of April and anticipates deploying online functionality later this summer. Some information on the Division's website may be temporarily unavailable during the implementation, including information from the Bulletin and ERNIE portals, as we seek to improve these services for you. Please do not hesitate to contact Division staff directly if you are unable to retrieve content or have any questions or concerns along those lines.

Finally, plans are under way in preparation for the 2013 Ohio Securities Conference. If you have ideas for potential panels or have other suggestions on ways to improve this year's Conference, please let the Conference Chair Shannon Himes or me know. We can be reached at shannon.himes@com.ohio.gov or andrea.seidt@com.ohio.gov.

Andrea Seidt
Securities Commissioner

Don't Miss Out on This Year's Conference!

If you would like to receive information on the 2013 Ohio Securities Conference, we would be happy to forward registration information when available.

Please provide your contact information, including email address, to

Shannon.Himes@com.ohio.gov

Information and Form Requests: 614-644-7381

General Inquiries: securitiesGeneral.Questions@com.ohio.gov

Sign up to receive the quarterly Bulletin:
karen.bowman@com.ohio.gov

Message from Commerce Director Andre T. Porter:

As you may know, Governor John R. Kasich recently appointed Commerce Director David Goodman as Director of the Ohio Development Services Agency. David did an outstanding job in leading the Department of Commerce and serving the citizens of Ohio for the past two years.

I am honored that Governor Kasich has appointed me as the new Director of the Department of Commerce – with this being my first week on the job.

Please allow me to briefly introduce myself. Most recently, I served as a Commissioner at the Public Utilities Commission of Ohio and assisted in the regulation of Ohio's public utilities. Prior to that, I was an attorney in private practice focused on real estate taxation and public utilities law, in addition to providing general counsel for public agencies. I plan to put my private and public sector experience to work at the Department of Commerce.

I'm especially looking forward to working with Ohio's securities industry as we pursue common sense ideas that can raise capital to grow Ohio's economy. Throughout the department, we will be focused on providing extraordinary customer service by assisting businesses to create jobs while safeguarding Ohioans.

Since the last issue of the Bulletin, the Division of Securities issued a notice order against a United Kingdom company and its operators. The action, which alleges that Ohio securities laws have been violated, joined enforcement actions taken or investor alerts issued by securities regulators in 15 other states and five Canadian provinces.

The Division's action alleged that Inter Reef, Ltd. doing business as Profitable Sunrise, its owner Roman Novak, and his brother Radoslav Novak engaged in securities fraud, selling securities without a license, and selling unregistered securities. The Division is concerned that these businesses could be targeting religious-based organizations with Bible quotations on its website and options for donating investment returns to charity. The website promotes extraordinary rates of return while claiming the investments are "risk-free" with "no chance of default."

The Division is seeking information from Ohioans who may have invested with Profitable Sunrise, Inter Reef, Ltd., Roman Novak, Radoslav Novak or any affiliated individuals or entities. Ohioans are encouraged to call the Division's Investor Protection Hotline or file a complaint online.

As we work to serve you better, Commissioner Seidt and I want to hear any thoughts and ideas you may have. Please feel free to call me or email me any time: 614-466-2186 or andre.porter@com.ohio.gov

Sincerely,

Andre T. Porter
Director, Ohio Department of Commerce

Looking for a past issue of the Bulletin?

If you are in need of a past Bulletin issue, you can find past issues on the Division's website at www.com.ohio.gov/secu/bulletins.aspx.

From this page, you can use the Abstract Search function to search by title, author, issue or abstract.

We currently have links on the website for issues dating 1994 to 2012. For issues prior to 1994, please contact Karen Bowman at 614-995-5791 or via e-mail karen.bowman@com.ohio.gov for a hard copy of that issue.

The Ohio Securities Bulletin is a quarterly publication of the Ohio Department of Commerce, Division of Securities.

The Division encourages members of the securities community to submit for publication articles on timely or timeless issues pertaining to securities law and regulation in Ohio. If you are interested in submitting an article, contact Karen Bowman at karen.bowman@com.ohio.gov for editorial guidelines and publication deadlines. The Division reserves the right to edit articles submitted for publication.

Ohio Division of Securities
77 South High Street, 22nd Floor
Columbus, Ohio 43215-6131

http://www.com.ohio.gov/secu

Securities Administrators Association ("NASAA") statements of policy applicable to DPPs.[3] The NASAA Guidelines generally require the sponsor and each person selling securities on behalf of the sponsor or issuer to make every reasonable effort to determine that the purchase of the securities is a suitable and appropriate investment for each investor.[4] The NASAA Guidelines also provide a non-exclusive list of relevant suitability factors and establish net worth and net income thresholds for determining minimum eligibility to purchase.[5]

OHIO PROSPECTUS SUITABILITY

The final source of suitability standards applicable to an offering is the prospectus itself. Often called "prospectus suitability," this is where the concentration limit is incorporated into an offering during the registration process. Negotiations with issuers may result in subtle variations in the wording of the standard printed in the prospectus, but the mathematical effect should always be the same. By writing the concentration limit language into the prospectus, the issuer adopts it as its own and should be prepared to assist securities salespeople in interpreting and complying with the limit.

With this suitability framework in mind, the Division has imposed for many years a concentration limit of 10% of the investor's liquid net worth in securities of a particular DPP issuer. While the Division did not initially include affiliates of the issuer or other similar programs in the prospectus restriction, over time the Division observed that the restriction failed to limit an investor's exposure to the risk of overconcentration in different securities of the same sponsor, or the risk of overconcentration in investments of the same asset class or industry sub-sector. In short, the limitation did not encourage sufficient diversification to mitigate these risks. As programs in the non-traded DPP space became more numerous and more complex, the Division clarified the concentration limit in 2011 to expressly include the following language in order to keep pace with the changing risks of an ever-evolving market:

It shall be unsuitable for an Ohio investor's aggregate investment in shares of the Issuer, Affiliates of the Issuer, and in other non-traded {program type} programs to exceed ten percent (10%) of his, her, or its liquid net worth. "Liquid net worth" shall be defined as that portion of net worth (total assets exclusive of primary residence, home furnishings, and automobiles minus total liabilities) that is comprised of cash, cash equivalents, and readily marketable securities.

HOW TO CALCULATE CONCENTRATION LIMIT

Embedded within the concentration limit are two calculations that must be performed every time suitability is to be assessed. The first is calculating the investor's liquid net worth. Arriving at a figure representing 10% of an investor's liquid net worth requires the following steps:

(1) TOTAL ASSETS
- Primary Residence
- Home Furnishings
- Automobiles
- TOTAL LIABILITIES

= NET WORTH[6]

(2) NET WORTH
- All Net Assets other than Cash, Cash Equivalents, and Readily Marketable Securities[7]

= LIQUID NET WORTH

(3) LIQUID NET WORTH
x .1

= MAXIMUM INVESTIBLE AMOUNT

This calculation considers only the investor's balance sheet and not the investor's portfolio. The Maximum Investible Amount as calculated above assumes that the investor has no existing investments in securities of the Issuer, Affiliates of the Issuer, or other similar non-traded DPPs. Thus, the second required calculation is to determine how much of the Maximum Investible Amount has already been deployed, and, if not all of it has been, how much remains available to invest.

Unlike suitability, which is a non-exclusive multi-factor assessment involving both quantitative and qualitative elements, concentration is a simple arithmetic snapshot. Because the concentration limit is expressed as a percentage, the calculation involved is simple division. The numerator is the *current* amount of the particular investor's *aggregate* investment in securities of the Issuer, Affiliates of the Issuer, and other similar non-traded DPPs. The denominator is the *current* amount of the particular investor's Liquid Net Worth, as calculated above. The quotient is the investor's current level of concentration in securities of the Issuer, Affiliates of the Issuer, and other similar non-traded DPPs. Concentration is a snapshot, meaning that it evaluates an investor only at a particular moment in time rather than on an ongoing basis. Because concentration is a snapshot, both the numerator and denominator of the concentration percentage must be calculated anew each time a non-traded DPP is recommended to a customer.

continued page 5

PRACTICAL APPLICATION

To illustrate how the concentration limit works in practice, consider the following hypothetical. Customer has a Liquid Net Worth of $100,000, no current investments in DPPs, and would like to invest in non-traded REITs. Customer's concentration is: $0 (invested in non-traded DPPs) / $100,000 (Liquid Net Worth) = 0% (concentration). Customer may invest up to 10%, or $10,000, in non-traded REITs. Customer invests $10,000 in REIT A. Now Customer's concentration is: $10,000 (invested in REIT A) / $90,000 (Liquid Net Worth) = 11.1%. Customer may not invest in any additional non-traded REITs at this time. But, because the calculus is always considered on an as-current basis, the investment in REIT A does not necessarily prevent Customer from investing in additional non-traded REITs in the future. For example, if after investing in REIT A, Customer receives an inheritance of $60,000 cash, Customer's concentration is then: $10,000 (invested in REIT A) / $150,000 (Liquid Net Worth) = 6.67%. Customer may invest up to $5,000 in additional non-traded REIT securities.

In algebraic terms, the formula is: $(A + B) / C \leq 10\%$, where **A** is the current amount of the investor's aggregate investment in securities of the Issuer, Affiliates of the Issuer, and other similar non-traded DPPs; **B** is the amount of the prospective additional purchase of securities of the Issuer, Affiliates of the Issuer, or other similar non-traded DPPs; and **C** is the investor's Liquid Net Worth immediately preceding the purchase of B. If this formula yields 10% or less, then the prospective purchase of B complies with the standard. If the product of the formula exceeds 10%, then the prospective purchase of B does not comply with the standard and will be considered by the Division to be unsuitable.

Prior to the Division's clarification in 2011 regarding affiliates and related programs, a salesperson would have been able to sell to Customer 10% of Customer's Liquid Net Worth in REIT A, 10% in REIT B, 10% in REIT C, and so on until nearly 100% of Customer's liquid assets were locked into illiquid REIT securities. This is the risk the revised concentration limit language seeks to reduce. By adding each prospective purchase of a similar program into the numerator, additional DPP purchases will no longer be suitable absent a corresponding increase in Liquid Net Worth.

A prospectus suitability standard applies to an offering for its duration. This means that DPP offerings registered by the Division are subject to the concentration limit printed in that program's prospectus. So long as each prospective purchase complies with the concentration limit printed in that program's prospectus, such purchase will be considered to be in compliance for purposes of prospectus suitability. However, complying with a prospectus suitability standard does not necessarily mean that the sale or recommendation satisfies FINRA Rule 2111, O.A.C. section 1301:6-3-19(A)(5), or an investment adviser's fiduciary duty. In order to remain in compliance with these provisions, securities professionals should be able to demonstrate that each recommendation or sale complied with all applicable rules and guidelines. Certainly, complying with Ohio's current concentration limit, even when not explicitly required, should help securities professionals comply with all suitability standards.

IMPORTANT TIP: Issuers of offerings registered under the old version of the concentration limit should be aware that the concentration limit applicable to their offering will be updated to the revised language as part of any renewal or follow-on registration application. Within one year of the date of this Bulletin, all active offerings should have adopted the current concentration standard.

A WORD ABOUT DRIPS

Another possible portfolio effect of the revised concentration limit relates to Distribution Reinvestment Plans, or DRIPs. A DRIP is a voluntary plan offered by some DPP sponsors that allows participating shareholders to automatically purchase additional shares using distributions from the company that would otherwise be paid to the shareholder in cash. What many do not realize is that each distribution reinvestment is a separate sale of securities pursuant to R.C. 1707.01(C)(1). Each distribution reinvestment triggers a broker-dealer's obligation to determine that the purchase of additional shares is suitable and appropriate for the participating shareholder.

In applying the concentration limit, each distribution reinvestment is added to the numerator and, since no cash is received by the shareholder, there is no change in the denominator.[8] Intuitively, each distribution reinvestment increases a shareholder's concentration, whereas receiving distributions as cash decreases concentration. Securities professionals should be careful to avoid inadvertent unsuitable sales to DRIP participants who are already at or near 10% concentration. Additionally, it would be unsuitable for a customer who has purchased up to his, her, or its Maximum Investible Amount in non-traded DPP securities to enroll in a DRIP.

continued page 6

CONCLUSION

Issuers, broker-dealers, and investment advisers should be aware that the concentration standard is subject to change to keep pace with developments in the non-traded DPP market. FINRA Rule 2111 and O.A.C. section 1301:6-3-19(A)(5) apply to broker-dealers and their salespeople independently of, and in addition to, prospectus suitability. The obligation to determine suitability is on the salesperson and broker-dealer, and may not be shifted to the customer,[9] or waived or modified by the customer or the Division. A salesperson and broker-dealer are not relieved of liability because a customer consented in, or even demanded, an unsuitable investment.[10] If you have specific questions regarding any of the topics discussed in this article, please contact Seth Hertlein in the Registration Section at 614-466-4375 or seth.hertlein@com.ohio.gov.

---

[1] (a) A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation. FINRA Rule 2111(a). *See also*, FINRA Regulatory Notices 11-02, 11-25, 12-25, and 12-55.

[2] No dealer or salesperson shall: (5) Sell, purchase, or recommend the sale or purchase of any security without reasonable grounds to believe that the transaction or recommendation is suitable for the customer, based upon reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other relevant information known to [the] dealer or salesperson.

[3] While FINRA Rule 2111 and O.A.C. section 1301:6-3-19(A)(5) are legally applicable only to broker-dealer firms and their salespeople, investment adviser firms and representatives are subject to an even higher standard: fiduciary duty. Investment advisers are fiduciaries to their clients, which generally means that when acting on behalf of a client, they must act in the client's best interest. Though not the same as fiduciary duty, suitability can be informative in this regard and can help to guide an adviser in acting in the best interest of the client. Investment advisers and investment adviser representatives should think of suitability as a starting point for fulfilling their fiduciary obligations to their clients. Additionally, both broker-dealers and investment advisers are subject to NASAA guideline suitability and prospectus suitability, including the concentration limit, because these standards are based on the investor and are not limited to a particular type of securities professional.

[4] NASAA Statements of Policy are available at: http://www.nasaa.org/regulatory-activity/statements-of-policy/. The section concerning suitability is typically Section III.

[5] For most DPPs subject to a NASAA Statement of Policy, the minimum annual income and net worth thresholds are: (a) annual gross income of $70,000 *and* net worth of $70,000; or (b) net worth of $250,000. These thresholds represent only the minimum eligibility to invest in a DPP; meeting or even exceeding either of these standards does not, in and of itself, mean that investing in a DPP is suitable. Income and net worth are but two of many factors that go into determining suitability.

[6] This calculus is consistent with the NASAA calculation of Net Worth. *See, e.g.,* section III.B.2 of the NASAA Statement of Policy regarding Real Estate Investment Trusts.

[7] For purposes of calculating liquid net worth, the Division considers a security to be "readily marketable" if it (a) is listed on the New York Stock Exchange, the American Stock Exchange, or the national market system of the NASDAQ stock market, or any successor to such entities; (b) is listed on a national securities exchange or system, or on a tier or segment of such exchange or system, designated by the Securities and Exchange Commission in rule 146(b) promulgated under section 18(b)(1) of the Securities Act of 1933; or (c) is able to be converted to cash, under ordinary and routine business conditions, within ten calendar days.

[8] The amount of the distribution reinvestment that must be added to the numerator may be reduced by any portion of the distribution that represents a return of capital from gross offering proceeds. This is because a return of capital that is reinvested results in no net change in the customer's aggregate invested amount. For simplicity, the example provided in this article assumes that distributions are fully funded from cash flow from operations.

[9] The Division notes that some DPP sponsors add language to their subscription agreements that purports to shift the burden of determining the continuing suitability of DRIP participants to the participant. Not only does such language have no ability to relieve an issuer or broker-dealer from their legal obligation to determine suitability, but it also violates provisions of most NASAA Statements of Policy on DPPs and may mislead investors as to their rights and responsibilities under the law. The Division objects to suitability burden shifting provisions and requires their removal from an issuer's offering materials.

[10] FINRA Regulatory Notice 11-02, at Footnote 11, states, in part, ". . . FINRA Rule 2111.02, moreover, explicitly states that a firm or associated person 'cannot disclaim any responsibilities under the suitability rule.' In the same vein, it is well-settled that a 'broker's recommendations must be consistent with his customer's best interests' and are 'not suitable merely because the customer acquiesces in [them].'" *Dane S. Faber*, Securities Exchange Act Release no. 49216, 2004 SEC Lexis 277, at 23-24 (February 10, 2004); *see also Dep't of Enforcement v. Bendetsen,* No. C01020025, 2004 NASD Discip. Lexis 13, at *12 (NAC August 9, 2004) ("[A] broker's recommendations must serve his client's best interests and the test for whether a broker's recommendations are suitable is not whether the client acquiesced in them, but whether the broker's recommendations were consistent with the client's financial situation and needs").

Division Comments on Title III of the JOBS Act – The CROWDFUND Act

In response to the Securities and Exchange Commission's ("SEC") invitation for public comment on its regulatory initiatives under Title III of the Jumpstart Our Business Startups Act of 2012 (the "JOBS Act"), the Division submitted a detailed letter setting forth its views on January 9, 2013.

The JOBS Act was signed into law on April 5, 2012 by President Obama. Title III of that Act, the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012, is more commonly known as the "CROWDFUND Act." The CROWDFUND Act creates an exemption from SEC registration for issuers raising no more than $1 million through a public securities offering facilitated by an online funding portal or broker-dealer. It is important for prospective crowdfunding issuers, funding portals, broker-dealers, and other interested parties to understand that the crowdfunding exemption is not yet available and, until the SEC and the Financial Industry Regulatory Authority ("FINRA") complete all required rulemaking, any offer or sale of securities purporting to rely on the crowdfunding exemption is in violation of Ohio and federal securities laws.[1]

As stated in its comment letter, the Division fully shares Congress's desire to help small businesses obtain capital they need to start or expand their operations. It is the method that Congress has chosen to help those businesses in this instance and the limited and confusing regulatory framework that Congress put in place to govern small businesses operating in this space that raise concern.

By design, the crowdfunding exemption opens all investor channels - from the smallest mom-and-pop investor to the largest institutional investor - to individual entrepreneurs and startup companies. While some of those small businesses will succeed to the benefit of their investors, government statistics confirm that many more small businesses will fail. Couple that reality with the fact that crowdfunding transactions will occur quickly over an internet already plagued with investment scams, the end result is a high-risk investment for even the most sophisticated investor. While the Act thankfully counters against these risks in a variety of ways, including a cap on how much an individual investor may invest based upon the investor's net worth, the risk of fraud and loss to investors remains substantial.

...the Division is hopeful the SEC will consider the Division's views and use the full scope of its rulemaking authority to clarify and reconcile provisions of the Act that pose the greatest threat of harm to both investors and small businesses.

While much of the public criticism regarding crowdfunding has centered on the foregoing investor protection considerations, investors are not the only ones subject to risk or loss in crowdfunding deals. In the Division's view, as articulated in its comment letter to the SEC, small businesses stand in perhaps the most precarious position. In an effort to provide swift assistance to small businesses, Congress inadvertently allowed some typographical and citation errors to slip through into the CROWDFUND Act, which have created a number of unintended, harmful consequences for the small crowdfunding issuer. Moreover, as written, the Act juxtaposes duties and responsibilities amongst crowdfunding market participants in such a way that non-compliance by any one participant might result in loss of the registration and licensing exemptions enjoyed by all other participants involved in the transaction.

While it is not within the SEC's authority to re-write the CROWDFUND Act, the Division is hopeful the SEC will consider the Division's views and use the full scope of its rulemaking authority to clarify and reconcile provisions of the Act that pose the greatest threat of harm to both investors and small businesses. The Division likewise urges readers of this Bulletin to share their views on these issues with the SEC to promote fully-informed rulemaking.

The Division's comment letter regarding Title III of the JOBS Act is available on the SEC's website at http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-199.pdf, along with the Division's previous comment letter regarding Title II of the JOBS Act at http://www.sec.gov/comments/s7-07-12/s70712-131.pdf.

[1] See Information Regarding the Use of the Crowdfunding Exemption in the JOBS Act, April 23, 2012, http://www.sec.gov/spotlight/jobsact/crowdfundingexemption.htm.

In Pari Delicto: A Bar to Investor Recovery for Securities Fraud

One of the highlights from last year's annual Securities Conference was a panel discussion on civil recovery for victims of securities fraud. The panel featured counsel for the Securities Investors Protection Act ("SIPA") trustee in the Bernie Madoff matter, as well as a court-appointed receiver and class action counsel. The panelists discussed the actions they had taken in order to recover funds for investors duped by Ponzi schemes and securities crimes, including filing suits against third parties such as banks, insurers, and broker-dealers for their assistance with or participation in the fraud. Invariably, the discussion turned to the topic of the *in pari delicto* defense, and its use in securities actions filed by trustees and receivers against these third-party defendants.

The doctrine of *in pari delicto* is grounded in equity. Meaning literally "in equal fault," *in pari delicto* is an affirmative defense used in instances where both parties are equally culpable of the offense.[1] Like the broader "unclean hands" doctrine, *in pari delicto* is founded on the principle that "courts should not lend their good offices to mediating disputes among wrongdoers" and that "denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality."[2]

For decades, *in pari delicto* has been available as an affirmative defense in the securities arena to block actions brought by at-fault plaintiffs. "A private [securities] action … may be barred on the grounds of the plaintiff's own culpability only where (1) as a direct result of his own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress, and (2) preclusion of suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public."[3]

The doctrine has been used, for example, to block shareholder derivative suits against corporate insiders and third-party fraud facilitators in cases where the guilty acts of corporate officers, agents, or shareholders were imputed to the plaintiff corporation.[4]

More recently, the doctrine has become muddled as defendants have increasingly invoked it to block actions by trustees or receivers acting on behalf of the afflicted corporation. As courts appoint independent, third-party trustees and receivers to clean up the mess left behind by the corporate fraudsters, one would not think the same agency-analysis at play in other securities actions would apply. As the federal district court for the Northern District of Ohio aptly explained:

> "The appointment of the receiver removed the wrongdoer from the scene. . . . Put differently, the defense of *in pari delicto* loses its sting when the person who is in pari delicto is eliminated. Now that the corporation [ ] ... [is] controlled by a receiver whose only object is to maximize the value of the corporation[ ] for the benefit of [its] investors and creditors, we cannot see an objection to the receiver's bringing suit to recover corporate assets unlawfully dissipated by [a principal of the corporation]."[5]

Not all courts agree, however, with this common sense view of the doctrine, but rather find themselves mired in the maxim that the "trustee stands in the shoes of the debtor."[6] Because trustees and receivers are deemed to "stand in the shoes" of the fraudulent company, they are barred by *in pari delicto* from raising any action just as the fraudulent company itself would be barred.

Indeed, defendants have enjoyed great success invoking *in pari delicto* defenses against bankruptcy trustees given the defined scope of the trustee's powers under the federal bankruptcy code.[7] In these bankruptcy cases, Section 541(a)(1) has been interpreted to limit the trustee to "no greater rights than the debtor himself had" before the bankruptcy proceeding commenced.[8]

That is exactly the battle currently facing the SIPA trustee in the Madoff matter. In one of many actions filed on behalf of investors, Trustee Irving Picard filed suit against two banks - HSBC and Chase - for their actions that allegedly allowed Madoff's fraud to flourish. Judge Jed S. Rakoff and Judge Colleen McMahon writing for the federal district court for the Southern District of New York both dismissed Trustee Picard's claims, in part, on *in pari delicto* grounds.[10]

Trustee Picard appealed the *in pari delicto* portion of the dismissals to the Second District, arguing that the bankruptcy case law applying the doctrine to trustee actions should not apply to a SIPA trustee. "[T]his is not a typical bankruptcy. A SIPA trustee's role is different than that of a typical bankruptcy trustee. A SIPA trustee marshals assets for the benefit of the customer property estate. Neither the debtor nor its shareholders (nor any wrongdoer) can benefit from any recovery for the customer property estate. As such, the policy concerns behind the application of the equitable doctrine of *in pari delicto* and *Wagoner* – that no wrongdoer should recover – does not exist here. Indeed, because the Trustee is the only party who has standing to assert claims generalized to customers or creditors, applying *in pari delicto* here would impede, not promote, equity."[11]

Oral argument was held on November 21, 2012, and the matter is still pending.

continued page 9

In Pari Delicto: A Bar to Investor Recovery for Securities Fraud continued...

In a typical Ponzi-type securities fraud, there are little to no funds available for defrauded investors. Even where there are funds, investors may lack the resources required to pursue their legal claims. For those investors, a court-appointed receiver or bankruptcy trustee may be the only hope for recouping any losses. Given the inherent difficulties investors have in obtaining any form of financial relief under these circumstances, the application of *in pari delicto* to trustee and receivership actions can deal a devastating blow to investor recovery. As in the Madoff case, investors are likely to view such a result as anything but equitable and, given the investor protection purpose of federal and state securities laws, one can easily understand that view. The Division will continue to monitor changes in the law regarding the application of the *in pari delicto* doctrine and how it impacts the Madoff investors in Trustee Picard's case and any future cases involving Ohio investors.

---

[1] BLACK'S LAW DICTIONARY at 794 (7th ed. 1999).

[2] *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 306 (1985); *see also Perma Life Mufflers, Inc. v. Int'l Parts Corp.,* 376 F.2d 692 (7th Cir. 1966).

[3] *Berner,* 472 U.S. at 310-311 (rejecting the *in pari delicto* defense as the plaintiff trading on the insider tip was not as culpable as the corporation); *see also Pinter v. Dahl,* 486 U.S. 622, 633-34 (1988) (concluding that *in pari delicto* may be available as an affirmative defense in section 12(1) private securities actions and is not limited to section 10(b) actions for fraud).

[4] *In re American Intern. Group, Inc., Consol. Derivative Litigation*, 976 A.2d 872 (Del. 2009).

[5] *DeNune v. Consolidated Capital of North America, Inc.*, 288 F.Supp.2d 844, 851 (N.D. Ohio 2003) (citing *Scholes v. Lehmann*, 56 F.3d 750, 754-55 (7th Cir. 1995) (citation omitted)). *See also FDIC v. O'Melveny & Myers*, 61 F.3d 17, 18-19 (9th Cir. 1995) (holding that imputing the negative conduct of the bank to the trustee would "elevate form over substance--something courts sitting in equity traditionally will not do."); *Gaines v. Wolcott*, 119 Ga. App. 313, 317(1969), aff'd, 225 Ga. 373, 169 S.E.2d 165 (1969) (doctrine of *in pari delicto* "is based on the principle that to give the plaintiff relief would contravene public morals and impair the good of society. Hence, it should not be applied in a case in which to withhold relief would, to a greater extent, offend public morals.")

[6] *Knauer v. Jonathon Roberts Fin. Group, Inc.*, 348 F.3d 230, 236 (7th Cir. 2003) (finding that while the *in pari delicto* doctrine is not a defense against a receiver in exceptional circumstances involving avoidance of fraudulent conveyances, it may apply as a defense to other types of claims brought by a receiver against third parties); *Thabault v. Chait*, 541 F.3d (3rd Cir. 2008) (applying *in pari delicto* to a third-party malpractice claim raised by an insurance receiver).

[7] 11 U.S.C. § 541-49; *see also In re Dublin Secs. Inc*., 133 F.3d 377 (6th Cir. 1997) (*in pari delicto* bars malpractice claims by Chapter 7 trustee against third party attorneys who participated in the fraudulent public stock offering); *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 120 (2nd Cir. 1991) (bankruptcy trustee did not have standing to bring actions against third parties who participated in the fraud with the cooperation of corporate management); *In re: Hedged-Investments Associates Inc.*, 84 F3d 1281, 1285 (10th Cir. 1996) (refusing to apply the *Scholes* reasoning in a bankruptcy matter); *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc.,* 267 F.3d 340 (3rd Cir. 2001) ("We hold that because the Committee, standing in the shoes of the debtors, was *in pari delicto* with the third parties it is suing, its claims were properly dismissed.").

[8] *Lafferty,* 267 F.3d at 356-58 (citing S. Rep. No. 95-989, at 82 (1978)).

[9] *Picard v. HSBC Bank PLC*, 454 B.R. 25 (S.D.N.Y. Jul. 28, 2011); *Picard v. JP Morgan Chase & Co., et al*., 460 B.R. 84 (S.D.N.Y. Nov. 1, 2011).

[10] *Picard v. HSBC Bank PLC, supra* at 37-38 (July 28, 2011); *Picard v. JP Morgan Chase & Co., supra* at 91-92.

[11] Trustee Brief at 17, *Picard v. HSBC Bank PLC, supra* (*In re: Bernard L. Madoff Inv. Sec. LLC*), Case No. 11-5175-bk (2nd Cir. Feb. 16, 2012).

Unlicensed Compensated Finders in Private Offerings

The Ohio Division of Securities wishes to remind issuers, counsel, and active participants involved in the solicitation, advertisement, and other attempts to dispose of securities through private offerings that acting as an unlicensed, compensated "finder" is most often illegal and can result in any number of criminal, civil and administrative sanctions for violators.[1] Misconceptions most frequently occur in the Regulation D private offering exemption context where both the issuer and the finder mistakenly assume that disclosure of the finder arrangement in Item No. 15 of the Form D is sufficient compliance under Ohio law. Disclosure without licensure is inadequate.

All compensated sellers of securities fall within Ohio's definition of "dealer" and, therefore, must be licensed or exempt from licensure with the Division:

"(1) Dealer, except as otherwise provided in this chapter, means every person who engages or professes to engage, in this state, for either all or part of the person's time, directly or indirectly, either in the business of the sale of securities for the person's own account, or in the business of the purchase or sale of securities for the account of others in the reasonable expectation of receiving a commission, fee, or other remuneration as a result of engaging in the purchase and sale of securities." R.C. 1707.01(E); R.C. 1707.14(A). Labeling oneself as a "finder" is not a work-around for this licensing requirement. There are, however, a few narrow licensing exceptions that may apply to specific types of finders.

First, Ohio Revised Code 1707.01(E)(1)(d) excludes from the "dealer" definition: "[a]ny person that brings an issuer together with a potential investor and whose compensation is *not directly or indirectly based on the sale of any securities by the issuer to the investor.*" R.C. 1707.01(E)(1)(d) (emphasis added). This provision is extremely limited as it is a rare situation that a finder's compensation is not tied directly or indirectly to the sale of securities.

Second, Ohio Revised Code 1707.01(E)(1)(c) provides a limited exception for business broker finders. A "business broker" is defined as"[a]ny person that, for the account of others, engages in the purchase or sale of securities that are issued and outstanding before such purchase and sale, if a majority or more of the equity interest of an issuer is sold in that transaction, and if, in the case of a corporation, the securities sold in that transaction represent a majority or more of the voting power of the corporation in the election of directors." R.C. 1707.01(E)(1)(c).

In most circumstances, the payment of compensation to a finder occurs outside of these narrow licensing exceptions and results in unlicensed activity that violates Ohio Revised Code 1707.14(A) and 1707.44(A). As the common private offering registration exemptions are themselves expressly conditioned on the payment of commissions or other remuneration only to *licensed* dealers or salespersons,[2] the finder's licensing violation also triggers loss of the registration exemption for the issuer, resulting in unregistered sales that violate Ohio Revised Code 1707.44(C)(1).

Where an unlicensed finder is found in the Regulation D offering context, it is not unusual for the Division to also discover the unlicensed finder engaging in other prohibited conduct. For instance, unlicensed finders are not always aware of the 35 non-accredited investors limitation[3] or the restrictions regarding advertising and general solicitation.[4] More serious problems arise when finders are found to have engaged in the sale of securities without knowledge of applicable antifraud provisions.[5]

Compliance with the foregoing licensing and registration requirements are a serious matter as violations of Ohio Revised Code 1707.44(A) and 1707.44(C)(1) are felonies ranging in the fifth to first degree depending upon the value of the securities involved in the transactions. R.C. 1707.99. At a minimum, violators should expect an administrative cease and desist order coupled with the unwinding or suspension of offering sales. Potential joint and several civil liability for both the issuer and the finder for the full amount paid by investors may also apply under Ohio Revised Code 1707.43.

1 The term "finder" is undefined in the Ohio Securities Act. We use the term here to mean unlicensed persons or entities that match investors with issuers.

2 R.C. 1707.03(O)(1)(f); 1707.03(Q)(3); 1707.03(W)(1); 1707.03(X)(2); or O.A.C. 1301:6-3-02(D)(1)(d)(iv).

3 Rules 505(b)(2)(ii) and 506(b)(2)(i) of the Securities Act of 1933.

4 Rule 502(c) of the Securities Act of 1933.

5 R.C. 1707.44(B)(4) and 1707.44(G).

ENFORCEMENT SECTION REPORTS

American Memorabilia, Inc.
On December 12, 2012, the Division issued a Cease and Desist Order, Order No. 12-029, against American Memorabilia, Inc., Victor J. Morena and Kieta Kieta. The Division found that Respondents had sold unregistered investment contracts to Ohio residents, representing that the investment funds would be used for business expansion and new facilities. In reality, Respondents used the funds to pay off other debts and credit cards, and for travel and other expenses. The Division found that Respondents made material misrepresentations in the sale of securities, in violation of R.C. 1707.44(B)(4).

Jason E. Schwartz
On February 26, 2013, following a criminal referral by the Ohio Department of Commerce's Division of Securities, Jason E. Schwartz of North Baltimore, Ohio entered a no contest plea to two counts of securities fraud in Wood County Common Pleas Court. Schwartz was the owner of TLC Genetics, LLC, a company located in Bucyrus, Ohio. In raising $120,000 from two investors, Schwartz failed to disclose to the investors that he was under federal investigation for mortgage fraud, for which he was later convicted and sentenced to five months in prison. He also failed to disclose to investors that he had previously filed bankruptcy on a company that owed more than $600,000 in federal and state taxes. After receiving the investor funds, Schwartz immediately used the funds to pay personal bills, mortgage payments, and his wife's credit card bill. The case was prosecuted by the office of Wood County Prosecutor Paul Dobson. Schwartz is scheduled to be sentenced on May 7, 2013.

Jonathan D. Davey
On February 8, 2013, certified public accountant Jonathan D. Davey, 48, of Newark, Ohio, was convicted on four criminal charges relating to an investment fraud conspiracy. He was convicted in U.S. District Court in Charlotte, North Carolina. The federal indictment, returned in February 2012, charged Davey with serving as the "administrator" for numerous hedge funds for the Black Diamond Ponzi Scheme. He was also charged with soliciting over $11 million from victims with his own hedge fund, "Divine Circulation Services", and with tax evasion. The charges arise from the Black Diamond investigation, which has brought criminal charges against 11 individuals and Community One Bank, relating to conduct in 2007 that deprived over 400 victims of more than $40 million. On July 15, 2010, the Division of Securities issued Order Number 10-058 against Jonathan D. Davey and Divine Stewardship, LLC providing Notice of Intent to Suspend or Revoke the licenses of Davey and Divine Stewardship, LLC. Davey withdrew both Ohio licenses and a Termination Order was subsequently issued. The Division cooperated with the federal investigation and provided testimony at the criminal trial in this case.

Pulsare Technologies Investments, LLC
On February 14, 2013, the Division issued Order No. 13-005 which suspended Pulsare's offering pursuant to Form 3-Q and file numbers 498031 and 498257, and suspended the right of the issuer or any dealer to buy, sell, or deal in any securities of the offering described therein. The Order was made pursuant to a Consent Agreement with Respondent. The Division found that Respondent violated R.C. 1707.44(B)(1) and (4) because it made material misrepresentations to the Division in its filing documents, and because it failed to show a reasonable basis for its future earnings projections. Furthermore, Respondent violated R.C. 1707.44(C) by selling unregistered securities that were not subject to a properly-claimed 1707.03(Q) exemption. As a result, the Division suspended the offering pursuant to R.C. 1707.13 and ordered Respondent to offer rescission pursuant to R.C. 1707.43.

Profitable Sunrise
On March 13, 2013, the Division issued a notice order, Division Order 13-006, against Inter Reef, Ltd., d/b/a/ Profitable Sunrise, its owner Roman Novak and his brother Radoslav Novak.

The action alleges that the Respondents have engaged in securities fraud, selling securities without a license, and selling unregistered securities in Ohio through their website profitablesunsrises.com. The Division's notice order joins enforcement actions taken or investor alerts issued by securities regulators in 15 other states and five Canadian provinces. On the same day the Notice Order was issued, the Department of Commerce issued an investor alert warning Ohioans of the website, and seeking information from anyone who may have invested with the Respondents.

Get Monthly Enforcement Reports via e-mail

Would you like to receive a monthly news release on the Division of Securities' criminal cases and Division orders?

You can do so by sending your e-mail address to:

karen.bowman@com.ohio.gov

While we will still be reporting the quarterly updates in our Bulletin, this is an opportunity to receive the information in a more timely fashion.