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BASICS OF OHIO SECURITIES LAW

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I. THE BASIC APPLICABILITY OF THE SECURITIES LAWS

A. Securities regulation in the United States is characterized by a "dual" regulatory system in which both federal law and pertinent state law apply to all transactions.

B. The federal securities laws: In general, the federal securities laws apply to the purchase and sale of securities through the instrumentalities of interstate commerce or the mails. The primary federal securities laws are the Securities Act of 1933 (15 U.S.C. § 77) (the "1933 Act") and the Securities Exchange Act of 1934 (15 U.S.C. § 78) (the "1934 Act"). The federal laws are administered and enforced by the Securities and Exchange Commission ("SEC").

C. The Ohio securities laws: The Ohio Securities Act (R.C. 1707) (the "Act") applies to the "sale" "in Ohio" of "securities." R.C. 1707 is administered and enforced by the Ohio Division of Securities ("Division").

1. "Sale." R.C. 1707.01(C)(1) states:

> "Sale" has the full meaning of "sale" as applied by or accepted in courts of law or equity, and includes every disposition, or attempt to dispose, of a security or of an interest in a security. "Sale" also includes a contract to sell, an exchange, an attempt to sell, an option of sale, a solicitation of a sale, a solicitation of an offer to buy, a subscription, or an offer to sell, directly or indirectly, by agent, circular, pamphlet, advertisement, or otherwise.

2. "In Ohio."

1. *Howard v. Rowley & Brown Petroleum Corp.*, No. 78-AP-113 (Franklin Cty., August 15, 1978): held Act applied where offeror resided in Ohio and the offeree resided in Mississippi.

2. *Martin v. Steubner,* 485 F. Supp. 88 (S.D. Ohio 1979): held Act applied where offeror resided in Minnesota and the offeree resided in Ohio.

3. *Bernie v. Waterfront Ltd. Dividend Housing Ass'n*, 614 F. Supp. 651 (S.D. Ohio 1985): held *in personam* jurisdiction over nonresident defendants who had sold securities to an Ohio resident.

4. *Corporate Partners, L.P. v. National Westminster Bank PLC,* 126 Ohio App. 3d 516 (7th Dist. Ct. App. 1998): held *in personam* jurisdiction over a non-Ohio resident underwriting firm where the underwriter participated in a series of meetings in Ohio and prepared a private placement memorandum that was distributed to prospective investors in Ohio.

5. *Federated Management Co. v. Coopers & Lybrand*, 137 Ohio App. 3d 366 (10th Dist. Ct. App. 2000): held Act applied where the issuer of securities was an Ohio resident and pre-offering activities took place in Ohio, even though neither the plaintiff purchaser, the defendant bank, nor the defendant underwriter were Ohio residents, and no sales or marketing activities took place in Ohio.

II. THE DEFINITION OF "SECURITY" UNDER OHIO LAW

A. Statutory definition. R.C. 1707.01(B) states:

"Security" means any certificate or instrument, or any oral, written, or electronic agreement, understanding, or opportunity, that represents title to or interest in, or is secured by any lien or charge upon, the capital, assets, profits, property, or credit of any person or of any public or governmental body, subdivision, or agency. It includes shares of stock, certificates for shares of stock, an uncertificated security, membership interests in limited liability companies, voting-trust certificates, warrants and options to purchase securities, subscription rights, interim receipts, interim certificates, promissory notes, all forms of commercial paper, evidences of indebtedness, bonds, debentures, land trust certificates, fee certificates, leasehold certificates, syndicate certificates, endowment certificates, interests in or under profit-sharing or participation agreements ~~or~~, interests in or under oil, gas, or mining leases, preorganization or reorganization subscriptions, preorganization certificates, reorganization certificates, interests in any trust or pretended trust, any investment contract, any life settlement interest, any instrument evidencing a promise or an agreement to pay money, warehouse receipts for intoxicating liquor, and the currency of any government other than those of the United States and Canada, but sections 1707.01 to 1707.45 of the Revised Code do not apply to the sale of real estate.

Note: This definition was amended effective September 16, 2003, to make clear that an opportunity need not be in writing in order to be a "security," and thereby reverse the Ohio Supreme Court's decision in *Gutmann v. Feldman*, 97 Ohio St. 3d 473 (2002).

2. Particular Items.

a. Corporate instruments: stock (including subscription rights), bonds, debentures, options, warrants.

b. Membership interests in LLCs.

c. "Investment contract." There is an investment contract when: "(1) an offeree furnishes initial value to an offeror, and (2) a portion of this initial value is subjected to the risk of the enterprise; and (3) the furnishing of the initial value is induced by the offeror's promises or representations which give use to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and (4) the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise." *State v. George*, 50 Ohio App. 2d 197, 302-303 (1975).

d. Promissory notes. In addition to the broad first sentence, the statutory definition also includes promissory notes and evidences of indebtedness. For a prosecution of violations of the Ohio Securities Act in connection with the sale of promissory notes, *State v. Taubman*, 78 Ohio App. 3d 834 (1992).

e. Partnership interests.

i. An interest in a limited partnership is a security. *See, e.g.*, *Hater v. Gradison Division of McDonald and Company Securities*, 101 Ohio App.3d 99 (1995).

ii. An interest in a general partnership typically is not a security. *See, e.g.*, *Brannon v. Rinzler*, 77 Ohio App. 3d 749 (1991).

iii. However, developing jurisprudence holds that a general partnership may be a security where: (1) an agreement among the parties leaves so little power in the hands of the partner that the arrangement in fact distributes power as would a limited partnership; or (2) the partner is so inexperienced and unknowledgeable in business affairs that he or she is incapable of intelligently exercising his partnership powers; or (3) the partner is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership powers.

(a) federal: *SEC v. Telecom Marketing, Inc.*, 888 F. Supp. 1160 (N.D. Ga. 1995); *Koch v. Hankins*, 928 F.2d 1471 (9th Cir. 1991); *Williamson v. Tucker*, 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981).

(b) Ohio: Division administrative orders *Joseph P. Medsker*, No. 94-194; *Continental Wireless Television Company*, No. 94-208; the *Unisco Corporation*, No. 94-017.

f. Viatical Settlements. Viatical settlements are included in the definition of "life settlement interest," a phrase contained in R.C. 1707.01(B). "Life settlement interest" is defined in R.C. 1707.01(HH).

g. Franchises. If an investment opportunity constitutes a "franchise," it is subject to the Ohio Business Purchaser's Protection Act, R.C. 1334, not the Ohio Securities Act. *Peltier v. Spaghetti Tree, Inc.*, 6 Ohio St. 3d 194 (1983).

III. THE GENERAL CONSEQUENCES OF APPLICABILITY OF THE OHIO SECURITIES ACT

A. Each security sold must be registered, properly exempted from regulation, or the subject of a notice filing.

B. Each person selling securities must be licensed or properly exempted from licensure.

1. Dealer

a) In general, a "dealer" is a person who engages in the business of selling securities. R.C. 1707.01(E)(1). There are exceptions to this general rule. R.C. 1707.01(E)(a) – (f). A commonly relied upon exception is for issuers of securities, R.C. 1707.07(E)(1)(a), which excepts:

> Any issuer, including any officer, director, employee, or trustee of, or member or manager of, or partner in, or any general partner of, any issuer, that sells, offers for sale, or does any act in furtherance of the sale of a security that represents an economic interest in that issuer, provided no commission, fee, or other similar remuneration is paid to or received by the issuer for the sale.

b) In general, "dealers" must be licensed by the Division. R.C. 1707.14(A)(1). There are some exceptions to this general rule. R.C. 1707.14(A)(1)(a) – (d).

2. Salesperson.

a) A salesperson is a natural person, other than a dealer, who is employed, authorized or appointed by a dealer to sell securities. R.C. 1707.01(F).

b) Every salesperson must be licensed by the Division and may be employed only by the licensed dealer specified in his or her license. R.C. 1707.16.

C. Persons giving advice regarding securities must be licensed by the Division or registered with the SEC.

1. An "investment adviser" is a person is who in the business of, for compensation, providing advice regarding securities. R.C. 1707.01(X). In general, an investment adviser operating in Ohio must be licensed by the Division, or registered with the SEC. R.C. 1707.141. An investment adviser registered with the SEC must make a "notice filing" with the Division. Id.

2. An "investment adviser representative" is a natural person who is employed by an investment adviser firm and regularly meets with a certain minimum number of clients. R.C. 1707.01(II). In general, an investment adviser representative must be licensed by the Division. R.C. 1707.161.

D. Anti-fraud standards apply to all securities transactions. R.C. 1707.44.

IV. THE BASICS OF OHIO SECURITIES REGISTRATION AND EXEMPTION

A. Registration.

1. R.C. 1707.06: registration by description -- a short form registration process where there are limited selling efforts, limited number of purchasers, or limited sales commissions (an "offering circular" is required if offering is greater than $250,000).

a. 6(A)(1): limited selling efforts.

i. unlimited number of investors
ii. selling commission and expenses cannot exceed 3%
iii. securities must be issued for cash or tangible property located in Ohio
iv. available only for corporations
v. Form 6(A)(1) filing; $50 filing fee

b. 6(A)(2): limited purchasers, limited commissions.

i. not more than 35 purchasers plus certain other "insiders" and "high worth" investors
ii. commissions cannot exceed 10%
iii. sales for the sole account of issuer and in good faith
iv. available only for corporations
v. Form 6(A)(2) filing; $50 filing fee

c. 6(A)(3): same as 6(A)(2) for partnership, limited partnership, partnership association, limited liability company, syndicate, pool, trust, trust fund or other unincorporated association. Use Form 6(A)(3) ($50 filing fee).

d. 6(A)(4): rights offering by a corporation to existing securities holders. Use Form 6(A)(4) ($50 filing fee).

2. R.C. 1707.09: registration by qualification -- a comprehensive filing for sales that are not eligible for registration by description.

a. 1707.09(J) requires that at least 85% of the offering proceeds must go to the issuer.

b. The Division must find that the business of the issuer is not fraudulently conducted, that the securities will not be offered or disposed of on grossly unfair terms, and that the plan of issuance and sale will not tend to, or in fact, defraud or deceive purchasers.

3. R.C. 1707.091: registration by coordination -- a streamlined procedure for offerings that are also being registered with the SEC under the 1933 Act.

4. Because of the statutory requirement that registered offerings in Ohio not be on "grossly unfair terms," registered offerings are subject to the Division's merit regulations.

a. Most merit standards are contained in the Division's merit guidelines, available at: http://www.securities.state.oh.us/Rules/Existing_Guidelines.aspx.

b. The prohibition on "blank check" offerings, and the limitations on transactions with affiliates and loans to insiders are codified in R.C. 1707.131.

B. Commonly Used Issuer Exemptions.

1. R.C. 1707.03(O): Ten or fewer purchasers.

a. Available for sales of equity interests by a corporation or membership interests by a limited liability company.

b. Issuer must reasonably believe that purchasers are purchasing for investment.

c. No advertising or announcement on radio or television may be used, but the issuer may deliver an offering circular to selected individuals.

d. Commissions are limited to a maximum of 10% and may be paid only to securities dealers or salespersons licensed by the Division.

e. No filing is required to perfect this exemption, but an issuer should memorialize reliance on this exemption in its corporate records.

2. R.C. 1707.03(Q): Private offerings pursuant to § 4(2) of the 1933 Act.

a. The offering must be one "not involving a public offering" as required by § 4(2) of the 1933 Act. This necessarily prohibits advertising and general solicitation, and requires investment intent.

b. Commissions are limited to a maximum of 10% and may be paid only to securities dealers or salespersons licensed by the Division.

c. A Form 3-Q must be filed with the Division within sixty days of the date of sale. O.A.C. 1301:6-3-03(B)(6) defines the date of sale as the later of the date that: (i) a purchaser signs a subscription agreement or loses control of the purchase funds, whichever is earlier, or (ii) the first date of disbursement of proceeds of the sale of security from an escrow account. The filing fees are $100 for the first filing of the calendar year and $50 for each subsequent filing. Out-of-state issuers must file an irrevocable consent to service on Form 11 or Form U-2 pursuant to R.C. § 1707.11.

3. R.C. 1707.03(X): Private offerings pursuant to SEC Rule 506.

a. The offering must comply with the conditions of SEC Rule 506, which among other things:

i. prohibits advertising and general solicitation

ii. limits the number of purchasers to 35 non-"accredited" investors (an unlimited number of "accredited" investors is permitted)

(a) "Accredited investor" is defined in SEC Rule 501. An individual is an "accredited investor" if he or she:

(i) is a director, executive officer or general partner of the issuer;

(ii) has an individual net worth, or joint net worth with spouse, in excess of $1,000,000; or

(iii) had an individual income in excess of $200,000 in each of the two most recent years, or joint income with spouse in excess of $300,000 in each of the two most recent years, and a reasonable expectation of reaching the same income level in the current year.

iii. requires that non-"accredited" investors be "sophisticated" (either alone or with a purchaser representative)

iv. requires the delivery of a disclosure document to all investors if the offering involves non-"accredited" investors

v. requires investment intent

b. A Form D, along with a $100 filing fee, must be filed with the Division within fifteen days of sale. Out-of-state issuers must file an irrevocable consent to service on Form 11 or Form U-2.

3. R.C. 1707.03(W): Private offerings pursuant to SEC Rule 505.

a. The offering must comply with the conditions of SEC Rule 505, which among other things:

i. limits the offering amount to $5,000,000

ii. prohibits advertising and general solicitation

iii. limits the number of purchasers to 35 non-"accredited" investors (an unlimited number of "accredited" investors is permitted)

iv. requires the delivery of a disclosure document to non-"accredited" investors

v. requires investment intent

b. Aggregate commissions are limited to 12% and may be paid only to dealers or salesmen licensed by the Division.

c. A Form 3-W must be filed with the Division at least five business days prior to the first use of an offering document or the first sale in Ohio. The filing fee is $100. Out-of-state issuers also must file an irrevocable consent to service on Form 11 or Form U-2.

d. "Bad Boy" provision: R.C. 1707.03(W)(2)(a) disqualifies any issuer or broker-dealer which would be prohibited from filing under Regulation A under the Securities Act of 1933 from using the exemption under R.C. 1707.03(W). Among the disqualifying actions would be convictions for fraud or securities law violations, administrative actions for securities law violations issued by state agencies, regulatory agencies or the SEC or civil actions enjoining the issuer or dealer from engaging in the offer or sale of securities or continued violations of any security law.

4. R.C. 1707.02(G): Private offerings of commercial paper and promissory notes.

a. Sales of commercial paper and promissory notes that are not offered directly or indirectly to the public are exempt from registration.

b. O.A.C. 1301:6-3-02(C) defines "private offering" to include sales to the following purchasers:

i. Officers and directors of the issuer, of the parent corporation, or of the corporate general partner of the issuer;

ii. General partners of the issuer;

iii. Persons who directly or indirectly control the management or policies of the issuer by ownership of voting securities, by contract or otherwise; or

iv. Ten purchasers per twelve-month period, provided that the issuer reasonably believes after reasonable investigation that the investor is purchasing for investment. Husband and wife, child and parent or guardian, partnership, association, trust or other unincorporated entity are deemed to be single

purchasers provided the partnership, trust association or unincorporated entity is not formed for the purpose of investing in the offering.

c. Additional conditions.

i. No advertising or public notice is permitted, other than an offering circular or other communication delivered to selected individuals.

ii. The issuer, including officers, directors, employees, partners or trustees, is not required to be licensed as a securities dealer pursuant to R.C. § 1707.14(A)(1)(c).

iii. Commissions are limited to ten percent of the initial offering price and may be paid only to licensed securities dealers. Legal, accounting and printing expenses are excluded from the ten percent commission limitation.

iv. No filing is required to perfect this exemption, but an issuer should memorialize reliance on this exemption in its corporate records.

5. R.C. 1707.03(Y): Offerings only to accredited investors.

a. Under certain conditions, an issuer may make a "general announcement" of an offering to a group of "accredited" investors.

b. Procedural requirements include:

i. A notice filing on Form 3-Y with the Division, including all offering materials, a description of the issuer and a copy of the general announcement. The general announcement must be limited to a brief description of the issuer's business, description of the securities, including the price and aggregate offering amount, and the issuer's address and telephone number. All offering materials must clearly indicate that the offering is limited to accredited investors.

ii. A filing fee of $100.

iii. A consent to service for out-of-state issuers.

iv. Resales must be limited to other accredited investors or the securities must be registered.

v. Issuers who have been subject to past enforcement actions may be disqualified from the exemption.

vi. There is no limit on commissions, but commissions or other remuneration may be paid only to licensed securities dealers.

vii. Sales may be made by the issuer without a securities dealer license provided no commissions or other compensation are paid.

C. Coordination with federal exemptions.

1. All securities sold in Ohio must be registered, properly exempted from registration, or the subject of a notice filing under both Ohio and federal law.

2. Ohio provisions that correspond with commonly used federal exemptions:

a. Federal § 3(a)(11)/Rule 147. R.C. 1707.03(O) is the most commonly used exemption for small (ten or fewer purchasers) intra-state offerings exempt federally pursuant to section 3(a)(11) of the Securities Act of 1933 or Rule 147 promulgated thereunder. Intra-state offerings under Section 3(a)(11) or Rule 147 with more than ten purchasers generally must be registered with the Division.

b. Federal Regulation A. Like all other states, Ohio does not have an exemption that directly corresponds to the federal Regulation A exemption. As a result, Regulation A offerings not otherwise exempted must be registered with the Division.

c. Federal § 4(2). R.C. 1707.03(Q) generally provides a companion exemption for transactions by an issuer not involving a public offering pursuant to Section 4(2) of the Securities Act of 1933.

d. Federal Rule 504. An issuer relying on the federal Rule 504 exemption that wishes to advertise its offering and issue freely transferable stock must register the offering with the Division and deliver a disclosure document to potential investors.

e. Federal Rule 505. R.C. 1707.03(W) generally provides a companion exemption for an offering up to $5,000,000 pursuant to federal Rule 505.

f. Federal Rule 506. R.C. 1707.03(X) generally provides a companion exemption for private offerings pursuant to federal Rule 506.

V. CORRECTIVE FILINGS

A. Qualification of Securities Sold Without Compliance: R.C. § 1707.39 allows an issuer or any interested party to apply to the Division to qualify any securities sold in violation of the Act. The Division must make a finding that no person has been defrauded, prejudiced or damaged by the violation or will be defrauded, prejudiced or damaged by such qualification. Upon qualification of the securities under R.C. § 1707.39, the Division is estopped from commencing criminal proceedings under R.C. § 1707.23(E) or administrative actions under R.C. § 1707.13. To complete the qualification, the following procedures must be completed:

1. A Form 39 and exhibits must be filed with the Division. The required exhibits include financial statements that may be either audited or attested to by the issuer.

2. A filing fee of $100 must be paid along with a qualification fee of 1/5 of one per cent of the aggregate price at which securities have been sold with a $100 minimum and a $2,000 maximum. The Division may also require additional fees for an examination either in Ohio or out of state.

3. The Division will require that each purchaser sign an Explanatory Statement/Non-Prejudice Statement. The statement details the purchaser's rights under R.C. § 1707.43 and requires the purchaser to indicate whether he desires a return of his investment, he is satisfied with his purchase, or an explanation of why he does not elect to waive any rights under R.C. § 1707.43. If an investor elects to rescind the transaction, the Division will require proof that such rescission has been made prior to granting the registration.

4. Any other information given to the purchasers should be filed with the Division and cleared prior to distribution.

5. The Division may require commissions, discounts, finder's fees or other compensation paid to unlicensed individuals be repaid. The Division may also require an escrow of outstanding securities issued at less than the public offering price or for consideration other than cash, prior to making a finding that no purchaser was defrauded, damaged or prejudiced.

B. Excusable Neglect: R.C. § 1707.391 provides that an issuer or securities dealer may apply to the Division for a corrective filing when securities have been sold in reliance upon R.C. §§ 1707.03(Q), 1707.03(W), 1707.03(X), 1707.03(Y) or

1707.08 and such reliance was improper due to the failure to timely or properly file the required forms. Upon a finding of "excusable neglect" by the Division, the applications are deemed timely and properly filed. Filings under R.C. § 1707.391 may be made only to correct late filings, filings where the wrong form was submitted to the Division, or not properly filed as defined in Ohio Administrative Code 1301:6-3-391(A)(2). Any other violations may be corrected only pursuant to R.C. § 1707.39.

1. Filing Requirements: The applicant must submit a Form 391 and the form that should have been timely and properly filed with all required exhibits. The filing fee is double the statutory filing fee of the underlying registration or exemption, excluding any fees already submitted. An irrevocable consent to service on either Form 11 or Form U-2 is required for all out-of-state applicants pursuant to R.C. § 1707.11.

2. Sworn Statements: Ohio Administrative Code 1301:6-3-391(D) also requires the issuer or its counsel to file two sworn statements stating that no investor was prejudiced by the failure to timely or properly file and the reason the form was not timely or properly filed.

3. Excusable Neglect: Ohio Administrative Code 1301:6-3-391 presumes excusable neglect if the Form 391 is filed within six months of the earliest sale made in reliance upon R.C. §§ 1707.03(Q), 1707.03(W) and 1707.03(Y). The presumption is limited to one month from the earliest sale for filings under R.C. §§ 1707.06 and 1707.08.

4. Effectiveness: The Form 391 is effective fourteen days after filing with the Division, unless the applicant is notified that the Division has not found excusable neglect.

5. Division Procedure: Ohio Administrative Code 1301:6-3-391(E) allows the Division to notify the applicant of denial by any reasonable means including telephone, telegram, mail, personal service or other electronic means. The Division may telephone the applicant and send a confirming letter. A form notice signed by the commissioner is sent later.

6. Division Policy: The Division has very strictly followed the presumption of excusable neglect set forth in Ohio Administrative Code 1301:6-3-391(B). The Division denies filings that are not submitted with the specific time periods of Ohio Administrative Code 1301:6-3-391.

7. Covered Securities: Issuers of "covered securities" that have not timely, or properly, submitted notice filings under R.C. §§1707.03(X) or 1707.092 are not required to file the Form 391 or the sworn statements. Issuers may only be required to submit the fees under R.C. § 1707.391. There are also no time limits defining "excusable neglect" for offerings of covered

securities because federal law provides that any failure to make a notice filing shall be "promptly" submitted to the state.

VI. CIVIL LIABILITIES

A. Civil Liability Provisions of the Federal Securities Laws.

1. § 11 of the 1933 Act (15 U.S.C. § 77k): Creates liability when "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." *Note:* The prospectus is part of the registration statement.

2. § 12(a)(1) of the 1933 Act (15 U.S.C. § 77l(a)(1)): Creates liability for an offer or sale of a security in violation of section 5 of the 1933 Act. *Note:* Section 5 requires that securities be registered, subject to exemptions for certain transactions and certain securities.

3. § 12(a)(2) of the 1933 Act (15 U.S.C. § 77l(a)(2)): Creates liability when there is an offer or sale of a security "by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading."

4. Rule 10b-5 promulgated under the 1934 Act (17 C.F.R. 240.10b-5). An implied private right of action under Rule 10b-5 was first recognized in 1946. *Kardon v. National Gypsum Co.,* 69 F. Supp. 512 (E.D. Pa. 1946).

   a. Text of the rule:

      It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

      (a) To employ any device, scheme or artifice to defraud,

      (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the

light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

b. Elements

Threshold Elements:

i. "in connection with." This element has been construed to mean "in a manner reasonably calculated to influence the investing public." *Securities and Exchange Commission v. Texas Gulf Sulphur Co.,* 401 F.2d 833 (2nd Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

ii. "purchase or sale." Standing is limited to *actual* purchasers or sellers (known as the "*Birnbaum* Rule"). *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), *rehearing denied*, 423 U.S. 884 (1975).

iii. "manipulative or deceptive device." Deception, not simply unfairness or breach of fiduciary duty, must be present. *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977).

Fraud Elements:

iv. Scienter: the mental state embracing an intent to manipulate, deceive or defraud. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

(a) The federal Private Securities Litigation Reform Act of 1995 added §21D(b)(2) to the 1934 Act, which states: In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

(b) To satisfy §21D(b)(2) in the Sixth Circuit, a plaintiff must allege "facts that give rise to a strong inference of reckless behavior but not by alleging facts that illustrate nothing more than a defendant's motive and opportunity to commit fraud." *In re Comshare, Inc. Securities Litigation,* 183 F. 3d 542 (6th Cir. 1999).

v. Materiality: "[T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available." *TSC Industries, Inc. v. Northway, Inc.,* 426 U.S. 438 (1976).

vi. Causation: a sufficient nexus between the wrongful conduct and the injury. Typically, two types of causation must be shown:

(a) Transaction causation: "but for" the defendant's wrongful conduct, the plaintiff would not have entered the transaction.

(b) Loss causation: a showing that the fraud produced the loss, *i.e.* proximate cause.

See, e.g., AUSA Life Insurance Co. v. Ernst & Young, 206 F. 3d 202 (2nd Cir. 2000).

vii. Reliance: justifiable action. In a face-to-face transaction, reliance can be presumed if materiality is shown. *Affiliated Ute Citizens v. United States,* 406 U.S. 128 (1972). The "fraud on the market" theory permits a presumption of reliance in market transactions: "An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action." *Basic Inc. v. Levinson,* 485 U.S. 224 (1988).

viii. Damages: Private 10b-5 plaintiffs have a full range of equitable and legal remedies. Section 28 of the 1934 Act limits damages to actual damages. Section 21D(e) of the 1934 Act caps damages in a manner that seeks to discount price volatility unrelated to the fraud.

c. Other considerations in a 10b-5 action.

i. Statute of Limitations: Pursuant to §804 of the Sarbanes-Oxley Act: two years after discovery of facts constituting the violation, but not more than five years after the violation.

ii. Pleading: Federal Rule of Civil Procedure 9(b) requires that fraud be pled with particularity. *See also* foregoing discussion of §21D(b)(2) of the 1934 Act.

iii. Duty: "Silence, absent a duty to disclose, is not misleading." *Basic v. Levinson, supra*. "No comment" statements are the functional equivalent of silence. *Id.* How does a duty arise?

(a) Legal or regulatory duty, *e.g.* SEC reporting requirements or exchange listing requirements. *Note:* New §13(l) of the 1934 Act (added by the Sarbanes-Oxley Act) requires "real time issuer disclosures."

(b) The duty of honesty: if you choose to speak, you must speak fully and truthfully.

B. Civil Liability Provisions of the Ohio Securities Act.

1. R.C. 1707.43 makes each sale or contract for sale made in violation of the Ohio Securities Act voidable at the election of the purchaser. R.C. 1707.43 also provides:

a. Joint and several liability for each person who participated or aided in making the sale, unless it is shown that the violation did not materially affect the protection contemplated by the violated provision. *Pencheff v. Adams*, 5 Ohio St. 3d 153 (1983). *Bell v. Le-Ge, Inc.*, 20 Ohio App. 3d 127 (8th Dist. Ct. App. 1985).

b. A limitation of the plaintiff's remedy to the full purchase price of the security upon tender of the security to the seller plus court costs. The plaintiff may not recover interest. *Roger v. Lehman Bros. Kuhn Loeb, Inc.*, 621 F. Supp 114 (S.D. Ohio 1985).

c. A statute of limitations of two years from when the plaintiff knew, or had reason to know, that the actions of the person were unlawful, or five years from the date of sale. *Hild v. Woodcrest*

Assn. 59 Ohio Misc. 13 (Montgomery Cty. C.P. 1977). *Eastman v. Benchmark Minerals, Inc.*, 34 Ohio App. 3d 255 (10th Dist. Ct. App. 1988).

i. In cases involving securities issues styled as fraud claims, courts have tended to find that R.C. 1707.43's statute of limitations, rather than R.C. 2305.09's statute of limitations, provides the appropriate statute of limitations.

ii. In *Hater v. Gradison Division of McDonald and Company Securities, Inc*., 101 Ohio App. 3d 99 (1st Dist. Ct. App. 1995), the plaintiffs alleged fraud by virtue of the defendants' concealment of a number of facts regarding a limited partnership and partnership property. Plaintiffs further alleged that the fraudulent acts occurred after the sale of the limited partnership interests, and that their claim was brought as "owners" of securities, rather than as "purchasers" of securities. Accordingly, plaintiffs contended that R.C. 2305.09 provided the appropriate limitations period. The First District Court of Appeals rejected this contention, holding that the "allegations of fraud [were] inextricably interwoven with the sale of the partnership units," and concluded that R.C. 1707.43 provided the appropriate limitations period.

iii. For a more recent decision to the same effect, *see Ware v. Kowars*, 2001 WL 58731 (10th Dist. Ct. App. 2001).

iv. However, there is a developing line of cases that permit the plaintiff to use the R.C. 2305.09 limitations period when the claim "arises out of common law fraud." *See Ferry v. Shefchuk,* 2003 WL 21139014 (11th Dist. Ct. App. 2003); *Ferritto v. Alejandro*, 139 Ohio App. 3d 363 (9th Dist. Ct. App. 2000).

d. Case law is split as to whether the failure to timely file a claim of exemption constitutes a basis for rescission under R.C. 1707.43. In *Obenauf v. Cidco Investment Services, Inc.*, 54 Ohio App. 3d 131 (8th Dist. Ct. App. 1990), the court refused to grant rescission where the Form 3-Qs were filed with the Division fourteen to sixteen days late. However, in *Sherman v. River Oaks Office Plaza, Ltd.*, 91 Ohio App.3d 450 (8th Dist. Ct. App. 1993), the court granted rescission to investors when the Form 3-Q was filed two days late and stamped "completed" by the Division.

e. Under R.C. 1707.43 no purchaser is entitled to relief under this section when he has failed to accept a written offer to repurchase the securities made at least two weeks after the purchase. The purchaser must have thirty days to accept or reject the repurchase offer. This section does not require a filing with the Division. While an issuer may limit civil liability under this section, the repurchase offer would not stop any Division action under its enforcement powers pursuant to R.C. 1707.13 and 1707.23.

f. R.C. 1707.431 provides that any attorney, accountant or engineer shall not be deemed to have effected, participated in, or aided the seller in making sales in violation of the Ohio Securities Act if his performance is incidental to the practice of his profession. *Leeth v. Decorator's Mfg., Inc.* 67 Ohio App. 2d 29 (10th Dist. Ct. App. 1979).

2. R.C. 1707.42 creates civil liability for those who unlawfully give advice regarding securities under certain circumstances.

a. R.C. 1707.42(A) states: "Whoever, with intent to secure financial gain to self, advises and procures any person to purchase any security, and receives any commission or reward for the advice or services without disclosing to the purchaser the fact of the person's agency or interest in such sales, shall be liable to the purchaser for the amount of the purchaser's damage thereby, upon tender of the security to, and suit brought against, the adviser, by the purchaser. No suit shall be brought more than one year subsequent to the purchase."

b. R.C. 1707.42(B) imposes liability on any person who acts as an investment adviser or investment adviser representative in violation of the Ohio Securities Act. Damages may include the consideration paid for the advice, any loss due to the advice, and court costs, less the amount of any income received from the advice. No action may be brought more than five years after the rendering of the advice or two years after discovery of the violation, whichever is shorter.

3. R.C. 1707.41 creates civil liability for the use of fraudulent offering materials. Any person who purchased a security in reliance upon a false circular, prospectus or advertisement may bring suit. The plaintiff need not show that the defendant acted with an intent to manipulate, deceive or defraud, but must show that he or she relied on the false circular, prospectus or advertisement and materiality. Among other defenses, a defendant may also avoid liability by showing that he or she had no knowledge of the publication prior to the transaction complained of, or

had just and reasonable grounds to believe such statement to be true or the omitted facts not to be material. Like R.C. 1707.43 and 1707.42(B), R.C. 1707.41 contains a two year/five year statute of limitations.

4. R.C. 1707.40 provides that the Ohio Securities Act does not support implied private rights of action.

5. In general, the Division may not recover money on behalf of aggrieved investors. *See generally State v. Buckeye Finance*, 54 Ohio St. 2d 407 (1978). However, R.C. 1707.261 (effective September 16, 2003) provides that if the Division obtains an injunction, pursuant to R.C. 1707.26, against a defendant (or defendants) for violating the Ohio securities laws, the Division may ask the court to order the defendant(s) to make restitution, or offer rescission, to investors damaged by the violations of the Ohio securities laws. In addition, pursuant to R.C. 1707.27 the Division may seek court appointment of a receiver, who has the power (under the direction of the court) to dispose of any proceeds collected during the receivership.