OHIO SECURITIES BULLETIN

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Anti-Fraud Dilemma: Defining Materiality

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Materiality is one of the more important and oft-used concepts in interpreting the requirements of the federal securities laws. Yet the term has never been defined by the administrator of those laws, the Securities and Exchange Commission. This is as it should be in the eyes of this commentator.

Nevertheless, the clamor for certainty through an SEC administrative definition of the term "material" never ceases. Though the Grand Inquisitor may have been correct in noting while administering his charge that at some point there must be certainty, that necessity may not exist in this area. In the securities area, the search for certainty is rather like the quest for the holy grail. It is the quest itself however, that continually modifies and refines the concept and therefore the definition of materiality. It is the common law development of securities law interpretations at its best. It is a practical recognition that materiality can differ over time and circumstance.

A hard and fast definition would require courts and administrators to find new tools to accomplish the purposes of the securities laws in this area and the fulfillment of the overall objective of those laws, namely the protection of investors and the stimulation of efficient, free and fair markets. Such a development would, at least in the short run, lead to a greater uncertainty than now exists in this area. The purpose of this article is to explore the development of the meaning of materiality, to place it in its various contexts within the securities law scheme and finally to attempt the impossible job of offering a contemporary working definition of the oft-damned term.

continued on page 2

The Supreme Court of Ohio

ISSUED By the Board of Commissioners
on Grievances and Discipline,
OFFICE OF SECRETARY:
OPINION 2000-1,
Issued February 11, 2000

SYLLABUS: It is ethically improper for a lawyer to accept a fee from a financial services group for referring clients in need of financial services. The referral fee agreement involves an improper business relationship with clients and non-lawyers under DR 3-103(A) and DR 5-104(A). The referral fee agreement creates a financial interest that will affect or reasonably may affect the professional judgment of a lawyer under DR 5-101(A)(1) and DR 5-107(A)(1) and (2). Full disclosure and consent do not resolve the conflict. While DR 5-101(A)(1), DR 5-104(A), and DR 5-107(A)(1) and (2) provide a full disclosure and consent exception, DR 3-103(A) does not. Because of the joint application of these rules, the full disclosure and consent exception does not apply.

OPINION: This opinion addresses whether it is ethically proper for a lawyer to accept a referral fee from a financial services group.

> Is it ethically proper for a lawyer to accept a fee from a financial services group for referring clients in need of financial services?

Ohio lawyers are being asked to enter into a business arrangement with a financial services group. The group offers

continued on page 6

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Ohio Securities Bulletin

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Table of Contents

Defining Materiality

continued from page 1

The proposal by the SEC to adopt Regulation FD in December 1999[2] was the occasion for renewed demands for a definition of materiality. Regulation FD regulates the dissemination of material nonpublic information.[3] An earlier SEC enforcement case, Dirks v. SEC,[4] created the requirement for a showing of breach of fiduciary duty as a predicate to establishment of a violation of Rule 10(b)(5).[5] Although the SEC had some success in cases in which the tipper of the information did not trade or benefit monetarily from such activities, those cases were particularly fact dependent. For example, breach of fiduciary duty was found when a CFO tipped an analyst on an impending earnings shortfall in order to protect his own reputation.[6] The analyst and his clients were thus able to "steal a march" on the unsuspecting buying public.[7] In the main, however, company officials found it increasingly necessary for the benefit of their company to curry favor with the analyst community by selectively disclosing nonpublic material information to them. These activities generally would not involve a breach of fiduciary duty since they were done for the benefit of the company. As a result, the SEC lacked effective tools to stop this activity in order to protect unsuspecting trading markets. At the same time, most of these same company officials scrupulously adopted and observed strictures against trading by themselves and other similarly situated until after such information was released to the general public. This general behavior was rational in that it recognized the materiality of the information where sanctions existed and disclosed the information where there were no sanctions. One unintended result of this process was to turn many analysts into mere tippees. The growing awareness of this practice of selective disclosure led to increasing concern by the public and regulators even in the midst of the explosions of the late 1990's bull market.

In the final release adopting Regulation FD,[8] the SEC staff refused to define materiality stating:

> [W]hile we acknowledge in the "Proposing Release" that materiality judgments can be difficult, we do not believe an appropriate answer to this difficulty is to set forth a bright-line test, or an exclusive list of "material items" for purposes of Regulation FD. The problem addressed by this Regulation is the selective disclosure of corporate information of various types; the general materiality standard has always been understood to encompass the necessary flexibility to fit the circumstances of each case.[9]

While not defining the term "materiality" the Commission gave some interpretative guidance by listing types of information or events that would call for careful review to determine whether they are material, namely, (1) earnings information; (2) mergers, acquisitions, tender offers, joint ventures or changes in assets; (3) new products or discoveries, or developments regarding customers or suppliers (e.g., the acquisition or a loss of a contract); (4) changes in control or in management; (5) changes in auditors or notification that the issuer may no longer rely on an auditor's audit report; (6) events regarding the issuer's securities such as defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and (7) bankruptcies or receiverships.[10] In what only can be characterized as a statement of accommodation, or perhaps a sign of weakness, the staff made the extraordinary statement: "...issuers need not fear being second-guessed by the Commission in enforcement actions for mistaken judgments about materiality in close cases."[11] Don't bet the ranch on that one!

The primary source of litigation and the concerns about the meaning of materiality comes from SEC Rule 10b-5[12] which makes it unlawful 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 light of the circumstances under which they were made, not misleading.[13] Language in this regulation came not from Section 10(b) of the Securities Exchange Act of 1934[14] itself, but rather from Section 17(a)(2) of the Securities Act of 1933.[15]

The term and concept of materiality is also used in the Ohio Securities Act.[16] Section 1707.41[17] establishes civil liability for "the loss or damage sustained by [a] person by reason of the falsity of any material statement ... or omission ... of material

OHIO SECURITIES BULLETIN

Desiree T. Shannon, Esq., Editor

The *Ohio Securities Bulletin* is a quarterly publication of the Ohio Department of Commerce, Division of Securities. The primary purpose of the *Bulletin* is to (i) provide commentary on timely or timeless issues pertaining to securities law and regulation in Ohio, (ii) provide legislative updates, (iii) report the activities of the enforcement section, (iv) set forth registration and licensing statistics and (v) provide public notice of various proceedings.

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 the Editor for editorial guidelines and publication deadlines. The Division reserves the right to edit articles submitted for publication.

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facts..." from any prospectus or similar document offering a security for sale.[18] Section 1707.44(B)[19] states that "[n]o person shall knowingly make or cause to be made any false representation concerning a material and relevant fact, in any oral statement or in any prospectus, circular, description, application, or written statement...."[20] Subparts (J)[21] and (K)[22] establish violations for statements and reports which are false in any material respect.[23] The concept is also utilized with respect to the disclosure called for in control bids in Sections 1707.041[24] and 1707.042.[25]

The classic definition of materiality remains that set forth by the U.S. Supreme Court in 1976 in TSC. v. Northway.[26] It must be remembered that TSC involved the affect of the omission of information on the voting process under the proxy rules of Regulation 14A.[27] Rule14a-9[28] prohibits solicitations of proxies containing statements which, at the time and in the light of the circumstances under which made, are false or misleading with respect to any material fact, or which omit to state any material fact necessary in order to make the statements made not false or misleading.[29] The question presented was whether the omission of certain facts regarding a change in control of TSC were material.[30] The Supreme Court granted certiorari because of a conflict among the Courts of Appeals in defining materiality.[31] The Court discussed the several definitions of materiality that had been utilized by various courts, including:

- All facts which a reasonable shareholder might consider important.
- Whether a reasonable man would attach importance to the facts misrepresented or omitted in determining his course of action.
- Whether there is a substantial likelihood that the misstatement or omission may have led a stockholder to grant a proxy.
- Facts which in reasonable and objective contemplation might affect the value of the securities.
- That the defect have a significant propensity to affect the voting process.[32]

Finally, the court established the definition that is used today when it stated "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.... Put another way, there 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."[33]

The test was further refined for contingent or speculative events by Basic v. Levinson in 1988.[34] The court there defined materiality concerning possible future events as depending upon a balancing of both the indicated probability that the event would occur and the anticipated magnitude of the event.[35]

For example, in declining to find materiality in Abbott Laboratories vs. Airco, Inc.[36] the court noted that the fact that the market did not have a significant reaction to the ultimate disclosure of the particular information indicated that the information was not material.[37] It is of course much harder to measure the impact of nondisclosure of information on the voting process than is the case in market manipulation cases in which courts can look with 20/20 hindsight at actual market reactions when information does become public as a measure of whether it was actually material. Nevertheless, TSC has become the standard for market manipulation cases.

In construing its statutes, Ohio courts have spoken in terms of particular disclosures being "...misleading to appellate as reasonable investors..."[38] and again the same court spoke in terms of a test being that reasonable minds could not come to but one conclusion[39] and again spoke of the conclusions of a reasonable juror in connection with a disclosure of environmental costs in a prospectus issued by Mid-American Waste Systems, Inc.[40]

Although the SEC has always refused to define materiality in a specific sense with respect to its anti-fraud rules, it has in fact established quantitative tests in accounting areas. For example, Item 2 of Form 8-K requires disclosures concerning acquisitions or dispositions of a significant amount of assets.[41] The term "significant" is defined by a quantitative test of ten percent of total assets.[42] A similar definition is used in Regulation S-X,[43] 1933 Act Rule 405[44] and 1934 Act Rule 12b-2[45] defining significant subsidiary. Note that the term "significant" rather than "material" is used. However, in August 1999 the SEC staff issued Staff Accounting Bulletin 99 in which it discussed materiality in financial statements and concluded that purely quantitative steps should be rejected in favor of a test that looks to surrounding circumstances and necessarily involves both quantitative and qualitative considerations of materiality.[46] The staff acknowledged the usefulness of the rule of thumb five percent test but noted that consideration of all relevant circumstances could well result in a judgment that misstatements below five percent are material.[47]

Quantitative materiality remains a useful context in many areas. Usually it is expressed in terms of a percentage of assets, shareholders equity, net income or operating income. While some types of information may be extremely important to a company, they may not be important to shareholders in the market and therefore their statement or omission would not be material. For example, the creation and implementation of a strategic plan for a midwest service based company to enter into the northeast market may be a prime concern to the company and involve strict security to maintain the confidentiality of the move from competitors. However that information could involve less than one percent of assets or projected revenues. From a quantitative perspective such information would not be material to investors.

There is good reason to analyze the test of materiality differently in voting and market situations. In the voting circumstance, the judgment of whether a particular incorrect statement or omission is material must involve a subjective analysis of factors affecting voting decisions. In that sense, the concept of the "reasonable investor" is about as good as we can find. In the market area, however, the test can be more objective by measuring the impact of the disclosure on the market. Here there is no reason to confine the test to reasonable investors. A reasonableness test may well exclude a majority of investors in many of the recent roman candle Nasdaq flare-ups and flame outs. Even an unreasonable

continued on page 4

Defining Materiality

continued from page 3

investor, however, deserves the protection of the securities laws. If, as is generally accepted, we analyze the market from the efficient market theory, then any act or omission which noticeably affects that market is material because the efficient market depends on the free flow of correct and complete information. Therefore, building on Basic vs. Levinson and the implication of TSC in market cases, one can say that a fact or omitted fact is material if an eventual disclosure causes a notable market reaction. Thus, at various times a misstatement of one percent in earnings could be material and in another day it may require a ten percent change to have a noticeable effect. Therefore, defining materiality is a nearly impossible task to achieve, but one that continues to evolve in our common law tradition.

But there is another view of materiality that must also be considered and that is qualitative materiality. Consider the requirement that the ages of directors and executive officers be set forth in proxy statements. Even if several ages were stated incorrectly by twenty percent, for example a 55 year old executive described as being 44, the information would not meet the TSC test of materiality. However, if the age of a dominant founder of a public company in the later stages of life were so understated it would be a material misstatement. One thinks of Walt Disney, Edward Lamb or at some point Bill Gates.

Likewise, breaches of fiduciary duty are almost always found to be material even though the amounts involved may involve a very small percent of assets. The case of the service business described above could also be material if the move signals a shift in business strategy involving greater risk or loss of a business advantage.

Thus it must be recognized that materiality is defined in the eyes of the beholder. This concept was noted by SEC Chairman Arthur Levitt, Jr. in a speech in September 1999 when he remarked:

> ... **materiality** [is] a word that captures the attention of both attorneys and accountants. Materiality is another way we build flexibility into financial reporting. Using the logic of diminishing returns, some items may be so insignificant that they are not worth measuring and reporting with exact precision.
>
> But some companies misuse the concept of materiality. They intentionally record errors within a defined percentage ceiling. They then try to excuse that fib by arguing that the effect on the bottom line is too small to matter. If that's the case, why do they work so hard to create these errors? Maybe because the effect can matter, especially if it picks up that last penny of the consensus estimate. When either management or the outside auditors are questioned about these clear violations of GAAP, they answer sheepishly....... "It doesn't matter. It's immaterial."
>
> In markets where missing an earnings projection by a penny can result in a loss of millions of dollars in market capitalization, I have a hard time accepting that some of those so-called non-events simply don't matter.

This phenomenon has been painfully observed in the flame out phase of the recent roman candle market. Announcements of declines or anticipated declines in earnings of a penny or less, or involving less than a percent in some cases, has sparked market declines of far greater proportion. This type of reaction can also affect blue chip companies. For example, in February 2001 a major Dow Jones company predicted a decline from 2.5 percent to four percent in its earnings for the quarter. The announcement promptly lead to a 6.5 percent drop in its market price. That is the kind of information that, prior to Regulation FD, may have been selectively disclosed by some issuers to analysts thereby enabling the analysts and their clients to trade before market reaction set in once the news was publicly announced. The market reaction then would likely be gradual over time as the tippees sold but it would allow more unwitting buyers to take positions than is the case with a sudden market drop.

Shareholders in these recent instances seem to be technical or momentum investors to whom trends far outweigh other considerations such as dividend yields or price earnings ratios. This condition may not continue. Therefore, the one cent change so material to the market today may not be material in a more traditional market setting tomorrow. A hard and fast definition of materiality would serve neither market environment well. The "definition" of materiality has and will continue to differ over time and circumstance.

Perhaps we can tweak the TSC definition, at least at it applies to market versus voting circumstances. This suggestion is that an omitted fact be considered material if there is a substantial likelihood that an active trading market would react to it.

Endnotes

1 Senior Partner, Keating, Muething & Klekamp P.L.L.; Vice Chairman of the Ohio State Bar Association Corporate Bar Committee; Adjunct Professor of Law, University of Cincinnati College of Law. This article is dedicated to former Ohio Commissioner of Securities George Ward who always asked "What's important about this offering?"

2 Selective Disclosure and Insider Trading, Exchange Act Release No. 34-42259, 1999 SEC Lexis 2696 (Dec. 20, 1999).

3 See 17 C.F.R. §§ 243.100-103 (2001).

4 463 U.S. 646 (1983).

5 See id.

6 See SEC v. Stevens, Litigation Release No. 12813, 1991 SEC Lexis 451 (Mar.19, 1991).

7 See id.

8 Selective Disclosure and Insider Trading, Exchange Act Release Nos. 33-7881, 34-43154, 2000 SEC Lexis 1672 (Aug. 15, 2000).

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Division Obtains Preliminary Injunction Against George J. Fiorini, II and Guardian Investments, LLC.

On September 4, 2001 Hamilton County Common Pleas Judge Robert Ruehlman issued a preliminary injunction against George J. Fiorini, II and Guardian Investments, LLC. Fiorini conducted business from Cincinnati; Guardian conducted business from Erlanger, Kentucky.

On April 20, 2001, the Division, through the Ohio Attorney General's Office, sued respondents, alleging violations of the Ohio Securities Act, including the fraud provisions, in connection with the sale of promissory notes and membership interests in Guardian. The lawsuit asked for preliminary and permanent injunctions against future violations of the Ohio Securities Act, and that an accounting be ordered of the receipt and disbursement of investor funds.

Judge Ruehlman issued his preliminary injunction with the consent of the parties. He additionally ordered Respondents to file an accounting with the Court by October 31, 2001.

Defining Materiality

continued

[9] Id at *35-6.

[10] See id at *37-8.

[11] Id at *18.

[12] 17 C.F.R. § 240.10b-5 (2001).

[13] See id.

[14] 15 U.S.C. § 78j (2001).

[15] Id at § 77g.

[16] Ohio Rev. Code Ann. § 1707 (2001).

[17] Id at § 1707.41.

[18] Id.

[19] Id at § 1707.44(B).

[20] Id.

[21] Id at § 1707.44(J). The statute states:

No person, with purpose to deceive, shall make, issue, publish, or cause to be made, issued or published any statement or advertisement as to the value of securities, or as to the alleged facts affecting the value of securities, or as to the financial condition of any issuer of securities, when the person knows that such statement or advertisement is false in any material respect.

Id.

[22] Id at § 1707.44(K). "No person, with purpose to deceive, shall make, record, or publish or cause to be made, recorded, or published, a report of any transaction in securities which is false in any material respect." Id.

[23] See id at § 1707.44(J), (K).

[24] Id at § 1707.041.

[25] Id at § 1707.042.

[26] 426 U.S. 438 (1976).

[27] See id.

[28] 17 C.F.R. § 240.14a-9 (2001).

[29] See id.

[30] See TSC, 426 U.S. at 440.

[31] See id at 443-44.

[32] See id at 445.

[33] Id at 449.

[34] 485 U.S. 224, 231 (1988).

[35] See id at 238.

[36] 1984 U.S. Dist. Lexis 20074 (N.D. Ill. Jan. 26, 1984).

[37] See id.

[38] Federated Management Co. v. Coopers & Lybrand, 738 N.E.2d 842, 859 (Ohio Ct. App. 2000).

[39] See id.

[40] See id at 864; see also Byrley v. Nationwide Life Insurance Co., 640 N.E.2d 187 (Ohio Ct. App. 1994).

[41] See 17 C.F.R. § 249.308 (2001).

[42] See id.

[43] Id at § 210.

[44] Id at § 230.405.

[45] Id at § 240.12b-2.

[46] 7 Fed. Sec. L. Rep. (CCH) ¶¶ 75,563, 75,701 (Aug. 12, 1999).

[47] Id.

Supreme Court

continued from page 1

financial services through its investment planners, investment advisors, and money managers. The group offers insurance services through independent insurance specialists and offers accounting services through several local accounting firms. The group proposes paying lawyers a fee for referring clients in need of financial services. Upon referral, the financial services group meets with the client at the lawyer's office. The lawyer is to be present at the initial meeting. The lawyer approves the plan or product before it is offered to the client. The lawyer receives a fee for each client referred. The financial services group and the lawyer negotiate the fee in advance of the referral.

The opinion addresses whether the proposed activity is ethical. The opinion does not address whether a referral fee from a financial/investment advisor is unlawful for that is beyond the advisory authority of the Board of Commissioners on Grievances and Discipline.

Several rules within the Ohio Code of Professional Responsibility are applicable to the question raised, DR 3-103(A), DR 5-101(A)(1), DR 5-104(A), and DR 5-107(A)(1) and (2). These rules govern two ethical concerns relevant to this opinion: (1) Improper business relationships with clients and other non-lawyers and (2) Interference with the professional judgment of a lawyer.

Improper business relationships with clients and other non-lawyers

> **DR 3-103(A)** A lawyer shall not form a partnership with a non-lawyer if any of the activities of the partnership consist of the practice of law.

> **DR 5-104(A)** A lawyer shall not enter into a business transaction with a client if they have differing interests therein and if the client expects the lawyer to exercise his [her] professional judgment therein for the protection of the client, unless the client has consented after full disclosure.

DR 3-103(A) prohibits the formation of partnerships between lawyers and non-lawyers when any of the activities include the practice of law. DR 3-103(A) has been construed as applying to the formation of business relationships and associations, not just true partnerships formed under state law. *See*, Ohio Sup Ct, Bd Comm'rs on Griev & Disc, Op. 92-15 (1992) advising that a law firm retained by a business corporation to perform services related to the corporation's marketing of wills, durable powers of attorney, and living wills gives the appearance of a business relationship, possibly running afoul of DR 3-103(A); and Ohio Sup Ct, Bd Comm'rs on Griev & Disc, Op. 97-1 (1997) advising that "[a] lawyer who enters a franchise agreement with a non-lawyer would be involved in a business relationship with a non-lawyer where the activities consist of the practice of law in violation of DR 3-103(A)."

The financial services group, while not asking lawyers to form partnerships as defined under state law, is asking for ongoing business associations or relationships with the law firms. As explained below, the proposed business relationships involve activities that consist of the practice of law and therefore violate DR 3-103.

Clients expect lawyers to make appropriate referrals to other individuals or groups when the need becomes apparent during the legal representation. If during the legal representation, a lawyer ascertains that a client needs financial services, the lawyer has a fiduciary duty to refer a client to appropriate resources. These referrals are part of the attorney's practice of law. The lawyer's duty of loyalty demands that the referral be made in the client's best interest, free of compromise and conflict. A lawyer should not make these referral decisions based upon financial incentives that a particular company may offer the lawyer.

DR 5-104 prohibits a lawyer from entering a business relationship with a client when there are differing interests therein. For the reasons stated below, the proposed business relationship involves the lawyer in a business relationship with the client and with the financial services group in which there are differing (and/or the potential for differing) interests that would violate DR 5-104(A) in the absence of informed client consent.

The lawyer appears to be entering a business relationship with only the financial services group and not with the client, but upon closer examination, the business relationship is a triumvirate. The financial services group receives the clients and earns money from the sale of its plans and products. The client receives plans and products from the financial services group and receives legal advise about the plans and products from the attorney. The attorney refers the client, provides office space for the meetings between the financial group and the client, attends the initial meeting, and approves the financial plans and products being offered. The attorney and the financial group might negotiate the referral fee in a variety of ways and as a consequence the interests would vary. For example, the fee might be negotiated as a one-time fee per referral. The fee might be negotiated as a one-time fee based upon how much of the product the client buys. Or, the fee might be negotiated as an ongoing fee throughout the life of the product, such as a negotiated portion of the asset management fee. Regardless of how the fee is negotiated, there exists a business relationship among the lawyer, client, and the financial services group.

Interference with the professional judgment of a lawyer

> **DR 5-101(A)(1)** Except with the consent of the client after full disclosure, a lawyer shall not accept employment if the exercise of professional judgment on behalf of the client will be or reasonably may be affected by the lawyer's financial, business, property, or personal interests.

> **DR 5-107(A)** Except with the consent of his [her] client after full disclosure, a lawyer shall not:
>
> (1) Accept compensation for his [her] legal services from one other than his [her] client.

> (2) Accept from one other than his [her] client any thing of value related to his [her] representation of or his [her] employment by his [her] client.

DR 5-101(A)(1) prohibits a lawyer's acceptance of employment when the lawyer has financial, business, property, or personal interests that will affect or reasonably may affect the exercise of a lawyer's professional judgment on behalf of the client. By logical extension, the rule also prohibits a lawyer's continued employment when there are such interests. A referral fee is a financial interest that will or reasonably may affect a lawyer's professional judgment under DR 5-101(A). The more referrals, the more money made.

DR 5-107(A)(1) prohibits a lawyer from accepting compensation for legal services from one other than the client. As already stated, making an appropriate referral of represented clients in need of financial services is a legal service expected of a lawyer in fulfilling his or her fiduciary duties to a client. A referral fee paid by a financial services group to a lawyer falls within the ambit of this rule because the fee indirectly provides compensation to a lawyer for expected legal services.

DR 5-107(A)(2) prohibits a lawyer from accepting any thing of value related to his or her representation or employment of the client. A fee paid by a financial services group to a lawyer for referring a client to the group is a thing of value related to a lawyer's representation or employment of the client and is restricted by this rule.

These rules provide that consent of a client after full disclosure obviates the restrictions of the rules. Nevertheless, whether a referral fee paid to a lawyer is appropriate upon client consent is subject to interpretation and is an area of disagreement among ethics committees interpreting the rules of professional conduct.

One view is that disclosure and consent cure such conflict.

> **Connecticut Bar Ass'n, Informal Op. 97-16 (1997).** An attorney may accept a referral fee from a network of associated investment advisor representatives if the referring attorneys abide by certain requirements including disclosure and consent.

> **Missouri SupCt, Chief Disciplinary Counsel, Op. 960124 (undated).** An attorney's participation in a program involving payment of an ongoing fee to an attorney by an investment advisor and securities broker-dealer for referring a client who opens an account will violate Rule 4-1.7(b), unless the attorney fully discloses the relationship and the potential for the attorney to receive a financial benefit as a result of the referral.

> **Rhode Island SupCt, Ethics Advisory Panel, Op. 99-08 (1999).** A lawyer may accept a referral fee from a business associate for referring a client in need of investment services, if permitted by the rules and law governing the other business, but pursuant to Rule 1.8(a) must disclose that fact to the client.

Another view is that disclosure and consent do not cure the conflict.

> **Kentucky Bar Ass'n, Op. E-390 (1996).** A lawyer may not receive compensation structured as a percentage share of a recurring account management fee for the lawyer's referral of a client to an investment advisor, even after disclosure to and consent by the client.

> **Maryland State Bar Ass'n, Op. 96-17 (1995).** A lawyer may not ethically participate in a proposed business arrangement with a financial planning organization pursuant to which the lawyer, following settlement, having previously entered the relationship with the organization, refers a client for financial planning services and receives a commission if the client purchases any financial services. The committee noted in footnote 2 of the opinion that "even with full disclosure to the client, this Committee most probably would not condone the marketing arrangement."

> **New York State Bar Ass'n, Op. 682 (1996).** An attorney may not accept a referral fee from an investment advisor. Disclosure and consent would not cure the conflict.

> **Vermont Bar Ass'n Op. 98-8 (undated).** A lawyer may not accept a referral fee from an investment advisory service even with prior disclosure and consent by the client.

This Board agrees that clients expect appropriate referrals by their lawyers during the course of representation and that such referrals should be made free of financial incentive to the lawyers. *See, e.g.,* Vermont Bar Ass'n, Op. 98-8 (undated) advising that "[c]lients view recommendations to other professionals as part of their representation by their lawyers and expect their lawyers to act independently of any underlying financial interest in such referral; New York State Bar Ass'n Op. 682 (1996) advising the "disclosure and consent would not cure the direct and substantial conflict between the client's and lawyer's interests inherent in accepting a referral fee from the investment advisor, even where the client is offered the choice to claim the referral fee and the attorney purports to exercise independent judgment in framing his or her initial recommendation to consult an investment advisor. Clients view recommendations of other professionals as part of their representation by their lawyers, and expect that lawyers will act as trusted fiduciaries in such matters."

This board also agrees that full disclosure and consent do not resolve the conflict. Under the Ohio Code of Professional Responsibility, DR 5-101(A)(1), DR 5-104(A), and DR5-107(A)(1) and (2) provide a full disclosure and consent exception, but DR 3-103(A) does not. Because of the joint application of these rules to the issue raised, the full disclosure and consent exception does not apply.

In *Cincinnati Bar Ass'n v. Bertsche*, 84 Ohio St. 3d 170, 174 (1998), the Supreme Court of Ohio imposed an indefinite suspension on an attorney who, along with committing other misconduct, assisted bankruptcy clients in obtaining loans from a company to pay off their Chapter 13 balances and received $1200 to $1900

continued on page 10

Lifeblood Biomedical Inc.; W. Jefferey Mann

On June 28, 2001 the Division issued a Cease and Desist Order, Division Order No. 01-197, to Lifeblood Biomedical Inc. and W. Jefferey Mann of Maitland, Florida.

On April 10, 2001, the Division issued a Notice of Opportunity for Hearing, Division Order No. 01-115, to Respondents pursuant to Revised Code Chapter 119. The Division alleged that Respondents violated Revised Code section 1707.44(C)(1) by selling or causing to be sold unregistered promissory notes of Lifeblood Biomedical Inc. The Division also notified Respondents of their right to an adjudicative hearing pursuant to Chapter 119 of the Revised Code. A hearing was not requested and a final Cease and Desist Order was issued on June 28, 2001.

Canko Environmental Technologies Inc.; Heinz Lueders

On August 6, 2001 the Division issued a Cease and Desist Order, Division Order No. 01-219, to Canko Environmental Technologies Inc. and Heinz Lueders of Edmonton, Alberta, Canada.

On April 10, 2001, the Division issued a Notice of Opportunity for Hearing, Division Order No. 01-116, to Respondents pursuant to Revised Code Chapter 119. The Division alleged that Respondents violated Revised Code section 1707.44(C)(1) by selling or causing to be sold unregistered promissory notes of Canko Environmental Technologies Inc. The Division also notified Respondents of their right to an adjudicative hearing pursuant to Chapter 119 of the Revised Code. A hearing was not requested and a final Cease and Desist Order was issued on August 6, 2001.

Ameritech Petroleum Inc.

On August 6, 2001 the Division issued a Cease and Desist Order, Division Order No. 01-226, to Ameritech Petroleum, Inc. of Dallas, Texas.

On April 27, 2001 the Division issued a Notice of Opportunity for Hearing, Division Order No. 01-133, to Respondent pursuant to Revised Code Chapter 119. An amended order was sent to Respondent on May 1, 2001. The Division alleged that Respondent violated Revised Code section 1707.44(C)(1) by offering and selling unregistered promissory notes of Ameritech Petroleum, Inc. The Division also notified Respondent of its right to an adjudicative hearing pursuant to Chapter 119 of the Revised Code. A hearing was not requested and a final Cease and Desist Order was issued on August 6, 2001.

John Lewis

On July 9, 2001 John Lewis entered into a Consent Agreement with the Division and consented to the issuance of a Cease and Desist Order, Division Order No. 01-205.

The Division found that John Lewis violated the provisions of Ohio Revised Code Section 1707.44(C)(1) and Ohio Administrative Code Section 1301:6-3-19(A)(19) by selling unregistered securities that were not approved by his employing broker-dealer, Capital Brokerage Corporation. The Division's allegations stem from Mr. Lewis' sale of Chemical Trust promissory notes. The SEC has taken action against Chemical Trust which is currently in receivership.

Mr. Lewis waived his right to the issuance of a Notice of Opportunity for Hearing and his right to an administrative hearing pursuant to Chapter 119 of the Revised Code in the Consent Order. The Final Order to Cease and Desist was issued on July 9, 2001.

Matrix Acceptance Corporation

On September 6, 2001 the Division issued a Cease and Desist Order, Division Order No. 01-258, to Matrix Acceptance Corporation of New York, New York.

On December 15, 2000 the Division issued a Notice of Opportunity for Hearing, Division Order No. 00-478, to Respondent pursuant to Revised Code Chapter 119. The Division alleged that Respondent violated Revised Code sections 1707.44(C)(1) and 1707.44(B)(4) and by selling unregistered investment contracts and making false representations in connection with the sale of such investment contracts. The Division also notified Respondent of its right to an adjudicative hearing pursuant to Chapter 119 of the Revised Code. A hearing was not requested and a final Cease and Desist Order was issued on September 6, 2001.

Charles Howard Collins

On August 7, 2001, the Division issued Division Order No. 01-228, a Cease and Desist Order by Consent against Charles Howard Collins. Collins conducted business from Columbus, Ohio.

The Division found that the Respondent had violated the provisions of Revised Code section 1707.44(C)(1) and Ohio Administrative Code 1301:6-3-19(A)(19), respectively, by selling unregistered securities and by selling securities not recorded on his affiliated dealer's books and records. The Division's allegations stem from Respondent's sale between March 1998 and August 2000 of 98 promissory notes and investment contracts of Heritage Financial Network, Inc. At the time of these sales, Respondent was a licensed salesperson with Lincoln Financial Advisors Corporation. The Division notified Respondent of his right to an administrative hearing pursuant to Chapter 119 of the Revised Code, which Respondent waived by entering into the Consent Agreement. Therefore, the Division issued Cease and Desist Order No. 01-228.

Ira Sidney Stern

On August 13, 2001 the Division revoked the Ohio securities salesperson license, Division Order No. 01-233, of Ira Sidney Stern of Columbus, Ohio.

On November 7, 2000 the Division issued a Notice of Opportunity for Hearing, Division Order No. 00-413, to Respondent pursuant to Revised Code Chapter 119. An amended Division Order was sent to Respondent on April 19, 2001, Division Order No. 01-066. The Division alleged that Respondent violated Ohio Administrative Code rule 1301:6-3-19(A)(10) and conducted business in violation of Revised Code section 1707.19(A)(9) for transferring a customer's securities to his own personal account. It was also alleged that Respondent was not of "good business repute" as set forth in Ohio Administrative Code rules 1301:6-3-19(D)(2), (D)(7), (D)(8), and (D)(9), and conducted business in violation of Revised Code section 1707.19(A)(1). Respondent was the subject of a permanent injunction on September 22, 2000, in Franklin County Common Pleas Court, fined and censured by the NASD on May 19, 1999, and expelled from NASD membership on February 9, 2001. The Division notified Respondent of his right to an adjudicative hearing pursuant to Chapter 119 of the Revised Code. Respondent and the Division subsequently entered into a consent agreement in which Respondent agreed to the Division's findings. Accordingly, a final order revoking Respondent's Ohio securities salesperson license was issued on August 13, 2001.

Harbay Kessef & Co.

On August 13, 2001 the Division revoked the Ohio securities dealer license of Harbay Kessef & Co., Division Order No. 01-234, of Columbus, Ohio.

On November 7, 2000 the Division issued a Notice of Opportunity for Hearing, Division Order No. 00-414, to Respondent pursuant to Revised Code Chapter 119. An amended Division Order was sent to Respondent on April 19, 2001, Division Order No. 01-067. The Division alleged that Respondent was not of "good business repute" as set forth in Ohio Administrative Code rule 1301:6-3-19(D)(2), (D)(7), and (D)(9), and conducted business in violation of Revised Code section 1707.19(A)(1). It was also alleged that Respondent's Ohio dealer license be revoked based on the lack of "good business repute" of its principal, Ira Sidney Stern, pursuant to Revised Code sections 1707.19(A)(1) and 1707.19(F). Stern was the subject of a permanent injunction on September 22, 2000, in Franklin County Common Pleas Court, fined and censured by the NASD on May 19, 1999 and expelled from NASD membership on February 9, 2001. The Division notified Respondent of its right to an adjudicative hearing pursuant to Chapter 119 of the Revised Code. Respondent and the Division subsequently entered into a consent agreement in which Respondent agreed to the Division's findings. Accordingly, a final order revoking Respondent's Ohio securities salesperson license was issued on August 13, 2001.

International Business Consortium, Inc.; William L. Brotherton

On September 12, 2001 the Division issued Order No.01-262, a Cease and Desist Order, against International Business Consortium and William L. Brotherton of Colorado.

On August 9, 2001 the Division issued Order No. 01-232, a Notice of Opportunity for Hearing against International Business Consortium, Inc and William L. Brotherton for allegedly violating Revised Code section 1707.44(C)(1), i.e., the unregistered sale of securities. The order notified the Respondents of the Division's intent to issue a final Cease and Desist Order. The Respondents failed to timely request a hearing pursuant to Chapter 119 of The Ohio Revised Code, thereby allowing the Division to issue its Cease and Desist Order, Order No. 01-262, incorporating the allegations set forth in the Notice of Opportunity for Hearing.

CRIMINAL CASE UPDATES

Jackson Melvin Johnson was found guilty in the Montgomery County Court of Common Pleas of one count of selling unregistered securities issued by his company, Canyon Investments, Inc. A bill of information was handed down in October 1998 alleging that Johnson had sold unregistered promissory notes to several investors. Johnson's plea of no contest was entered on September 18, 2001, and the Court found him guilty after the plea was entered.

On July 18, 2001 **Thomas E. Freeman** was found guilty in Montgomery County on one count each of grand theft and fraudulent acts in connection with the sale of shares in a non-existent mutual fund to an Ohio resident. Freeman also converted the investor's funds for his own use and sent statements containing false investment and dividend information. He was sentenced to community control and ordered to pay restitution and court costs.

In plea agreements dated July 27, 2001 **Donald Wayne Owens** pled guilty to one misdemeanor count of attempted sale of securities without a dealer's license; **Peggy A. Hilty-Kaufman** and **Matthew Painter** each pled guilty to one count of attempted sale of an unregistered security. Owens, Hilty-Kaufman, Painter, and William E. Thurman II were indicted in Montgomery County Common Pleas Court on January 8, 2001 on felony securities charges relating to sales of promissory notes of **Tee to Green Golf Parks**, a golf practice business located in Buffalo, New York.

On August 6, 2001 **Gerald and Betty Payne,** founders of **Greater Ministries International Church,** were sentenced in U.S. District Court in Tampa for their role in what has been quoted as one of the largest Ponzi schemes in American history. The Paynes were found guilty on charges of conspiracy and securities fraud following a seven week criminal trial earlier this year. Gerald Payne received a 27-year prison sentence. Betty Payne was sentenced to 12 years, 7 months. Greater Ministries took in $490 million from 19,000 investors before the Ohio Division of Securities and the Alabama Securities Commission sought and received a permanent injunction in 1999 from a federal court in Tampa.

On August 16, 2001 **Joseph E. Erwin** was sentenced in U.S. District Court in Columbus to 10 years in prison for embezzling $2.2 million from 11 of his clients that was to be used for purchasing stocks and other securities. Erwin managed a branch office of Eisner Securities in central Ohio. The Division had revoked Erwin's Ohio securities salesperson license on February 5, 2001.

On August 22, 2001 **Geoffrey P. Benson** of **The Infinity Group** received a 30-year sentence in U.S. District Court in Youngstown. Benson was convicted for mail and wire fraud, conspiracy to commit wire fraud, conspiracy to impede and impair the Internal Revenue Service, and tax evasion. In addition, Benson's wife, **Susan L. Benson**, and **Geoffrey J. O'Connor** of Painesville, Ohio, were each sentenced to 10 years, 1 month in prison on the same charges. The judge also ordered the Bensons and

continued on page 10

Enforcement Reports

continued from page 9

O'Connor to pay $12.4 million in restitution to the investors. The Infinity Group sold investments to as many as 10,000 people worldwide in a $26.6 million pyramid and Ponzi scheme. While investigating the Infinity Group in 1997, the Division attempted to review the company's records, but was refused access to the records. The Division then requested and was granted a preliminary injunction against the company.

On August 27, 2001 Akron attorney and financial planner **Andrew Paul Bodnar, Jr.,** received an eleven-year sentence in U.S. District Court in Akron. Bodnar was also ordered to pay $20 million in restitution. In a plea agreement in April, Bodnar pleaded guilty to charges of securities fraud, mail fraud, tax evasion, and conspiracy to commit securities fraud, mail fraud, and wire fraud. Bodnar was the mastermind of a Ponzi scheme in which he defrauded at least 700 investors of more than $41 million. Many of the investors were elderly residents of the Akron area. In August1998, the state filed a motion asking the Summit County Court of Common Pleas to appoint a receiver to recover the assets of Bodnar and his affiliated entities.

continued on page 12

Streamlined Licensing Procedures

For the 2002 renewal cycle, securities dealers affiliated with the National Association of Securities Dealers, Inc. (NASD) and licensed in Ohio will, for the first time, be able to renew their dealer license via the Central Registration Depository (CRD). Dealer renewals will, as a consequence, be entirely electronic as the Division will no longer require the Ohio specific dealer questionnaire. This streamlined process will enhance the efficiency of the licensing procedure in Ohio for both the industry and Division personnel.

In addition, securities dealers will also enjoy a licensing fee reduction for the 2002 renewal cycle as a result of the initial and renewal fee being changed to a flat $100 from the current graduated scale.

Securities dealers are not the only beneficiary of the recent changes as the fees for investment advisers—both federal filers submitting a notice filing in Ohio and state filers—have also been reduced to $50 annually. These reductions in fees are an effort to assist small businesses by minimizing some of their financial burdens and were contained in S.B. 32 which became effective October 5, 2001.

In conjunction with these licensing changes, investment advisers should be aware of certain other changes taking place with regard to their annual licensing procedures. Those investment advisers registered with the Securities and Exchange Commission (SEC) who must submit notice filings to the Division must do so via the Investment Adviser Registration Depository (IARD). As these federal filers are mandated by the SEC to submit their application using the IARD, so should these federal filers submit their Ohio notice filing via the IARD. An Ohio administrative rule requiring federal filers to submit their notice filings using the IARD will become effective in November 2001.

Although not currently mandated in Ohio, investment advisers not registered with the SEC and otherwise required to submit an application in Ohio should review the procedures and transitioning process, and begin using the IARD to submit applications in Ohio. **It is anticipated that the Division will mandate IARD usage for state filers in early 2002.** As a consequence, if you are not yet familiar with the IARD, the online database maintained by the NASD, please visit the IARD web site located at www.iard.com or contact the NASD help desk.

Supreme Court

continued from page 7

in fees from the company on each loan. According to the court,

> [r]espondent neither advised his clients in advance of his fees for loan refinancing nor filed the required applications to inform the court of those fees. As a consequence, respondent set his fee unilaterally with no input from his clients or the court. Thus, if respondent represented his clients in the loan transactions, he failed to adhere to our Ethical Considerations and failed to comply with the federal bankruptcy rules.

The record indicates that at least two of respondent's clients believed that the $1500 added to their loans was a fee that Associates [the company] paid to respondent for referring the clients to it. If such was the case, respondent was in a conflict-of-interest situation. In either this situation or the unilateral-fee-setting situation, respondent was in violation of our disciplinary standards

Id. At 173-74

In conclusion, this Board advises that it is ethically improper for a lawyer to accept a fee from a financial services group for referring clients in need of financial services. The referral fee agreement involves an improper business relationship with clients and non-lawyers under DR 3-103(A) and DR 5-104(A). The referral fee agreement creates a financial interest that will affect or reasonably may affect the professional judgment of a lawyer under DR 5-101(A)(1) and DR 5-107(A)(1) and (2). Full disclosure and consent do not resolve the conflict. While DR 5-101(A)(1), DR 5-104(A) , and DR 5-107(A)(1) and (2) provide a full disclosure and consent exception, DR 3-103(A) does not. Because of the joint application of these rules, the full disclosure and consent exception does not apply.

Advisory Opinions of the Board of Commissioners on Grievances and Discipline are informal, nonbinding opinions in response to prospective or hypothetical questions regarding the application of the Supreme Court Rules for the Government of the Bar of Ohio, the Supreme Court Rules for the Government of the Judiciary, the Code of Professional Responsibility, the Code of Judicial Conduct, and the Attorney's Oath of Offices.

Registration Statistics

The following table sets forth the number of registration, exemption, and notice filings received by the Division during the third quarter of 2001, compared to the number of filings received during the third quarter of 2000. Likewise, the table compares the year-to-date filings for 2001 and 2000.

Filing Type	3rd Qtr '01	YTD '01	3rd Qtr '00	YTD '00
1707.03(Q)	8	105	39	153
1707.03(W)	0	16	6	19
1707.03(X)	59	819	339	1189
1707.03(Y)	4	13	5	9
1707.04/041	0	0	1	1
1707.06	11	66	24	80
1707.09/091	15	123	39	132
1707.092(A)*	296	3614	1139	3660
1707.092(C)**	0	0	1	1
1707.39	1	3	8	14
1707.391	2	58	11	76
Total	396	4817	1612	5334

** Investment company notice filings.*
***Offerings of covered securities not otherwise covered by another statutory provision in the Ohio Securities Act.*

Capital Formation Statistics*

Because the Division's mission includes enhancing capital formation, the Division tabulates the aggregate dollar amount of securities to be sold in Ohio pursuant to filings made with the Division. As indicated in the notes to the table, the aggregate dollar amount includes a value of $1,000,000 for each "indefinite" investment company filing. However, the table does not reflect the value of securities sold pursuant to "self-executing exemptions" like the "exchange listed" exemption in R.C. 1707.02(E) and the "limited offering" exemption in R.C. 1707.03(O). Nonetheless, the Division believes that the statistics set out in the table are representative of the amount of capital formation taking place in Ohio.

Filing Type	Third Qtr 2001	YTD 2001
Exemptions		
Form 3(Q)	4,923,334	198,712,602
Form 3(W)	0	30,053,340
Form 3(X)	8,907,243,419	91,698,294,584
Form 3(Y)	2,710,124	18,360,124
Registrations		
Form .06	64,335,000	1,410,846,348
Form .09/091	241,045,383	24,655,771,393
Form .092(C)	0	0
Investment Companies		
Definite	28,301,500	424,087,000
Indefinite**	139,000,000	2,045,000,000
TOTAL	**$9,387,558,760**	**$120,481,125,391**

**Categories reflect amount of securities registered , offered, or eligible to be sold in Ohio by issuers.*
***Investment companies may seek to sell an indefinite amount of securities by submitting maximum fees. Based on the maximum filing fee of $1100, an indefinite filing represents the sale of a minimum of $1,000,000 worth of securities, with no maximum. For purposes of calculating an aggregate capital formation amount, each indefinite filing has been assigned a value of $1,000,000.*

Enforcement Reports

continued from page 10

The Millennium Group; Terry Fairbanks

On March 28, 2001 the Division issued a Cease and Desist Order against The Millennium Group and Terry Fairbanks. The Order found the respondents had sold stock that was not registered in violation of R.C. 1707.44(C)(1). The stock had been issued by The Millennium Group, a company located in Panama City, Panama. Fairbanks sold stock on behalf of The Millennium Group in the amount of $6,500 to an Ohio investor.

John W. Taylor

On May 9, 2001 the Division issued a Consented Cease and Desist Order against John W. Taylor. The Order found the respondent had sold a promissory note that was not registered in violation of R.C. 1707.44(C)(1). The note had been issued by South Mountain Resort and Spa, Inc., a North Carolina company. Taylor had sold a note in the amount of $17,000 to an Ohio investor. Upon issuing a Notice of Opportunity for Hearing to the Respondent alleging the above facts, the Division and the Respondent entered into talks that lead to the issuance of the final Cease and Desist Order. The Respondent consented to the issuance of this Order and stipulated to the findings stated therein.

Edward M. Stanko, Jr.

On July 19, 2001 Edward M. Stanko, Jr., entered into a Consent Agreement with the Division and consented to the issuance of a Cease and Desist Order, Division Order No. 01-210.

The Division found that Mr. Stanko sold securities to investors without having been licensed by the Division as a dealer, and therefore, violated Ohio Revised Code section 1707.44(A)(1). The securities that Mr. Stanko sold were five promissory notes issued by Tee to Green Golf Parks, Inc., and two partnership interests in Driving Force I, RLLP. The Final Order to Cease and Desist was issued on July 19, 2001.

Licensing Statistics

License Type	YTD 2000
Dealer	2,348
Salesmen	126,699
Investment Adviser	1,407
Investment Adviser Representative	8,481

OHIO SECURITIES BULLETIN

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