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Frankenstein Roams God's County: Orange County Fiasco Demonstrates the Perils the Use of Derivatives Can Pose to Public Funds

by Desiree T. Shannon, Esq.

The word *derivatives,* used in the context of the securities industry, has taken on the sort of patina that used to be reserved for a word on the order of *hemorrhoids.* Some commentators have indeed likened certain derivatives to some dangerous and painful growth that is plaguing the backside of the securities industry, characterizing them as the equivalent of "toxic waste." These attitudes are no doubt borne by numerous high-profile fiscal debacles in and outside of Ohio. In the late '80s and early '90s, public officials purchased these complex, highly volatile securities from various brokers; the derivatives, in turn, supplied outstanding yields, sometimes double those of conventional "vanilla" securities. But public officials discovered the dark side of these godsend securities when interest rates began to fluctuate in the early '90s.

A derivative's value, by definition, is derived from the performance of an underlying asset, such as a mortgage-backed security, a currency, or interest rate. Most derivatives purchased for public funds were based on mortgage-backed securities but also tied in some fashion to interest rates, their value being dependent upon the direction interest rates were moving (*see* "An Introduction to Mortgage-Backed Derivatives" *below*). Public investment funds sustained huge losses when interest rates began moving away from the direction favorable to the derivatives' value. Many public funds quietly housed these securities for years, not realizing any dan-

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An Introduction to Mortgage-Backed Derivatives

by Thomas E. Geyer, Esq.

"Derivative" is a generic term describing a financial instrument, the value of which is "derived" from another financial instrument or asset. An option is a simple form of derivative, because the value of a put or call is derived from the value of the underlying security. Other common forms of derivatives are those based on mortgage-backed securities, commodities, foreign currencies and interest rates.

Among these common forms, mortgage-backed derivatives have been vilified as a result of recent investment fund debacles. While it is true that some mortgage-backed derivatives were in the Orange County portfolio (*see* "Frankenstein Roams..." *above*) and mortgage-backed derivatives were at issue in two recent Division enforcement actions (*see* "Division Revokes..." *supra* p. 8), mortgage-backed derivatives are not inher-

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ger until the damage was evident. In most cases, the losses resulted from the misuse and mismarketing of derivatives (*see* "Division Revokes..." *supra* p. 8).

Perhaps a more fitting allegory to the derivative dilemma would be that of Frankenstein's monster. Frankenstein's monster, like these securities, was a complex hodgepodge creature, that, in essence, was not inherently bad. He turned bad, however, because people misunderstood and misused him. This theme of misunderstanding and misuse of derivatives was played out in operatic proportions in no place other than Orange County, California, the sunny bastion of suburban bliss that begot the Magic Kingdom, Richard Nixon and Proposition 13. For in December 1994, Orange County was brought to its knees (and managed to drag many others down with it) because its long-time treasurer, Robert L. Citron, had sunk the County's investment pool with exploding derivatives, and, even worse, had done so through a complicated leveraging arrangement with several large investment firms.

Voodoo Investment Strategy in the Magic Kingdom

In retrospect, Robert L. Citron seemed an unlikely participant in the destruction of Orange County's investment pool, which contained billions of dollars in funds. Citron, who had been Orange County's treasurer since 1973, was said to be so conservative with his own finances that he kept most of his own money in bank accounts.[1] In 1979, Citron was instrumental in getting the California legislature to change state law to allow counties to borrow money through arrangements called reverse repurchase agreements.[2] Using these agreements, Citron borrowed funds from various investment banks against the pool's $7.5 billion in investment holdings, leveraging the fund to more than $20 billion.[3]

Reverse repurchase agreements typically allow public fund managers to buy securities, while simultaneously pledging them to an investment bank as collateral for a loan.[4] If an investor uses the loan to purchase a security of comparable value and yield, and he or she is being charged a low interest rate for the loan, the yield on the underlying security increases as long as interest rates remain stable.[5] If interest rates go up, a double squeeze occurs, because he or she is using short-term borrowing (reverse repurchase agreements typically have a life of not more than 60 or 90 days) to purchase long term investments. The value of the collateral drops, causing the lender to demand additional collateral to make up the difference. Additionally, the agreements are rolled over, increasing the danger that the cost of the loan may rise above the return on the underlying investment in the wake of fast-rising interest rates.[6]

What made Orange County's use of reverse repurchase agreements even more precarious was that a significant portion of Orange County's collateral pool was made up of derivatives called *inverse floaters*, whose market values and interest rates decline by a multiple of any increase in the market rate.[7]

This risky investment strategy paid off temporarily for Orange County and its many pool participants, which included school districts, public safety departments and city governments who were attracted by the fund's investment return of up to 9%.[8] But the alarm bells began to sound in early 1994, when interest rates began to inch up. In March 1994, John Moorlach, an accountant who was Citron's Republican opponent in an upcoming election, had the fund's financial statement evaluated by several bond brokers, who he claims were troubled by what they found. He tried to use the fund's problems as an election issue, attempting to stir up media interest. However, his attempts fell on the deaf ears of the media and the public, who were

OHIO SECURITIES BULLETIN

Thomas E. Geyer, 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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star-struck by the high-rolling Citron's impressive returns on the fund. Citron was re-elected as the fund continued to reach a crisis point.[9]

Orange County's financial time bomb exploded in early December 1994, when most of its lenders refused to roll over reverse repurchase agreements with the county, demanding cash and additional collateral.[10] With the value of the fund diving, county officials had approached several Wall Street firms in an attempt to liquidate the fund's plethora of troublesome derivatives. All of the firms ran away screaming after reviewing the fund's portfolio.[11] Meanwhile, the investment bankers who had extended loans to the fund demanded payment, forcing Orange County into default on most of the loans. Most of the banks, in turn, liquidated the fund's collateral.[12] On December 6, 1994, Orange County became the largest municipality in U.S. history to file for bankruptcy protection. Needless to say, Citron resigned as Orange County treasurer.[13]

Fall-Out and Finger-Pointing

Predictably, once Orange County's bankruptcy became public, investors holding municipal bonds issued by the county began screeching like a chorus of scorched cats. They commenced lawsuits against the county, as well as brokers who sold the bonds, such as Merrill Lynch and Smith Barney, claiming the firms concealed the county's "reckless investment practices."[14] Orange County bondholders were not the only ones fearful of the situation; investors around the country were afraid other municipalities who had delved into similar investments would be forced to crawl out of the dark, like cockroaches on the march to bankruptcy court.[15]

The SEC launched several investigations relating to the crisis. The SEC itself was stung by criticism from Orange County officials that it had refused to take steps that would have forestalled a bankruptcy because it wanted to pressure Congress into giving it more power to regulate the municipal securities market.[16] An SEC enforcement official colorfully denied the allegation, saying that "...we're not responsible for the financial condition of this county...(s)omebody must have been smoking something or dropped in from planet Mars."[17] Initially, the SEC was investigating Citron's activities, particularly regarding risk disclosure issues to pool participants. Regulators were also reviewing the possibility that Citron shifted bonds among various accounts at book value, rather than market value, to shuffle gains and losses among various members of the investment pool.[18]

The investigation eventually widened to include brokerage firms such as Merrill Lynch, who sold Orange County municipal securities during the summer of 1994, and whether proper disclosures were made regarding the fund's losses, which were becoming apparent by that time.[19] Regulators were also questioning possible campaign contributions by certain brokers to Orange County officials' election campaigns.[20] Arthur Levitt, Chairman of the SEC, chastised the Orange County Board of Supervisors for allowing Citron such free reign regarding investment practices, saying "(I)f your supervisors are so lax that they allow you...to make that kind of speculation, I think the voters of that community should throw the whole bunch out of office."[21]

County officials and brokers were not the only ones at the end of a finger. Rating agencies, such as Standard & Poor's and Moody's Investors Service, were pummeled for giving high ratings to the county's general obligations up to the day of the bankruptcy.[22] The agencies countered that their ratings were merely based on information provided by Citron, claiming that he understated his fund's derivative position.[23] After Orange County's problems, the agencies stepped up inquiries to public bond-issuing entities regarding possible use of derivatives.[24]

Of course, Citron remained at the center of the dark, mushrooming cloud hanging over Orange County. Early on, Citron attempted to portray himself as an innocent trapped in a jungle that was ruled by financial wolves. At a hearing conducted by a special committee appointed by the California Senate in January 1995, he claimed he was an "innocent investor" who relied on advice from "financial professionals," primarily at Merrill Lynch. He claimed he relied on a statement by an official at Merrill that the interest rate increases would not last into 1994.[25] In response to Citron's remark, Merrill claimed it did not determine the county's investment strategy, and attempted to warn Citron that the county's fund could sustain big losses as interest rates rose.[26] Meanwhile, Citron also managed to deflect some blame to the Board of County Supervisors, whom he said never asked for monthly reports as required by California law.[27]

In preparation for criminal charges being formulated against him, Citron began laying groundwork for a defense. His defense basically consisted of two points: that the risky investments primarily responsible for sinking the county's portfolio were permissible under California law, and that he made full disclosure of their risky nature to everyone whom he owed a duty to do so.[28] He also maintained that pool investors should have realized how risky the county's investment pool had become, given that their level of sophistication was comparable to his.[29] However, investigators and regulators noted the contradiction in the fact that Citron claimed to have no knowledge of the financial issues that figured in the pool's loss, yet advised pool investors of risk elements of the pool,

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often either minimizing or tempering these elements with overly-optimistic market opinions.[30] Still, a lot of respected financial players had held the same views, and legal experts debated whether information Citron passed onto investors was unreasonable.[31]

Ultimately, Citron was charged criminally and pled guilty in April to several fraud-related charges, although none of them alleged any of his activities served the purpose of personal gain.[32] The felony charges dealt primarily with Citron's efforts to cover losses the pool was sustaining by making false bookkeeping entries and manipulating accounts.[33] Citron still awaits sentencing and is participating in investigations spurred by various governmental agencies at the state and federal levels.[34] He now says he suffers from a progressive brain disease which made it possible for others to mislead him into making bad decisions regarding the fund.[35]

In the year since Orange County's financial meltdown, the county still finds itself in financial tumult. Orange County voters soundly rejected a sales tax increase to ease the County's financial woes.[36] However, the county managed to pay back pool investors most of their principal, blunting cuts in local government services.[37] The county continues legal maneuvering in attempts to deal with angry bondholders, some of whom have accused the county of trying to avoid its moral and legal obligations. One SEC official mused at the bondholders' dilemma, noting that in the event of default, they "couldn't seize the courthouse. All you have is the word of the...county behind these bonds."[38]

Some Troubling Questions Linger

In observing the Orange County fiasco, no one clear villain emerges. The episode has certainly made investors wary of derivatives like those that were loaded into the Orange County investment pool, as well as financing strategies that allow the borrowing of huge sums of money to buy them. It is true that, by definition, many types of derivatives are highly volatile instruments. After all, their performance is based on underlying factors that are themselves volatile and unpredictable, such as interest rates. Very few people would have predicted just a few years ago that interest rates would drop into the single digits, much less rise again significantly in just one year. Moreover, as Citron discovered, these types of securities can be highly profitable—as long as the investor is of a sort who has money to gamble away in the event of a sour turn. Regulators have challenged whether securities such as these should ever be sold to a public entity, and have investigated how such securities are marketed. An investor who purchases these securities not fully understanding how they work and assuming they guarantee any degree of safety is likely to find his or her financial house crushed by the investing world's equivalent of Frankenstein's monster.

If there is blame to go around regarding the county's woes, it falls squarely on the shoulders of anyone and everyone involved (or notably uninvolved) in structuring the investment pool, as well as those who have tried to escape the consequences if its demise. This not only includes Citron, but many other government officials in California. It also includes investment banks and brokerages who reaped huge fees from financing and selling derivatives to the fund. And ultimately, some blame must be put on taxpayers of all economic classes who don't want to pay increased taxes, yet gladly consume an ever-escalating level of government services that go way beyond basics such as law enforcement, road maintenance and education.

Most politicians are understandably afraid of being honest with taxpayers by telling them that nothing can be gotten for free and that citizens must decide whether they want to pony up or pare down. Measures like Proposition 13 have made it much more difficult for governmental entities to raise money. Fear of taxpayer reprisal makes it far easier for government officials to look toward complex, quick-money schemes of the type that battered Orange County's financial health. It makes it easier for them to ignore early warning signs of impending financial catastrophe. It makes it easier for them to look the other way when the returns on investments seem just a little too good to be true. It makes it easier for them to form perhaps what could be characterized as unhealthy symbiotic relationships with huge financing institutions.

For a long time, everyone involved in the Orange County fiasco was getting what they wanted at the financial table. Investment bankers and brokerages were getting fees; county officials were getting high praise for bringing in large amounts of revenue without having to raise taxes; and Orange County residents were getting a high level of services without having to pay extra for them in the short term. But everyone choked when they got the final bill.

Endnotes

1. Greenwald, *The California Wipeout; Orange County Files for Bankruptcy after Losing Big on High Risk Investments,* Time, Dec. 19, 1994, at 55; L.A. Times, Dec. 3, 1994, at 1, col. 5.

2. Greenwald, *supra.*

3. *American Municipalities; Citron Presse,* The Economist, Dec. 10, 1994, at 7.

4. *Id.*

5. L.A. Times, Dec. 3, 1994, at 1, col. 5.

6. *Id.*

7. Coffee, *The Suitability Doctrine Revisited: Can Orange County Sue Its Broker for Recommending the Purchase of Unsuitable Securities for Its Fund?*, The National Law Journal, Jan. 16, 1995 at B4.

8. Greenwald, supra.

9. Davis, *Investing*, Kiplinger's Personal Finance Magazine, April, 1995, at 75.

10. The Economist, *supra*.

11. L.A. Times, Dec. 7, 1994, at 1, col. 5.

12. *Id.*

13. *Id.*

14. New York Times, Dec. 10, 1994, at 39, col. 6.

15. *Id.*

16. L.A. Times, Dec. 8, 1994, at 1, col. 6.

17. *Id.*

18. Mathews and Machen, *Securities Enforcement*, Insights, June 1995, at 3.

19. L.A. Times, Dec. 10, 1994, at 1, col. 1.

20. New York Times, Dec. 16, 1994, at 39, col. 6.

21. *Id.*

22. Davis, *supra*.

23. *Id.*

24. *Id.*

25. New York Times, Jan. 18, 1995, at 1, col. 3.

26. *Id.*

27. *Id.*

28. L.A. Times, Dec. 30, 1994, at 1, col. 4.

29. *Id.*

30. *Id.*

31. *Id.*

32. New York Times, April 28, 1995, at 1, col. 2.

33. *Id.*

34. U.S.A. Today, Nov. 30, 1995, at 2B.

35. *Id.*

36. New York Times, Sept. 16, 1995, at 6, col. 6.

37. *Id.*

38. New York Times, June 4, 1994, at 1, col. 5.

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ently evil securities. Rather, mortgage-backed derivatives, as Ms. Shannon points out, are beneficial when used properly, but catastrophic when used (and marketed) improperly.

Mortgage-backed derivatives are derived from mortgage-backed securities. Mortgage-backed securities, first introduced in the early 1970s, are created when home mortgage loans are pooled together and then interests in the pool are sold to investors. The interest purchased by an investor is the right to receive the payments made on the underlying mortgages. In its simplest form, the principal and interest payments made on an underlying mortgage are simply passed through to the investor. While there are some privately issued mortgage-backed securities, most are issued by the Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA") and the Federal Home Loan Mortgage Corporation ("FHLMC").

The federal government created GNMA, FNMA and FHLMC not only to pool mortgages for investment and in turn return the investment proceeds to mortgage lenders, but also to eliminate "credit risk," (the risk that the issuing party will not pay as promised) associated with mortgage-backed securities. The timely payment of principal and interest is backed by, in the case of GNMA, the full faith and credit of the federal government, and the case of FNMA and FHLMC, the respective federal agency. This elimination of credit risk makes the mortgage-backed security an attractive investment and a permitted investment for most local governments (*see, e.g.*, R.C. § 135.35).

A mortgage-backed security is similar to a bond in that it entitles the purchaser to interest payments and the repayment of principal. However, a mortgage-backed security differs from a typical bond in two major respects. First, while a bond typically repays the principal in its entirety at maturity, because a homeowner's mortgage payment contains both a principal component and an interest component, a mortgage-backed security repays principal throughout the life of the security. Second, while many bonds are not "callable," because a homeowner can prepay a mortgage

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at anytime, a mortgage-backed security contains an embedded call feature.

This "prepayment risk" is the primary risk associated with mortgage-backed securities. Prepayments increase when interest rates decline, as homeowners pay off mortgages and refinance at a lower rate, and decrease when interest rates increase. Prepayment materially affects the value of a mortgage-backed security by shortening its life and reducing the interest component of the anticipated return. Although sophisticated prepayment models are used when mortgage-backed securities are created and priced, the unpredictability of interest rates and prepayment rates makes mortgage-backed securities a sometimes unpredictable investment.

In an attempt to make mortgage-backed securities more stable and predictable for investors, in 1983 mortgage-backed securities experts established the Collateralized Mortgage Obligation ("CMO") as the standard form of mortgage-backed security. A CMO divides underlying mortgage payments into series or "tranches," usually identified by letters, and attempts to spread out the prepayment risk by sequentially paying off the tranches. For instance, all payments on the underlying mortgages are first applied to the "A" tranche until it is paid off; then to the "B" tranche, and so on. Although the CMO structure spreads out prepayment risk, the tranche system does not eliminate prepayment risk.

In 1987, in response to the Tax Reform Act of 1986, mortgage-backed securities experts created the Real Estate Mortgage Investment Conduit ("REMIC") security. The REMIC is a type of CMO that achieves favorable tax treatment for both issuers and investors. Because of these tax advantages, today virtually all CMOs are issued in REMIC form.

In the 1990s, mortgage-backed securities experts began to derive other securities from the basic mortgage-backed security form. Among these derivations were securities that "stripped" the interest payment component from the principal payment component of the underlying mortgage payment and created two new derivative securities: a "principal only" ("PO") security, in which the investor purchases the right to receive the principal payment component of the underlying mortgage payment; and an "interest only" ("IO") security, in which the investor purchases the right to receive the interest payment component of the underlying mortgage payment.

POs and IOs are both risky securities because they are extremely sensitive to interest rates. However, the IO is the riskier of the two. While a PO investment is affected by prepayment in that the investor receives the principal earlier than expected, an IO investment evaporates with prepayment because the homeowner will no longer make any interest payments.

For example, consider a $100,000, thirty year, eight percent fixed rate mortgage that is part of a mortgage-backed security pool from which PO and IO securities have been derived. If this mortgage is prepaid after five years, the PO investor still gets the $100,000 principal, albeit sooner than expected. However, the IO investor gets only the interest payments for the five years the mortgage is outstanding — there are no more interest payments after the mortgage is prepaid. Undoubtedly, the IO investor will suffer a loss because the investor will have paid for the right to receive interest payments over thirty years, but will have received them for only five. Further, while the federal government or issuing agency guarantees timely payment on the underlying mortgage, neither the interest payment stream nor the original amount invested in an IO is guaranteed because once a mortgage is prepaid there is no longer an interest payment obligation. While an IO may provide an above market return when interest rates are stable or rise slightly, because the series of interest payments received over time will exceed the discount paid for the right to receive the payments, an IO will suffer a precipitous decrease in value when interest rates decline and prepayments increase causing the interest payments to evaporate.

Experts derived additional securities from the standard mortgage-backed securities by creating mortgage-backed derivatives with floating coupon rates. So called "floaters" have a coupon rate that is adjusted periodically by adding an amount (the "spread") to a benchmark index, such as the London Interbank Offered Rate ("LIBOR"). Floaters are attractive as hedging devices to investors such as financial institutions, whose liabilities float with the market rate. However, when used as a high yield investment and not a hedge, floaters can be disastrous because their rate is affected not only by prepayment, but also by a multiple of the benchmark index.

From IOs and floaters, experts derived "inverse" IOs and "inverse" floaters. Designed as hedging instruments, the inverse derivatives have a coupon rate that adjusts periodically in the opposite direction of the benchmark index. Although the inverse derivatives provide above market returns under certain market conditions, they are designed as hedging devices and are very dangerous if used otherwise.

Investors have learned over the past several years that "dangerous if used otherwise" is a fundamental concept of investing in mortgage-backed derivatives. As the lead article in this issue of the *Bulletin* describes, Orange County Treasurer Robert Citron used inverse floaters

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Jury Returns 152 Guilty Verdicts Against Three Dublin Securities Defendants

On December 11, 1995, a Franklin County Common Pleas Court jury found three defendants guilty of a total of 152 felony counts for their participation in the Dublin Securities, Inc., securities fraud scheme. Dublin Securities was central Ohio based intra-state securities dealer that used high pressure sales tactics to sell high risk penny stocks to Ohio investors before being shut down in the fall of 1992 when the Division and other local authorities executed a search warrant at its corporate headquarters. The Division estimates that Dublin Securities defrauded over 6,000 Ohio investors and the trustee administering the Dublin Securities bankruptcy estate has been unable to account for $92 million that the securities dealer once held.

Columbus attorney Dwight I. Hurd, who served as a legal counsel to Dublin Securities, was convicted on four felony counts. He was convicted of one count of engaging in a pattern of corrupt activity, a first degree felony, and three counts of false representations in the registration of securities.

Robert D. Hodge of Columbus, former vice-president and general sales manager, was convicted on 103 felony counts. Included in the 103 were one count of engaging in a pattern of corrupt activity, a first degree felony, fourteen counts of grand theft and 87 counts of theft.

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The guilty verdicts against the three defendants who stood trial resulted in felony convictions of all five individuals who had been indicted by a Franklin County Grand Jury in April 1994 *(see Bulletin* Issue 94:2) for their part in the Dublin Securities scheme. In addition to Clarence Eyerman, David M. Carmichael, former executive vice-president and treasurer, had also reached a plea agreement with the special prosecutor prior to trial and testified for the prosecution at trial. Also, former controller Anthony Kohl had reached a plea agreement with the special prosecutor prior to the indictment pursuant to which he pleaded guilty to three felony counts and also testified for the prosecution at trial.

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as high yield investments during a period of declining interest rates. However, when interest rates begin to rise, the returns on the inverse floaters evaporated.

Similarly, in the Division's enforcement action against Government Securities Corporation ("GSC"), which resulted in the revocation of GSC's Ohio Securities Dealer License, the Division alleged that GSC marketed IOs and inverse IOs as high yield investments and also represented that the IOs were guaranteed by the federal government. And in the enforcement action against Kenneth Schulte, which resulted in the revocation of Schulte's Ohio Securities Salesman License, the Division cited an NASD arbitration finding that Schulte made misrepresentations and omissions of material facts in the sale of mortgage-backed derivatives.

Mortgage-backed securities are as fundamental to American society as the home mortgages for which they provide financing. Mortgage-backed derivatives were created to attract additional, specialized investors into the mortgage-backed securities market and thus increase the pool of funds available for mortgage loans. As this brief introduction to mortgage-backed derivatives outlines, mortgage-backed derivatives are complex, risky investments. However, as the Orange County, GSC and Schulte cases demonstrate, it is usually the misuse and misrepresentation of mortgage-backed derivatives that cause investment debacles.

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Taube and Whittaker, *Insecurities?*, Business Law Today 32-37, 43 (Sept./Oct. 1994).

Mr. Geyer is a Staff Attorney in the Enforcement Section and the Editor of the Ohio Securities Bulletin.

Division Revokes One Salesman License, One Dealer License in "Derivatives" Cases

During the fourth quarter of 1995, the Ohio Division of Securities issued two final orders, one revoking an Ohio Securities Salesman License and one revoking an Ohio Securities Dealer License, based on the sale of high risk "derivative" securities to Ohio public entities.

On October 6, 1995, the Division issued Division Order No. 95-071, a Final Order of Revocation against Kenneth James Schulte. As part of the final order, Schulte entered into a Consent Agreement with the Division in which he consented to the revocation of his Ohio Securities Salesman License and also agreed to never reapply for a license to sell securities in Ohio. Schulte also waived his right to appeal the final order.

The original notice order issued to Schulte on February 6, 1995, Division Order No. 95-008, alleged that Schulte, while employed in the Houston, Texas, offices of Murchison Investment Bankers and Hart Securities, made material misrepresentations and omissions in selling "Interest Only" derivative securities ("IOs") to Ohio counties, municipalities and school boards. An amended notice order issued to Schulte included an NASD arbitration award against Schulte based on false communications and omission of material facts in selling mortgage-backed derivative securities to a municipality.

On November 1, 1995, the Division revoked the Ohio Securities Dealer License of Government Securities Corporation of Houston, Texas ("GSC"), pursuant to Division Order No. 95-083, captioned "Consent Agreement and Final Order of Revocation." In addition to the revocation, GSC agreed never to reapply for an Ohio Securities Dealer License. GSC also waived its right to appeal the final order.

In the final order, GSC acknowledged that the Division had made specific allegations against it as set forth in the notice order issued to GSC on February 27, 1995, Division Order No. 95-012. Among the allegations were that former GSC salesman James Winter made material misrepresentations and omissions in the sale of derivative securities, including IOs and "Inverse" IOs, to Ohio counties. In addition, the notice order alleged that GSC failed to properly supervise Winter and also failed to determine whether investment in the derivatives was suitable for the counties. Two counties, Sandusky and Portage, sued GSC civilly for losses suffered as a result of the precipitous drop in the value of derivatives sold by GSC. Both lawsuits settled, with GSC paying a reported $5,500,000 to Sandusky County and a reported $3,200,000 to Portage County.

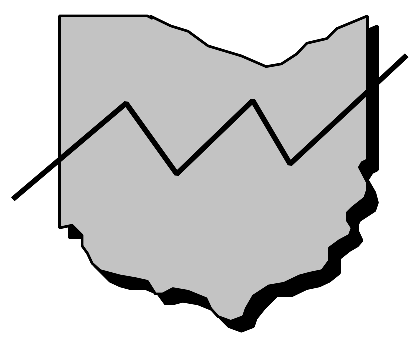
Ohio Division of Securities goes Online: New Website Installed

The Ohio Division of Securities has installed an internet website. The website contains a directory of telephone numbers for Division offices, a listing of forms and directions for use of the Division's faxback system, and an archive of past issues of the *Bulletin* in Adobe Acrobat PDF format with instructions on the use of Adobe Acrobat Reader.

In addition, the Ohio Securities Act, Chapter 1707 of the Ohio Revised Code, and the Administrative Rules promulgated thereunder are presented on the website as a convenience. Note, however, that they do not represent the conclusive text of the statute and rules, which are maintained by the Ohio Secretary of State. At this point most of the rules are available on-line while the statute text is currently under review for proper form and will be completed within the first quarter of 1996.

Future pages will contain Division Final Orders, investor information and news releases of interest to investors.

To access the Division home page, use any commercial web browser (i.e.Netscape or Mosaic) on any PC or Macintosh computer and contact the address http://www.securities .state .oh.us. If you have questions or suggestions regarding the Division home page send your e-mail to the sys-op at *doc_dachtyl@ohio.gov*.



Division Enforcement Section Reports

Administrative Orders

Hart Securities, Inc.

On September 18, 1995, the Division issued Division Order No. 95-057, a Final Order of Revocation of the Ohio Securities Dealer License of Hart Securities, Inc., of Houston, Texas. The Division found Hart Securities to be in violation of at least two Ohio Administrative Code requirements applicable to licensed dealers and revoked the license under the authority of R.C. section 1707.19.

O.A.C. Rule 1301:6-3-15(H) requires every licensed dealer to file with the Division an annual financial statement within ninety days of the end of the dealer's fiscal year. Rule 1301:6-3-15(D)(1) requires every licensed dealer to maintain a net capital of at least $25,000. Hart Securities failed to timely file its annual financial statement for 1994, but did eventually file it on April 3, 1995. That financial statement revealed that Hart Securities had a net capital of $(386,574) as of December 31, 1994. In addition, the Division learned that on or about March 3, 1995, Hart Securities filed Chapter 7 bankruptcy in the United States Bankruptcy Court for the Southern District of Texas.

On May 26, 1995, the Division issued to Hart Securities a Notice of Intent to Revoke, Division Order 95-027, notifying Hart Securities of the alleged violations of the dealer licensing requirements, and giving Hart Securities notice of its right to request an administrative hearing on the matter. The copy of the notice order mailed to Hart Securities by certified mail was returned to the Division undelivered. The Division then published notice of the notice order as required by R.C. Chapter 119. After the statutory publication requirements were satisfied and Hart Securities failed to request the administrative hearing, the Division issued the final order of revocation.

Great Western Communications International; Robert Seibert; Gulf Partners; and Steve Stonehill

On September 29, 1995, the Division issued a final Cease and Desist Order, Division Order No. 95-068, against Great Western Communications International, Robert Seibert, Gulf Partners and Steve Stonehill. Great Western is a California corporation and Seibert is the sole shareholder and director of Great Western. Stonehill serves as a senior advisory consultant to Great Western. Great Western is the managing partner of Gulf Partners, a purported California general partnership. Both individuals and both entities have business addresses in Newport Beach, California.

An investigation by the Division revealed that Gulf Partners was formed to engage in the acquisition of Multi-channel, Multi-point Distribution Services ("MMDS") licenses issued by the Federal Communications Commission to deliver cable formatted television to an area in Ocala, Florida. In August 1993, Stonehill contacted Ohio residents Victor and Ruth Haight about investing in a general partnership interest in Gulf Partners. The Haights purchased a one-eighth of one percent interest in the general partnership for $7,500.

Although the investment was labeled a "general partnership" interest, the Division determined that the investment was actually an "investment contract" and, therefore, within the statutory definition of "security" set out in R.C. section 1707.01(B). In reaching this conclusion, the Division analyzed the investment under the four prong test established by State v. George, 50 Ohio App. 2nd 297 (Franklin Cty. 1975). The Division concluded that the investors furnished initial value, such initial value was subject to the risk of the enterprise, the investment was induced by the representation of future financial gain and investors were not granted any management control over the enterprise. In particular, the Division found that the partnership agreement did not provide for partnership meetings and did not otherwise provide any method for individual or concerted action by the partners.

Since the investment was a security, it was sold to Ohio investors in violation of R.C. section 1707.44(C)(1), because it was not registered with the Division nor properly exempted from the registration provisions. In addition, at the time of sale to the Ohio residents, neither Great Western, Gulf Partners, Seibert nor Stonehill were licensed by the Division. Consequently, the sale of the investment also constituted a violation of R.C. section 1707.44(A).

On November 4, 1994, the Division issued Division Order No. 94-199, a Notice of Opportunity for Hearing, which gave Great Western, Gulf Partners, Seibert and Stonehill notice of the Division's allegations and an opportunity to request an administrative hearing on the matter. The notice order was sent via certified mail to each Respondent at their last known business address. All notice orders were returned to the Division undelivered. After satisfying the statutory publication requirements set out in R.C. Chapter 119, and failing to receive a request for an administrative hearing, the Division issued the final order which ordered Great Western, Gulf Partners, Seibert and Stonehill to cease and desist from violations of R.C. section 1707.44(A) and (C)(1).

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Administrative Orders

Continued from page 9

The final order marked the second action taken by the Division for violations of the Ohio Securities Act in connection with the solicitation and sale of purported interests in MMDS licenses. The first was Division Order No. 94-141, a final Cease and Desist Order, issued on August 16, 1994, against Reifsnyder, Torosian and Arnold, Inc., of Costa Mesa, California, and described in *Bulletin* Issue 94:3.

Liberty Bell Association, Inc.; Theodore E. Mong aka Ted E. Mong

On October 12, 1995, the Division of Securities issued Division Order No.95-081, a final order confirming the Suspension of the Right to Sell Securities in the State of Ohio pursuant to R.C. section 1707.13 in the matter of Liberty Bell Association, Inc. and Theodore E. Mong aka Ted E. Mong (collectively, "Respondents"). Liberty Bell is an Ohio corporation with a business address in Newark, Ohio, and Mong served as the president and a director of Liberty Bell. In connection with the final confirmation order, the Division and Respondents entered into a Consent Agreement in which Respondents consented, stipulated and agreed to the findings, conclusions and order set forth in the final confirmation order.

From at least December 6, 1993, to October 4, 1995, Respondents issued and sold approximately 52 promissory notes to Ohio residents. Respondents solicited investors for the promissory notes by, among other things, placing ads in a local Newark, Ohio, newspaper. One advertisement discovered by the Division promised a 230% return on minimum deposit of $2,000 for 48 months and also stated that, "all deposits are fully secured and guaranteed according to Liberty Bell's president, Ted E. Mong." However, the records of the Division revealed no registration filing nor filing for claim of exemption for these promissory notes. Consequently, the promissory notes were sold in violation of R.C. section 1707.44(C)(1). In addition, neither Liberty Bell nor Mong were licensed with the Division and, therefore, the sales were made in violation of 1707.44(A).

Because the unlicensed sale of the unregistered promissory notes was continuing, on October 4, 1995, the Division had issued Division Order No. 95-069, a Suspension of the Right to Sell Securities in the State of Ohio, pursuant to R.C. section 1707.13. The suspension order set forth the Division's findings and immediately suspended the right to deal in the promissory notes. The suspension order also set an administrative hearing on the matter for October 13, 1995, but Respondents and the Division entered into the Consent Agreement before the administrative hearing was held.

The confirmation order permanently suspended the unlicensed sale of the unregistered promissory notes.

Maple Associates Limited Partnership

On November 13, 1995, the Division issued a final Cease and Desist order, Division Order No. 95-085, against Maple Associates Limited Partnership, an Ohio limited partnership with a business address in Cleveland, Ohio. The final order resulted from Maple Associates' attempt to file a Form 3-Q with the Division to perfect an exemption from registration for the sale of its limited partnership interests.

On March 2, 1994, Maple Associates filed with the Division a Form 3-Q. The Form 3-Q reported the date of sale of limited partnership interests as January 17, 1994. However, an examination by the Division revealed the date of sale of the limited partnership interests, as determined by O.A.C. Rule 1301:6-3-03(B)(5), ranged from September 29, 1993, to December 3, 1993. Since R.C. section 1707.03(Q) requires that a Form 3-Q be filed no later that 60 days after the date of sale of securities, the Form 3-Q was not timely filed and therefore did not serve to exempt the sale of the limited partnership interests from registration.

On September 7, 1995, the Division issued to Maple Associates Division Order No. 95-055, Notice of Opportunity for Hearing, setting forth the allegations regarding the improper claim of exemption, and informing Maple Associates of its right to request an administrative hearing on the matter. The notice order was served on Maple Associates' representative of record, but no administrative hearing was requested. Consequently, the Division issued the final order which declared Maple Associates' Form 3-Q filing to be null and void and also ordered Maple Associates to cease and desist from violations of R.C. section 1707.44(C)(1).

Madison Group Securities, Inc.

On November 27, 1995, the Division issued Division Order No. 95-086, a Final Order of Revocation of the Ohio Securities Dealer License of Madison Group Securities, Inc., of Seattle, Washington.

O.A.C. Rule 1301:6-15(D)(1) requires every licensed dealer to maintain a net capital of at least $25,000. On or about August 3, 1995, Madison Group Securities submitted to the Division its audited annual financial statement which reflected a net capital of only $4,022. Despite repeated contact by the Division, Madison Group Securities failed to remedy its net capital deficiency.

When Madison Group failed to remedy its net capital deficiency, the Division, on October 4, 1995, issued to Madison Group Securities

Division Order No. 95-070, a Suspension/Notice of Intent to Revoke. After Madison Group Securities failed to request an administrative hearing as permitted by the notice order, the Division issued the final order revoking Madison Group Securities' Ohio Securities Dealer License pursuant to R.C. section 1707.19.

Hocking Valley Gymnastics Center, Inc.

On November 28, 1995, the Division issued a final Cease and Desist order, Division Order No. 95-087, against Hocking Valley Gymnastics Center, Inc., of Lancaster, Ohio.

On September 30, 1994, pursuant to R.C. section 1707.391, Hocking Valley filed with the Division an application on Form 391, accompanied by a Form 3-Q, to claim an exemption for the sale of eleven shares of its common stock. An examination by the Division subsequent to this filing revealed that the shares were sold in November and December of 1993. R.C. section 1707.391 provides that a corrective filing may be made if the required filing had not been made due to "excusable neglect." O.A.C. Rule 1301:6-3-391(B) defines excusable neglect in the context of the 3-Q exemption to mean the failure to file a Form 3-Q with the Division within six months of the earliest date of sale for which the exemption was sought. Since the earliest sale had taken place in November 1993, and the Form 391 had not been filed until September 1994, the Division found a lack of excusable neglect. Therefore, the Form 391 was denied and did not become effective to properly exempt from registration the sales of common stock. Since there was no effective claim of exemption nor effective registration, the shares were sold in violation of R.C. section 1707.44(C)(1).

On September 15, 1995, the Division issued to Hocking Valley Division Order No. 95-056, a Notice of Opportunity for Hearing, setting forth the allegations and notifying Hocking Valley of its right to request an administrative hearing on the matter. When Hocking Valley failed to request an administrative hearing, the Division issued the final order which ordered Hocking Valley to cease and desist from violations of R.C. section 1707.44(C)(1).

Directory Catalog Services, Inc.

On November 28, 1995, the Division issued to Directory Catalog Services, Inc., of Cincinnati, Ohio, Division Order No. 96-088, a final Cease and Desist order and Order Declaring Form 3-Q, File No. 456074, Partially Null and Void.

On February 7, 1994, Directory Catalog filed with the Division a Form 3-Q seeking a claim of exemption for the sale of certain of its securities, each consisting of a promissory note and shares of common stock. The Form 3-Q reported the date of sale of the securities as December 28, 1993. However, an examination by the Division revealed that the dates of sale, as determined by O.A.C. Rule 1301:6-3-03(B)(5), were actually October 21, 1993 and November 11, 1993. Consequently, the Form 3-Q was not timely filed to exempt the securities from registration.

On October 20, 1995, the Division issued to Directory Catalog a Notice of Opportunity for Hearing, Division Order No. 95-082, setting forth the allegations and notifying Directory Catalog of its right to request an administrative hearing on the matter. When Directory Catalog failed to request an administrative hearing, the Division issued the final order declaring the Form 3-Q partially null and void and also ordering Directory Catalog to cease and desist from violations of R.C. section 1707.44(C)(1).

The Dayton Voice, Inc.

On December 27, 1995, the Division issued Division Order No. 95-107, final Cease and Desist order, against The Dayton Voice, Inc., of Dayton, Ohio. In connection with the cease and desist order, the Division and Dayton Voice entered into a Consent Agreement, in which Dayton Voice consented, stipulated and agreed to the findings, conclusions and orders set forth in the final cease and desist order.

In 1993, Dayton Voice filed with the Division a Form 3-Q to claim an exemption from registration for 20 shares of Class A and 170 shares of Class B preferred stock. However, an examination by the Division revealed that additional shares of Class A stock, additional shares of Class B preferred stock and promissory notes had been sold for which there were no corresponding registration filings nor claims of exemption. In light of these findings, the Division, on August 10, 1995, issued to Dayton Voice, Division Order No. 95-049, a Notice for Opportunity for Hearing, setting these alleged violations of R.C. section 1707.44(C)(1) and giving Dayton Voice notice of its right to request an administrative hearing on the matter.

Subsequent to the issuance of Division Order No. 95-049, the Division determined that Dayton Voice sold additional shares of Class B preferred stock for which there was no registration filings nor claims of exemption. Consequently, on December 15, 1995, the Division issued Division Order No. 95-049-Amended, an amended Notice of Opportunity for Hearing, which set forth the alleged violations resulting from these additional sales.

Instead of proceeding to an administration hearing on the matter, Dayton Voice chose to enter into the Consent Agreement with the Division. The Consent Agreement

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was incorporated into the final Cease and Desist order, which ordered Dayton Voice to cease and desist from future violations of the Ohio Securities Act.

M&M Automotive; Michael W. Kreuz

On December 29, 1995, the Division issued Division Order 95-110, a Final Order to Cease and Desist to M&M Automotive and Michael W. Kreuz, both of Columbus, Ohio. The final order followed an administrative hearing on the matter which had been held on September 26, 1995.

At the administrative hearing, the Division presented evidence that on May 11, 1994, Kreuz had sold to an Ohio resident a security in the form of a profit sharing agreement, in exchange for an investment of $5,000 and a promised repayment within one year of principal plus 20%. Under the agreement, the investor had no right of management over the enterprise. The records of the Division revealed no registration filing nor filing for claim of exemption and, therefore, the hearing officer found that the profit sharing agreement had been sold in violation of R.C. section 1707.44(C)(1). In addition, at the time of the sale, neither M&M Automotive nor Kreuz were licensed as a dealer or salesman with the Division and, therefore, the sale was also in violation of R.C. 1707.44(A).

The hearing officer's report and recommendation was completed on December 6, 1995. The findings of fact, conclusions of law, recommendation of the hearing officer were accepted by the Commissioner. After neither M&M Automotive nor Michael W. Kreuz filed any objections to the report and recommendation, the Division issued the final order, which ordered M&M Automotive and Kreuz to cease and desist from violations of R.C. sections 1707.44(A) and (C)(1).

Criminal Actions

Floyd L. Bishop

On September 13, 1995, a Lorain County Grand Jury returned a five count indictment against Floyd L. Bishop, a Meadville, Pennsylvania resident. On October 11, 1995, Bishop presented himself to Lorain County authorities for service of the indictment.

Included in the indictment were one count of theft in violation of R.C. Chapter 2913, one count of selling securities without a license in violation of R.C. 1707.44(A), one count of selling unregistered securities in violation of R.C. 1707.44(C)(1), one count of making false representations for the purpose of selling securities in violation of R.C. 1707.44(B), and one count of securities fraud in violation of R.C. 1707.44(G).

The indictment was based on Bishop's activities as Chairman of American Intertech Corporation, a Pennsylvania corporation. The indictment alleges that Bishop enticed an Ohio investor to invest in American Intertech under the premise that American Intertech would acquire numerous companies. The indictment further alleges that Bishop never did acquire the companies as he had represented, but rather misappropriated the investment proceeds and used them for his own personal expenses. In addition to the theft of the Ohio investor's money, the indictment alleges that Bishop made false and misleading statements to the Ohio investor to entice him to invest in American Intertech.

Kenneth D. Moore

On October 16, 1995, Kenneth D. Moore, of Columbus, Ohio, pleaded guilty in Franklin County Common Pleas Court to one count of theft by deception and was sentenced to two years incarceration. As part of the plea arrangement, four counts of forgery were dropped. As reported in *Bulletin* Issue 95:3, Moore was arrested in May 1995 on the five count indictment that had been returned in 1992. The indictment was based on Moore's forgery and conversion of customer checks while he was a licensed securities salesman at two now-defunct Columbus-based securities dealers.

Postscript to Orange County article

On January 24, 1996, the day before this issue of the *Bulletin* went to print, the SEC announced the filing and settlement of a civil complaint against Citron and his assistant treasurer, Matthew R. Raabe, alleging violations of the antifraud provisions of the federal securities laws. In the settlement, both Citron and Raabe denied any wrongdoing, but both also agreed to a federal court injunction against future violations of the federal securities laws. The SEC also announced the filing and settlement of administrative charges against Orange County and it Board of Supervisors, citing alleged material misstatements and omissions in municipal bond offering documents. In a similar settlement agreement, both the County and the Board denied wrongdoing but accepted a permanent injunction.

Registration Statistics

The table to the right sets out the number of registration filings received by the Division during the fourth quarter of 1995, compared to the number received during the Fourth quarter of 1994, as well as the number of registration filings received by the Division in 1995, compared to the number received in 1994.

*Effective October 11, 1994, the Form 2(B) and Form 3-O filing requirements were eliminated.

1707	*4Q'95*	*Total '95*	*4Q'94*	*Total '94*
.02(B)*	0	0	51	836
.03(O)*	0	0	1,123	10,420
.03(Q)	272	1,157	329	1,409
.03(W)	28	119	37	136
.04	0	0	0	2
.041	0	1	0	0
.06(A)(1)	26	113	30	132
.06(A)(2)	6	35	15	51
.06(A)(3)	3	22	7	24
.06(A)(4)	4	26	7	45
.09	87	441	146	584
.091	866	3,405	893	3,407
.39	9	47	14	93
.391/.09	0	0	0	3
.391/.091	5	23	1	10
.391/.03(O)	6	191	217	960
.391/.03(Q)	30	133	41	182
.391/.03(W)	2	3	1	9
.391/.06(A)(1)	0	0	0	0
.391/.06(A)(2)	0	0	0	0
.391/.06(A)(3)	0	1	0	0
.391/.06(A)(4)	0	0	0	0
Totals	1,344	5,717	2,912	18,303

Licensing Statistics

The table below sets out the number of Salesmen and Dealers licensed by the Division at the end of the fourth quarter of 1995, compared to the same quarter of 1994, as well as the number of Salesmen and Dealers licensed by the Division at the end of the first, second and third quarters of 1995, compared to the same quarters of 1994.

	End of Q1 1995	End of Q1 1994	End of Q2 1995	End of Q2 1994	End of Q3 1995	End of Q3 1994	End of Q4 1995	End of Q4 1994
Number of Salesmen Licensed:	69,143	65,991	70,580	70,200	72,062	72,045	71,658	70,642
Number of Dealers Licensed:	1,837	1,778	1,873	1,842	1,891	1,894	1,863	1,759

Rules Amendments Effective January 21, 1996

Amendments to three administrative rules of the Ohio Division of Securities became effective on January 21, 1996. O.A.C. Rule 1301:6-3-03 was amended to extend a technical exemption under R.C. 1707.03(V) to the direct sale or sale of a unit including a warrant, subscription right, or option to purchase a security exempted by R.C. 1707.03(E), to a security which is exempt under division R.C. 1707.03(E), and to any guarantee, letter of credit, standby purchase agreement, or other credit enhancement that is offered and sold in conjunction with a security that is exempt under R.C. 1707.02(B) and which is not traded separately. Rule 1301:6-3-09 was amended to revise the definition of liquidity for the purpose of determining permissible investments for Investment Companies. Rule 1301:6-3-14 was amended to correct an incorrect reference in paragraph B of the rule with reference to the exemption from SEC registration for Ohio securities dealers.

KEY

- New language appears in upper case, and each letter to remain in upper case is underlined. Added punctuation at the end of added text is also underlined.
- Existing language is shown in normal upper case - lower case distribution.
- Language to be deleted is lined through.
- For this summary only, • • • indicates where unamended language has not been reprinted.

1301:6-3-03 Exempt transactions.

• • •

(D) Additional exemptions in accordance with division (V) of section 1707.03 of the Revised Code.

• • •

(6) The sale of a warrant, subscription right, or option to purchase a security exempted by division (E) of section 1707.02 of the Revised Code or the sale of a unit consisting of a warrant, subscription right, or option TO PURCHASE A SECURITY EXEMPTED ~~which is exempt~~ under division (E) of section 1707.02 of the Revised Code and a security WHICH IS exempt under division (E) of section 1707.02 of the Revised Code is exempt pursuant to division (V) of section 1707.03 of the Revised Code. ~~if it is sold by a licensed dealer.~~

(7) The sale of a security of an issuer that is either a pooled income fund, a charitable remainder trust or a charitable lead trust and that has a qualified charity as the only charitable beneficiary, or the sale by a qualified charity of a security that is a charitable gift annuity if:

(a) The sale is made by persons not licensed as dealers or salesmen whose compensation, however characterized, is not based directly on the amount of sales of the security;

(b) The security is evidenced by a written instrument that has been executed by the donor and the issuer and a copy of which has been provided to the qualified charity which is designated in the security as the beneficiary; and

~~(C)~~ (c) The designation of the qualified charity in the security is irrevocable so long as the qualified charity retains its status as a qualified charity.

(8) ANY GUARANTEE, LETTER OF CREDIT, STANDBY PURCHASE AGREEMENT, OR OTHER CREDIT ENHANCEMENT THAT IS OFFERED AND SOLD IN CONJUNCTION WITH A SECURITY THAT IS EXEMPT UNDER DIVISION (B) OF SECTION 1707.02 OF THE REVISED CODE AND WHICH IS NOT TRADED SEPARATELY IS EXEMPT UNDER DIVISION (V) OF SECTION 17O7.03 OF THE REVISED CODE.

1301:6-3-09 Registration by qualification.

• • •

(E) The offering or disposal of shares of any investment company of the management type, regardless of the section of Chapter 1707. of the Revised Code under which the shares are registered, is deemed to be an offer or

disposal on grossly unfair terms unless the prospectus or instruments under which the company, or the sponsor, manager or custodian thereof is created, organized or administered are effective to:

• • •

(12) Prohibit the investment of more than fifteen per cent of the company's total assets in ~~the~~ securities ~~of issuers~~ which ~~together with any predecessors have a record of less than three years continuous operation or securities of issuers which~~ are ~~restricted as to disposition~~ ILLIQUID. FOR THE PURPOSES OF THIS PARAGRAPH, AN ILLIQUID SECURITY SHALL BE CONSIDERED TO BE A SECURITY THAT CANNOT BE DISPOSED OF IN THE ORDINARY COURSE OF BUSINESS WITHIN SEVEN DAYS AT APPROXIMATELY THE AMOUNT AT WHICH THE COMPANY VALUES THE SECURITY. AN ILLIQUID SECURITY SHALL NOT INCLUDE:

(a) SECURITIES ELIGIBLE FOR RESALE PURSUANT TO RULE 144A UNDER THE SECURITIES ACT OF 1933 THAT HAVE BEEN DETERMINED TO BE LIQUID BY THE INVESTMENT COMPANY'S BOARD OF DIRECTORS OR TRUSTEES; AND

(b) COMMERCIAL PAPER THAT IS SOLD UNDER SECTION 4(2) OF THE SECURITIES ACT OF 1933 WHICH:

(i) IS NOT TRADED FLAT OR IN DEFAULT AS TO INTEREST OR PRINCIPAL; AND

(ii) IS RATED IN ONE OF THE TWO HIGHEST CATEGORIES BY AT LEAST TWO NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS AND THE INVESTMENT COMPANY'S BOARD OF DIRECTORS OR TRUSTEES HAVE DETERMINED THE COMMERCIAL PAPER TO BE LIQUID; OR

(iii) IS RATED IN ONE OF THE TWO HIGHEST CATEGORIES BY ONE NATIONALLY RECOGNIZED STATISTICAL RATING AGENCY AND THE INVESTMENT COMPANY'S BOARD OF DIRECTORS OR TRUSTEES HAVE DETERMINED THAT THE COMMERCIAL PAPER IS OF EQUIVALENT QUALITY AND IS LIQUID .

1301:6-3-14. Dealer license and securities and exchange commission registration requirements.

• • •

(B) In accordance with division (D) of section 1707.14 of the Revised Code, the division may, by division order, exempt a dealer from the requirement of being registered with the securities and exchange commission set out in division (B) of section 1707.14 of the Revised Code where the division determines that all of the following have been met:

(1) The dealer has been continuously licensed by the Ohio division of securities since October 11, 1994;

(2) The dealer, alone or with any other dealer with which it is affiliated, does not employ more than five securities salesmen at any time;

(3) No less than eighty per cent of the securities bought and sold by the dealer, as determined by the aggregate price of all securities bought and sold by the dealer, are securities of banks, as the term "bank" is defined in division (O) of section 1707.01 of the Revised Code, which have their principal place of business in Ohio;

4) The dealer enters into an undertaking with the division whereby the dealer agrees that it will immediately surrender any exemption from the requirement of being registered with the securities and exchange commission in the event that it fails to disclose in writing to any person to whom it sells securities its compensation, however that compensation is characterized, for the sale of the securities; and

(5) The dealer enters into an undertaking with the division whereby the dealer agrees that it will immediately surrender any exemption from the requirement of being registered with the securities and exchange commission in the event that it no longer meets the standards set forth in paragraphs ~~(C)~~ (B)(1), ~~(C)~~ (B)(2) and ~~(C)~~ (B)(3) of this rule.

OHIO SECURITIES BULLETIN

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