

**BAILEY CAVALIERI LLC**  
ATTORNEYS AT LAW

One Columbus 10 West Broad Street, Suite 2100 Columbus, Ohio 43215-3422  
telephone 614.221.3155 facsimile 614.221.0479  
www.baileycavalieri.com

**AN OVERVIEW OF OHIO INVESTMENT ADVISER LAW**

**Prepared by**  
**Thomas E. Geyer**  
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*The material in this outline is not intended to provide legal advice as to any of the subjects mentioned but is presented for general information only. Readers should consult knowledgeable legal counsel as to any legal questions they may have.*

## A. Background

In general, an investment adviser is a person who: (1) for compensation, (2) is engaged in the business of, (3) providing advice, making recommendations, issuing reports or furnishing analyses regarding securities, either directly or through publications. A person must satisfy all three of these elements in order to be an "investment adviser." Either a natural person or a business entity can be an investment adviser.

Historically, the regulation of investment advisers began with the enactment of the federal Investment Advisers Act of 1940 (the "1940 Act"), which is administered and enforced by the SEC. Many states also began to oversee investment advisers, especially after the promulgation of the Uniform Securities Act of 1956, which contained investment adviser regulatory provisions. By 1996, all but four states (Colorado, Iowa, Ohio and Wyoming) regulated investment advisers on the state level. Federal and state regulation was virtually identical, establishing similar registration, business practice and anti-fraud standards.

The National Securities Markets Improvement Act of 1996 ("NSMIA") adjusted the national investment adviser oversight system to eliminate duplicative regulation and reallocate regulatory resources. Specifically, NSMIA amended the 1940 Act to provide that only certain categories of investment advisers are eligible to register with the SEC. These "federally covered advisers" register only with, and are overseen only by, the SEC, although NSMIA requires such advisers to make a "notice filing" with state authorities in the state of the adviser's principal place of business. Investment advisers not eligible for registration with the SEC register only with, and are overseen only by, state authorities. At the time NSMIA's investment adviser amendments took effect, there were approximately 23,000 investment advisers registered with the SEC. It was estimated that about one-third of those advisers would be eligible to maintain SEC registration, and about two-third would register with state authorities.

NSMIA created a regulatory void in Ohio since the Buckeye State was one of the four states that did not have state-level investment adviser oversight in place. In response, the Ohio Division of Securities (the "Division") developed a legislative proposal to add investment adviser provisions to the Ohio Securities Act. The proposal was introduced into, and ultimately approved by, the 123<sup>rd</sup> Ohio General Assembly, and was signed into law by Governor George V. Voinovich on December 17, 1998. The Ohio investment adviser provisions first took effect on March 18, 1999, and after the completion of certain "phase-in" periods, took full effect on January 1, 2000.

The Ohio investment adviser provisions are based primarily on the provisions of the 1940 Act. The Ohio provisions were codified as part of the Ohio Securities Act, R.C. 1707, and are administered and enforced by the Division. Administrative rules amplifying the statutory provisions are contained in Ohio Administrative Code chapter 1301.

## B. Definition of Investment Adviser

The starting point for any analysis under the Ohio investment adviser laws is the definitional section. As mentioned at the beginning of this discussion, in general, an investment adviser is a person who: (1) for compensation, (2) is engaged in the business of, (3) providing advice,

making recommendations, issuing reports or furnishing analyses regarding securities, either directly or through publications. The Ohio definition of "investment adviser" is contained in R.C. 1707.01(X), and is virtually identical to the federal definition contained in section 202(a)(11) of the 1940 Act.

The elements of the definition are construed broadly. The "compensation" element is satisfied by the receipt of any economic benefit by the person providing advice, and the benefit need not be provided by the recipient of the advice. The "engaged in the business" element is satisfied if any one of the following occurs: the person holds himself or herself out as an investment adviser or as one who provides investment advice; the person receives compensation that represents a clearly definable charge for providing advice about securities; or, the person, on anything other than rare, isolated and non-periodic instances, provides specific investment advice. Finally, the advice must pertain to "securities" (in contrast to other investment alternatives like real estate or coins). However, in order to satisfy the "securities" element, the advice need not be about specific securities, but rather only about securities as an investment alternative.

### C. Exclusions from the Definition of Investment Adviser

R.C. 1707.01(X)(2) excludes several classes of persons from the Ohio definition of investment adviser. These exclusions track the exclusions from the federal definition of investment adviser (*see* section 202(a)(11)(A)-(F) of the 1940 Act). Whether an exclusion is available depends on all of the relevant facts and circumstances.

The first exclusion is for attorneys, accountants, engineers and teachers whose performance of advisory services is solely incidental to the practice of their profession. In general, three factors are relevant to whether the "solely incidental" exclusion is available: whether the person holds himself or herself out to the public as an investment adviser, financial planner, or other provider of advisory services; whether the advisory services are rendered in connection with and reasonably related to the professional services; whether the fee charged for advisory services is based on the same factors as those used to determine the fee for professional services.

The second exclusion is for publishers of bona fide newspapers, news magazines and business and financial publications of general and regular circulation. In order to meet this exclusion, the publication must offer only impersonal advice, contain disinterested commentary and analysis, and be of a general and regular circulation (*see* Lowe v. Securities and Exchange Commission, 472 U.S. 181 (1985)). This exclusion, if available, extends to authors.

The third exclusion is for a person who acts solely as an investment adviser representative. This exclusion exists to prevent unintentional dual licensure requirements.

The fourth and fifth exclusions are for banks and bank holding companies. Note that "bank" is defined in R.C. 1707.01(O) to include virtually all financial institutions. This exclusion extends to an employee of a bank to the extent that the employee is acting in his or her capacity as an employee.

The sixth exclusion is for any securities dealer or salesperson licensed by the Division whose performance of advisory services is solely incidental to their business as a dealer or salesperson, and who receives no special compensation for advisory services.

The seventh exclusion is for persons who give advice only as to certain government and government-sponsored securities.

The eighth exclusion is for persons excluded from the federal definition of investment adviser.

The ninth and final exclusion is for persons excluded pursuant to the rules adopted by the Division. There are two rules promulgated under this statutory provision. O.A.C. 1301:6-3-01(K)(1) excludes from the definition of investment adviser certain persons who privately advise a small number of the sophisticated, trust or family entities specified in the rule. O.A.C. 1301:6-3-01(K)(2) sets out a "safe harbor" for solicitors, providing that a person who acts solely as a solicitor and is in compliance with the rule regarding cash payments for client solicitations (O.A.C. 1301:6-3-44(C)(1)) is not deemed to be an investment adviser.

#### D. Definition of Investment Adviser Representative

The Ohio definition of "investment adviser representative" is contained in R.C. 1707.01(II), and is virtually identical to the federal definition set out in SEC rule 203A-3(a).

In general, an investment adviser representative is a natural person who gives advice on behalf of an investment adviser to a certain minimum number of natural person clients through regular meetings or communications.

Specifically, in order to be an investment adviser representative, the natural person first must be a "supervised person." "Supervised person" is defined in R.C. 1707.01(JJ) and generally means officers, directors and employees of an investment adviser as well as others who provide advice on behalf of the investment adviser firm.

Second, the supervised person must have more than five clients who are natural persons other than "excepted persons," and more than 10% of the clients must be natural persons other than "excepted persons." "Excepted person" is defined in R.C. 1707.01(KK) and generally means certain wealthy and high worth individuals.

Third, the supervised person must on a regular basis solicit, meet with, or otherwise communicate with clients of the investment adviser.

All three of these elements must be met in order for a person to qualify as an investment adviser representative. However, even if a natural person meets all three of these elements, R.C. 1707.01(II)(1)(b) provides that the natural person is excluded from the definition of investment adviser representative if the natural person provides advisory services only by means of written materials or oral statements that do not purport to meet the objectives or needs of specific individuals or accounts.

E. Definition of Solicitor

A solicitor is any person who, directly or indirectly, solicits any client for, or refers any client to, an investment adviser or investment adviser representative. Solicitors *per se* are not required to be licensed by the Division. Rather, solicitors need to be licensed by the Division only if their activities meet the definition of investment adviser or investment adviser representative. Like under federal law, Ohio law requires a solicitor who receives cash payments to provide a written solicitation disclosure document to clients.

F. Investment Adviser Registration/Notice Filing/Licensure

Subject to certain limited exceptions, all investment advisers operating in Ohio must be either registered with the SEC or licensed by the Division. Investment advisers registered with the SEC must make an annual notice filing with the Division in order to advise the Division that it is conducting advisory activities in Ohio. Investment advisers not registered with the SEC must be licensed by the Division, subject to certain limited exceptions. In order to be licensed by the Division, an investment must meet a minimum competency standard by passing one of a specified series of tests, or by achieving and maintaining one of a specified series of professional designations. Licensees must also be of “good business repute.” All investment adviser filings (with both the SEC and the Division) must be made through the Investment Adviser Registration Database, or IARD, the internet-based electronic filing system located at [www.iard.com](http://www.iard.com).

G. Investment Adviser Representative Licensure

Subject to certain limited exceptions, all investment adviser representatives with a place of business in Ohio must be licensed by the Division. Like licensed investment advisers, licensed investment adviser representatives must meet the minimum competency standard and be of good business repute. All investment adviser representative filings are made through the Central Registration Depository, or CRD, an internet-based electronic filing system that is the sister system to the IARD.

H. Fiduciary Duty: Business Practice and Anti-Fraud Standards

Investment advisers and investment adviser representatives stand in a fiduciary relationship with their clients. Rooted in fiduciary principles is a detailed set of business practice and anti-fraud standards contained in the Ohio Securities Act and related administrative rules. The Ohio standards are based on analogous federal standards. Following is a summary of some (but not all) of those standards.

1. Business Practice Standards

The Ohio business practice standards include the following:

a) Books and Records (O.A.C. 1301:6-3-151(E))

Investment advisers licensed by the Division are required to make and keep certain books and records. The required records include basic financial records (such as journals, ledgers, check books and bills) and basic client records (such as correspondence and order memoranda). The required books and records must be maintained for not less than five years, the first two years in an appropriate office of the investment adviser and subsequently in an easily accessible place. All records of an investment adviser licensed by the Division are subject “at any time, and from time to time” to examination by the Division.

b) Delivery of a Brochure (O.A.C. 1301:6-3-151(G))

An investment adviser licensed, or required to be licensed, by the Division generally is required to deliver to each client and prospective client a written disclosure statement, which may take the form of a brochure, that describes the adviser’s business practices and the adviser’s business and education background. Specific information must be disclosed, including: advisory services and fees; types of clients; types of investments; methods of analysis; sources of information and investment strategies; education and business standards; education and business background; other business activities; other financial industry activities or affiliations; participation or interest in client transactions; conditions for managing client accounts; review of accounts; investment or brokerage discretion; additional compensation; and a balance sheet.

c) Fee Arrangements (O.A.C. 1301:6-3-151(H))

With respect to most clients, investment advisers licensed by, or required to be licensed by, the Division are prohibited from entering into “performance fee arrangements,” which are plans of compensation based on a percentage of capital gains or appreciation in a client’s account. Contingent fee arrangements, including contracts that provide for the fee to be waived or reduced if certain performance levels are not met, also are prohibited. However, the prohibition on performance fee arrangements does not apply with respect to certain specified high worth clients.

d) Duty of Supervision (O.A.C. 1301:6-3-151(D))

Investment advisers licensed by the Division are required to reasonably supervise their investment adviser representatives and other persons employed by or associated with the investment adviser with a view towards preventing violations of the Act, the Securities Act of 1933, the Securities Exchange Act of 1934, the Commodity Exchange Act, and the rules and regulations promulgated under those statutes. There is a “safe harbor” for compliance with this rule that generally applies if the adviser has established procedures reasonably expected to prevent and detect violations, and the adviser discharges the obligations incumbent upon the adviser by reason of the established procedures.

e) Material Nonpublic Information (O.A.C. 1301:6-3-151(F))

In addition to the general duty of supervision, investment advisers licensed by the Division have a specific obligation to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the unlawful use of material, nonpublic information by the investment adviser or any person associated with the investment adviser

## 2. Anti-Fraud Standards

Some of the more significant Ohio anti-fraud standards include the following:

a) Prohibition on Misrepresentations (R.C. 1707.44(B)(5))

No person shall knowingly make, or cause to be made, any false representation concerning a material and relevant fact for purposes of advising for compensation, as to the value of securities or as to the advisability of investing in, purchasing or selling securities. Note that this prohibition extends to any “person,” not just those that fit within the definition of “investment adviser” or “investment adviser representative.”

b) General Fraud Prohibitions (R.C. 1707.44(M))

Investment advisers and investment adviser representatives are prohibited from employing any device, scheme, or artifice to defraud any person, and from engaging in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any person. They also are prohibited from acting in violation of Division rules that are designed to prevent fraudulent, deceptive, or manipulative acts, practices, or courses of business.

It is a violation of the statutory anti-fraud standards for an investment adviser or investment adviser representative licensed or required to be licensed by the Division to take or have custody of any securities or funds of any person, except as provided in rules adopted by the Division.

In addition, an investment adviser may act in a principal capacity, and certain agency capacities, with respect to an advisory client only after disclosure to and consent by the client.

Further, in the solicitation of clients or prospective clients, no person shall make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made not misleading in light of the circumstances under which the statements were made.

c) Advertisements (O.A.C. 1301:6-3-44(A))

Advertisements that contain any untrue statement of a material fact, or that are otherwise false or misleading, are prohibited. Advertisements that refer to or use any kind of testimonial also are prohibited. References to past specific recommendations, and to graphs, charts and formulas are permitted only under limited circumstances.

d) Custody of Client Funds and Securities (O.A.C. 1301:6-3-44(B))

“Custody” means directly or indirectly holding client funds or securities, having any authority to obtain possession of client funds or securities, or having the ability to appropriate funds or securities. An investment adviser licensed or required to be licensed by the Division, and its investment adviser representatives, may maintain custody only in compliance with the Division’s

rules. The rules generally provide for safekeeping by a “qualified custodian,” require that clients receive notice of the custody arrangements, and require that clients receive account statements at least quarterly.

e) Cash Payments to Solicitors (O.A.C. 1301:6-3-44(C))

Investment advisers and investment adviser representatives may use persons to solicit, develop, and refer business. These persons are known as “solicitors.” It is a fraudulent, deceptive, or manipulative practice for investment advisers licensed or required to be licensed by the Division, and their investment adviser representatives, to pay a cash fee, directly or indirectly, to a solicitor, except under certain circumstances

f) Best Execution

An investment adviser has a fiduciary duty to obtain “best execution” of client securities transactions. This obligation results from the common law agency principle that obligates an agent to act exclusively in the best interests of the principal. In general, “best execution” means executing client securities transactions in such a manner that the client’s total cost or proceeds in each transaction is the most favorable under the circumstances.

*For a more detailed discussion of the Ohio investment adviser laws, see the Ohio Investment Adviser Manual (LexisNexis 2002).*

*{Available at <http://bookstore.lexis.com/bookstore/product/45137.html>}*