

# THE OHIO DIVISION OF SECURITIES: RULEMAKING, THE ADMINISTRATIVE PROCEDURE ACT AND THE OHIO SECURITIES BULLETIN

The Ohio Division of Securities began publication of the Ohio Securities Bulletin, which was intended to be the division's official means of communication to the securities industry of Ohio, in May 1973. The bulletin was designed primarily as a medium for expression of division views, policies, and interpretations concerning the administration of the securities laws in Ohio, and secondarily as a means of disseminating information concerning issuer filings with the division and actions taken on license applications. The bulletin was conceived as a step toward openness in the administration of the laws.<sup>1</sup> However, it soon became clear that it is very difficult to separate disclosure of the inner workings of an agency from legislation by that agency. Although the division asserted in the first issue that the matters contained in the bulletin would not be subject to the Ohio Administrative Procedure Act,<sup>2</sup> that view has been questioned by members of the securities bar.<sup>3</sup>

The purpose of this note is to demonstrate that certain of the matters discussed in the bulletin are rules, and that the Ohio Administrative Procedure Act is therefore applicable to the process of developing and publishing much of the bulletin. Compliance with the Ohio Administrative Procedure Act would require that the division give notice of its intent to promulgate a rule, grant interested parties an opportunity to present their views on the proposed rule, and publish the resulting rule. It is further argued that the added burden of compliance with the Administrative Procedure Act ought not cause the division to abandon its announced policy of openness. Disclosure of policies and standards is not a matter of grace, but merely good administration, and may be mandated by statute. Where an agency takes the type of action that gives rise to the need for the protection afforded by disclosure and hearing, attempts to avoiding giving that protection should be examined with suspicion.

## I. THE OHIO SECURITIES BULLETIN AS RULEMAKING

An agency can become subject to the Ohio Administrative Prod-

---

<sup>1</sup> OHIO SECURITIES BULLETIN, May 1973, at 1.

<sup>2</sup> *Id.* at 9.

<sup>3</sup> OHIO SECURITIES BULLETIN, Vol. II, No. 4, at 2.

cedure Act<sup>4</sup> [hereinafter, APA] in two ways. First, the APA is applicable to any "official, board, or commission having authority to promulgate rules."<sup>5</sup> Second, the "functions of any administrative or executive officer, department, division, bureau, board, or commission of the government of the state specifically made subject to sections 119.01 to 119.13, inclusive, of the Revised Code" are governed by the APA.<sup>6</sup> In carrying out its duty of administering the Ohio Securities Act,<sup>7</sup> the Ohio Division of Securities is made subject to the APA under both approaches. The division's enabling legislation requires it to prescribe "rules and regulations regarding the sale of securities, the administration of sections 1707.01 to 1707.45, inclusive, of the Revised Code, and the procedure and practice before the division." Moreover, this statute granting rulemaking powers begins with the preamble: "In addition to fulfilling the requirements of sections 119.01 to 119.13, inclusive, of the revised code . . . ."<sup>8</sup> It is clear, then, that if the division does engage in rulemaking, the APA will apply. The determination is more than academic; the validity and enforceability of the matters contained in the bulletin turn upon whether those matters are "rules." It does not, for purposes of the APA, turn on the wisdom of the policy behind those matters.

The publication of the Ohio Securities Bulletin began with high hopes for improved administration of the Ohio Securities Act. In the first issue, Commissioner William L. Case III explained that his primary goal was to aid those who genuinely sought full compliance with the securities act by publishing the rules, statements of policy, and policy guidelines, collectively known as "regulatory standards," that the division would use in discharging its regulatory functions.<sup>9</sup>

---

<sup>4</sup> OHIO REV. CODE § 119.01 et seq. (1969).

<sup>5</sup> OHIO REV. CODE § 119.01 (1969).

<sup>6</sup> *Id.*

<sup>7</sup> OHIO REV. CODE § 1707.01 et seq. (1964).

<sup>8</sup> OHIO REV. CODE § 1707.20 (1964).

<sup>9</sup> One of the most frequent criticisms of the Division which has been related to me during the last five months is that with virtually no written regulatory standards and no regular and continuous method of communicating its policies to persons who are subject to its regulation, the Division puts a particularly onerous burden upon those who genuinely seek full compliance with such policies. It is in recognition of the legitimacy of such criticism and of the fact that this lack of communication has compounded the difficulty for the Division of exercising its regulatory functions, that this *Ohio Securities Bulletin* has been created. Probably the most significant feature of this bulletin will be the material published regularly under the heading "*Regulatory Standards*." This Publication will be the principal outlet, and therefore, the principal source of reference, for Division Rules, Statements of Policy, Forms, and Written Policy Guidelines . . . , both adopted and proposed, which will collectively represent the expressed regulatory standards of the Division as they are formu-

As those regulatory standards were given content, however, the result was rulemaking within the meaning of the APA. Therefore, any regulatory standard promulgated would be of no force or effect unless promulgated in compliance with the APA.<sup>10</sup>

Two particular matters attracted the division's attention when the bulletin was first published: the standards to be used in determining whether an issue was offered on substantively fair terms and the sale of foreign real estate in Ohio. Under Ohio Rev. Code §§ 1707.09 and 1707.13, the division is empowered to determine whether any given offering within its jurisdiction is fair in substance. In June and August of 1973, the division began publishing the standards which it intended to use in making a determination of fairness with respect to issuance of securities.<sup>11</sup> Among the aspects of an offering covered by these "written policy guidelines" were offering price, capitalization of newly organized issuers, compensation of promoters, selling procedures, and the rights of the security holders. The guidelines asserted that the division might, in its discretion, refuse registration of any security which failed to conform to those guidelines.<sup>12</sup>

In the area of foreign real estate registration, the division developed and published a comprehensive regulatory system designed to protect Ohio investors. The Ohio Securities Act's definition of "security" includes "real estate not situated in this state and any interest in real estate not situated in this state."<sup>13</sup> Thus, the test of substantive fairness is applicable to offerings of foreign real estate to Ohio investors. The guidelines developed for the sale of foreign real estate range from simple disclosure requirements<sup>14</sup> to a requirement that the offering price not exceed the fair market value of the land as determined by a qualified independent appraiser.<sup>15</sup>

### A. *Actions That Constitute Rulemaking*

The APA applies whenever an agency subject to its provisions promulgates a "rule." The question then becomes whether the development and publication of regulatory standards in the bulletin

---

lated, in perhaps the most significant new undertaking of the Division, during the months to come.

OHIO SECURITIES BULLETIN, May 1973, at 1.

<sup>10</sup> OHIO REV. CODE § 119.02 (1969).

<sup>11</sup> OHIO SECURITIES BULLETIN, June 1973, at 9; OHIO SECURITIES BULLETIN, August 1973, at 5.

<sup>12</sup> OHIO SECURITIES BULLETIN, June 1973, at 9.

<sup>13</sup> OHIO REV. CODE § 1707.01(B) (Supp. 1974).

<sup>14</sup> OHIO SECURITIES BULLETIN, Vol. II, No. 3, at 14.

<sup>15</sup> *Id.* at 17.

amount to rulemaking within the meaning of the APA. A "rule," for purposes of that statute, is "any rule, regulation, or standard, having a general and uniform operation, adopted, promulgated, and enforced by any agency under the authority of the laws governing such agency, but it does not include regulations concerning internal management of the agency which do not affect private rights."<sup>16</sup> Once it is decided that a particular communication or action is a "rule," no action can be taken on the matter except under certain conditions. The heart of the policy behind the APA is the requirement of a hearing at which citizen input is accepted,<sup>17</sup> and the publication of the resulting action.<sup>18</sup> Failure to comply with these requirements makes the rule so promulgated invalid.<sup>19</sup>

The meaning of the term "rule" has not been frequently litigated in Ohio;<sup>20</sup> however, judicial decisions under the federal Administrative Procedure Act<sup>21</sup> are more numerous. The federal act has a different definition of "rule" so that the cases cannot be dispositive of questions under Ohio law. However, there is enough similarity in the statutes so that the reasoning used by federal courts can be helpful in determining the type of quasi-legislative conduct that is considered rulemaking.<sup>22</sup> In defining "rule" for purposes of the federal APA, the court in *American Express Co. v. United States*<sup>23</sup> said that the nature of rulemaking is essentially legislative. As such, it is concerned with creating policy for the future rather than the evaluation of past conduct. Rulemaking looks not to evidentiary fact finding but to policy decisions to be made on the basis of facts.

Rulemaking need not be explicitly legislative, however. The fact that an agency acts, rather than drafts, is not necessarily fatal to an argument that rulemaking is occurring. In *P.A.M. News Corp. v.*

---

<sup>16</sup> OHIO REV. CODE § 119.01(C) (Supp. 1974).

<sup>17</sup> OHIO REV. CODE § 119.03 (1969).

<sup>18</sup> OHIO REV. CODE § 119.04 (1969).

<sup>19</sup> OHIO REV. CODE § 119.02 (1969).

<sup>20</sup> The only reported case construing Ohio Rev. Code § 119.01(C) is *Lloyd v. Indus. Comm'r*, 119 Ohio App. 467, 200 N.E.2d 705 (1964).

<sup>21</sup> 5 U.S.C. § 551 et seq. (1970).

<sup>22</sup> The federal statute defines "rule" more fully but not necessarily more broadly. One difference between the statutes is that a federal rule is of "general or particular applicability," 5 U.S.C. § 551(4) (1970), while an Ohio rule is something of "general and uniform operation," OHIO REV. CODE § 119.01(C) (1969). Thus it could be argued that federal cases are inapplicable, since the federal definition is more sweeping. The words "or particular," however, should be read out of the federal statute. It has been said that the language represents an excess of legislative zeal and cannot be read literally, or every agency action would be a rule under federal law. K. DAVIS, *ADMINISTRATIVE LAW* (1959).

<sup>23</sup> 472 F.2d 1050 (C.C.P.A. 1973).

*Hardin*,<sup>24</sup> the Department of Agriculture's decision to institute an agricultural data news service in competition with the plaintiff's private service was held to be a rule. The court was apparently persuaded by the argument that, prior to such action, the department ought to give reasoned consideration to facts and arguments presented by those who would be affected by the decision.<sup>25</sup>

Apparently, a rule can be implied from a consistent course of conduct. In *Oil Shale Corp. v. Morton*,<sup>26</sup> it was held that the Department of Interior's policy of twenty-five years stating that oil shale claims would not be voided for failure to perform assessment work on the claim, amounted to a rule. The Department of Interior could not, therefore, refuse to issue mineral patents to the plaintiff-claim owners merely because of failure to perform the assessment work. The court emphasized that claim holders ought to be able to rely on the uniformly applied policy which the department had followed in numerous previous instances.<sup>27</sup>

The definitional problem often arises where an agency's choice of methods for problem solving is questioned. In *Regular Common Carrier Conference v. United States*,<sup>28</sup> the plaintiff attacked the Interstate Commerce Commission's action of removing certain restrictions from approximately 250 interstate carrier certificates by a rule-making procedure, rather than case-by-case adjudication. It was held that the action was rulemaking. The court stated that adjudication would be appropriate where an agency must make a decision in a particular situation in which the individual parties have more knowledge of the situation but that rulemaking is appropriate where a policy is to be made based on the general characteristics of an entire industry.<sup>29</sup>

A leading commentator has said that any attempt to define "rulemaking" will lead to confusion and the distinction is that rulemaking results when an agency engages in legislative conduct.<sup>30</sup> But accounting for the factors considered in the above-cited cases and the policy behind the Administrative Procedure Act, a general theme emerges. If the information which an agency requires to act in the best interests of the public can be gathered only from the class of

---

<sup>24</sup> 440 F.2d 225 (D.C. Cir. 1971).

<sup>25</sup> *Id.* at 258 n. 4.

<sup>26</sup> 370 F. Supp. 108 (D.C. Colo. 1973).

<sup>27</sup> *Id.* at 123.

<sup>28</sup> 307 F. Supp. 941 (D.D.C. 1969).

<sup>29</sup> See also *WBEN, Inc. v. United States*, 396 F.2d 601 (2d Cir.), *cert. denied* 393 U.S. 914 (1968).

<sup>30</sup> K. DAVIS, *ADMINISTRATIVE LAW* 84 (1959).

persons subject to the agency's jurisdiction, rulemaking is the proper agency response.<sup>31</sup> When a problem becomes so widespread in the agency's area of authority that general prospective action is needed, rulemaking becomes advantageous for both the agency and those affected. For the agency, it is more economical to legislate than to proceed on an ad hoc basis; furthermore, the agency would be proceeding with valuable input from the public, rather than acting on its own limited information. For the public, considerations of fairness militate for the notice of agency action to be published and for the public to be given an open hearing on the reasonableness of the impending action. Any agency action taken in response to a problem which ought to be solved legislatively should be held to be rulemaking, regardless of the actual method employed. In short, "rulemaking" must be defined in the context of the policy of openness and public input expressed by the Ohio APA. If considerations of fairness and efficiency make those policies applicable to agency action, an agency should not be able to argue that it is not making rules.

#### B. *Is the Publication of the OHIO SECURITIES BULLETIN Rulemaking?*

The division is aware of the problems of administrative law inherent in the bulletin, as evidenced by the Commissioner's view on the APA frequently contained in the bulletin. For example, an article in the first issue attempted to distinguish the different types of regulatory standards on the basis of the division's theories on the different effects of the standards (*i.e.* "statements of policy" are standards having "a general operation adopted for the purpose of implementing the authority of the Division . . .").<sup>32</sup> Written policy guidelines are similar to policy statements, but are standards which are in the process of being formulated and are not yet suitable for publication as a policy statement. Despite the fact that policy guidelines are not as complete as policy statements, the division reserves the right to implement guidelines at any time without publication or notice.<sup>33</sup> The only standards which the division considers to be "rules" are those standards which are promulgated in compliance with the Administrative Procedure Act.<sup>34</sup> Apparently, no standard can be a rule in the division's view unless the division chooses to proceed under the Act.

---

<sup>31</sup> Bernstein, *The NLRB's Adjudication-Rule Making Dilemma Under the Administrative Procedure Act*, 79 YALE L.J. 571, 616-17 (1970).

<sup>32</sup> OHIO SECURITIES BULLETIN, May 1973, at 8.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

The definition leaves the decision of whether a standard is to be a rule to be made by the division itself.

In the development of these written policy guidelines, the division claims virtual exemption from the Administrative Procedure Act. The Commissioner reasoned that since the division could develop regulatory standards in connection with specific adjudications without complying with the APA, the division could also develop regulatory standards having the effect of rules without compliance with the APA.<sup>35</sup> Furthermore, although the division reserved the right to apply its regulatory standards as rules, the Commissioner said that compliance with the regulatory standards would not necessarily preclude unfavorable action by the division. The Commissioner apparently saw the regulatory standards as a system of law which was binding upon the industry, but not upon the division.<sup>36</sup>

Some of the problems with the division's current policies regarding the procedure for adopting its regulatory standards and the effect of those standards are illuminated by the two specific examples mentioned earlier in the paper. The first example involved the determination of whether an issue was offered on substantively fair terms. In particular, the division promulgated a regulatory standard containing four tests for determining whether the price of a proposed offering is grossly unfair. Under the first test, the division announced that it would hold any offering to be grossly unfair under Ohio Rev. Code § 1707.09 if its price exceeded the product of twenty-five times the net earnings per share of the issuer for the last accounting period.<sup>37</sup> In the recent market, twenty-five times earnings would seem to be a generous ceiling, and the standard may be criticized for being too loose; however, it is unknown how the precise multiple was selected. Certainly the division could not have proceeded on the assumption that any security selling at twenty-five times earnings is intrinsically unfair. In the not too distant past, such a standard would have been irrelevant to any concept of fairness. For example, in 1960, the fol-

---

<sup>35</sup> It is the interpretation of the Division of Securities of Chapters 1707 and 119 of the Ohio Revised Code that regulatory standards of the Division may be adopted for application in the exercise of substantive judgments in connection with specific adjudications required by the Ohio Securities Act without compliance with the procedure prescribed in Sections 119.01 to 119.13, inclusive. Therefore, Statements of Policy, Forms, Written Policy Guidelines, and Unwritten Policies of the Division will be considered to be in all respects equivalent to Rules of the Division and will be applied accordingly.

*Id.* at 9.

<sup>36</sup> *Id.*

<sup>37</sup> OHIO SECURITIES BULLETIN, June 1973, at 12.

lowing common stocks sold at earnings multiples exceeding twenty-five:<sup>38</sup>

<u>Issuer</u>	<u>Price-Earnings Ratio</u>
Alcoa	48.0
du Pont	27.5
Eastman Kodak	34.9
General Electric	37.7

Under another test, the division may block the sale of a security if its price exceeds the net book value per share of the issuer's tangible assets.<sup>39</sup> Yet the asset value of common stock is widely regarded as a meaningless figure,<sup>40</sup> since the price of common stock depends on the earning power of the issuer, rather than the value of assets held by the issuer. Although the net book value test only applies to a company which has no securities being actively traded or has had no net earnings in the last accounting period, this test makes the price of any securities sold equal to no more than the shareholder's portion of the firm's value if liquidated. Even in the context of a start-up company, an investor must be anticipating receipt of more than a pro rata share of tangible assets—he is anticipating future earnings. The price of the security ought to be allowed to reflect that expectation. Neither the earnings multiple nor the book value standards is necessarily unreasonable. However, contrary to the purposes of the APA, the division has made a decision without the benefit of citizen input.

The standards developed for the sale of foreign real estate also have occupied large portions of the bulletin. They range from increased disclosure requirements to price ceilings. For the purpose of ensuring effective disclosure, the division intends to require that the seller of foreign real estate read verbatim the offering circular to the prospective purchaser.<sup>41</sup> It has been suggested, however, that an investor relies more on second-hand information gleaned from disclosure documents by professionals, rather than his own analysis of the information.<sup>42</sup> If so, forcing a seller to read the disclosure document aloud is unlikely to add to the purchaser's knowledge. While the requirement will probably be no more than an annoyance, it was

<sup>38</sup> GRAHAM, DODD & COTTLE, *SECURITY ANALYSIS* 232 (1962).

<sup>39</sup> OHIO SECURITIES BULLETIN, June 1973, at 13.

<sup>40</sup> In two industries, public utilities and financial companies, the figure is of importance. These industries, however, are the exception. GRAHAM, DODD & COTTLE, *supra* note 38, at 216.

<sup>41</sup> OHIO SECURITIES BULLETIN, Vol. II, No. 3, at 14.

<sup>42</sup> Kripke, *The S.E.C., the Accountants, Some Myths and Some Realities*, 45 N.Y.U.L. REV. 1151 (1970).



adopted without allowing the industry a chance to argue that its operations should not be burdened with time consuming, if innocuous, requirements.

A second requirement of the foreign real estate standard creates even greater problems. The division states that it will limit the offering price of foreign real estate to its fair market value as evidenced by a report prepared by an independent appraiser acceptable to the division.<sup>43</sup> Furthermore, the division has expressed the intent to limit the qualification of foreign real estate to a period of twelve months, after which time re-registration with another substantive fairness examination will be required.<sup>44</sup> Since the offeror must bear the expense of gathering information for such an examination,<sup>45</sup> the expense of a yearly appraisal could, if the requirement is strictly enforced, prevent smaller developers from selling in Ohio. The division's concern with the sale of foreign real estate is justifiable since offering real estate to a buyer geographically removed from the land presents opportunities for fraud. The division's solution, however, may have the effect of preventing some meritorious offerings in Ohio.

The issue is not whether the standards published for qualifying foreign real estate and judging the substantive fairness of an offering are reasonable; they may or may not be. The question is whether they and other such pronouncements in the Ohio Securities Bulletin are rules, which must be promulgated in accordance with the Ohio Administrative Procedure Act. The particular standards discussed above seem to be rules. They are to be applied generally and uniformly, in keeping with the Ohio definition of rules, and they are to be applied prospectively. More importantly, the guidelines amount to a type of comprehensive regulatory scheme which ought to be adopted only after careful consideration. The Ohio Administrative Procedure Act expresses a policy of favoring public hearings before the adoption of any such scheme; the definition of "rulemaking" and the applicability of the APA ought to be considered in the light of that policy. The standards announced in the bulletin are comprehensive, drawn with precision, and designed to affect a large industry and a significant segment of Ohio citizens. Drawing such standards without the benefit of formal input from industry and general sources ignores the policy behind the APA.

---

<sup>43</sup> OHIO SECURITIES BULLETIN, Vol. II, No. 3, at 17.

<sup>44</sup> OHIO SECURITIES BULLETIN, Dec. 1973, at 9.

<sup>45</sup> OHIO REV. CODE § 1707.09(K) (1964).

## II. RULEMAKING OUTSIDE OF THE ADMINISTRATIVE PROCEDURE ACT.

The division is currently reassessing its use of the Ohio Securities Bulletin and bulletin publication has been discontinued pending a determination concerning the need for such a document.<sup>46</sup> The future course of disclosure and rulemaking is uncertain. The division is now soliciting input from the securities bar and industry concerning many of the matters dealt with in the bulletin. It would be beneficial to all concerned if the division were to pursue a course of rulemaking in full compliance with the APA, whether or not the bulletin continues as the medium of communication. Treating disclosure of policy as a matter of grace and relying on ad hoc adjudication or the exercise of discretion, as has been done in the past, is a grievously flawed approach.

The division must operate with some standards if it is to discharge its duties. The substantive fairness of an offering, for example, must be judged by something more relevant than a division employee's disposition on any given day. A decision to abandon the bulletin and a refusal to promulgate rules therefore, would mean that the division had decided to follow one or more of three courses of action: adjudication on an ad hoc basis, exercise of its discretion, or use of non-public standards. Each of these three actions will be examined in the following sections with particular focus on the legality of each and possible remedies through the courts.

### A. *Adjudication as an Alternative to Rulemaking*

The division is vested with the power to proceed against suspected violations of the Ohio Securities Act through statutory adjudication procedures,<sup>47</sup> initiating criminal proceedings,<sup>48</sup> suspending or revoking dealers' licenses,<sup>49</sup> enjoining violations of the securities act,<sup>50</sup> or enjoining the issuance or sale of securities for procedural irregularities.<sup>51</sup> Commissioner Case has argued that the division, as an alternative to rulemaking, could proceed by adjudication in particular instances and thereby establish law without pursuing formal rulemaking. He also argued that the choice between rulemaking and adjudica-

---

<sup>46</sup> Letter to subscribers of the OHIO SECURITIES BULLETIN from Commissioner James S. Reece, Feb. 25, 1975.

<sup>47</sup> OHIO REV. CODE § 1707.23 (1964).

<sup>48</sup> OHIO REV. CODE § 1707.23(E) (1964).

<sup>49</sup> OHIO REV. CODE § 1707.23(D) (1964).

<sup>50</sup> OHIO REV. CODE § 1707.26 (1964).

<sup>51</sup> OHIO REV. CODE § 1707.25 (1964).

tion is solely a matter within the division's discretion.<sup>52</sup> To the extent that federal administrative law is similar to that of Ohio, that position is partially supported by *S.E.C. v. Chenery*.<sup>53</sup> In that case, the Securities and Exchange Commission, in approving a reorganization plan under the Public Utility Holding Company Act of 1935,<sup>54</sup> ordered that the preferred stock of the company, purchased by management during the period of reorganization, be surrendered to the company at cost plus interest, rather than be converted into stock of the new company along with other shares of the same class. The Supreme Court approved the Commission's action notwithstanding an attack based on the failure to develop a rule governing the matter. The Court held that the choice between proceeding by rulemaking or ad hoc decisions is one that lies within the discretion of the agency. To render the action invalid, as was urged by the officers and directors, would be to hold that the failure of the Commission to anticipate the problem and legislate a rule in response would invalidate agency action taken in the valid discharge of the agency's adjudicatory duties.<sup>55</sup>

*Chenery* was questioned in *N.L.R.B. v. Wyman-Gordon Co.*<sup>56</sup> That case involved the National Labor Relation Board's attempt to enforce an order directing an employer to surrender to the union a list of all its employees. The Court of Appeals for the First Circuit held<sup>57</sup> that the order could not be enforced because it was based on a rule developed by adjudication in a prior case, *Excelsior Underwear*.<sup>58</sup> The Supreme Court majority agreed with the appellate court's rationale, holding that the provisions of the federal APA may not be avoided by the process of making rules through adjudication, and that the *Excelsior Underwear* rule was therefore invalid. However, in this instance, the employer had been directed in a lawful adjudicatory proceeding to comply with the order reached in that proceeding, rather than a prior rule established by adjudication. The First Circuit was therefore reversed and the order enforced. The remaining justices concurred in the result but disagreed with the language concerning rulemaking, feeling that *Chenery* should control.

The holding of *Chenery* was again recognized in dictum in the recent case of *N.L.R.B. v. Bell Aerospace Co.*<sup>59</sup> The Supreme Court

---

<sup>52</sup> OHIO SECURITIES BULLETIN, Vol. II, No. 4, at 2.

<sup>53</sup> 332 U.S. 1974 (1947).

<sup>54</sup> 15 U.S.C. § 79 (1970).

<sup>55</sup> 332 U.S. at 201.

<sup>56</sup> 394 U.S. 759 (1969).

<sup>57</sup> *Wyman Gordon Co. v. N.L.R.B.*, 397 F.2d 394 (1st Cir.), *rev'd* 394 U.S. 759 (1966).

<sup>58</sup> 156 N.L.R.B. 1236 (1966).

<sup>59</sup> 416 U.S. 267 (1974).

held that the NLRB was not required to proceed by rulemaking rather than adjudication to determine whether certain employees were "managerial" and therefore excluded from the coverage of the NLRA.<sup>60</sup> While the discussion of administrative law is dictum because the case turned on the statutory interpretation of "managerial," *Bell Aerospace* does indicate a willingness on the part of the Court to return to *Chenery*.

The Ohio courts have also struggled with the issue of whether an agency has absolute discretion to proceed by adjudication or rulemaking. The question has never been definitely settled by the Supreme Court of Ohio. A recent Ohio appellate decision, *In re Application of Blue Cross*,<sup>61</sup> has specifically rejected the *Chenery* approach for purposes of the Ohio Administrative Procedure Act. The superintendent of insurance had attempted, in a ratemaking hearing, to impose certain duties upon Blue Cross to exert pressure on member hospitals concerning increasing costs. As in *Wyman-Gordon*, however, a holding that the adjudicative rulemaking was invalid was of no help to the complaining party. The Superintendent was required to approve or reject Blue Cross' proposed rates but did not have the power to modify them, and therefore the proposed rates were rejected.

The problem of whether an agency can make law through adjudication is inherent in granting one body both adjudicatory and legislative functions. Even if it is the law that the division cannot, in its discretion, proceed by adjudication to make rules, what is a complaining party's remedy? The division should be allowed a reasonable amount of time to proceed against a particular problem through case-by-case adjudication. At some point, however, it must become apparent that the problem is ripe for a legislative remedy and that such a remedy would be more economical to the agency and more equitable for the public. If the division still refuses to promulgate rules, an affected party's remedy would be available only if the courts were willing to reverse a particular adjudication for failure to proceed by rulemaking. *Chenery* can be read to say that in a particular case, an agency's decision should not be reversed for failure to anticipate a problem and legislate accordingly.<sup>62</sup> That reading would leave open the question of whether an agency's knowing refusal to promulgate rules in the face of an industry-wide problem should be penalized upon judicial review. If the courts were to answer in the affirmative,

---

<sup>60</sup> 29 U.S.C. § 151 et seq. (1973).

<sup>61</sup> 40 Ohio App. 2d 285, 318 N.E.2d 212, (Franklin 1973).

<sup>62</sup> 332 U.S. at 201.

it would put them in the position of reversing an agency's adjudication, correct on the merits, for reasons not relevant to the subject matter of particular adjudication. It may be, however, that courts reviewing administrative adjudication will be willing to put themselves in such a position. *Chenery* does not hold that the agency has absolute discretion to choose between rulemaking and adjudication; it holds that the choice lies *primarily* in the informed discretion of the agency.<sup>63</sup> The Court also said that the SEC's function of administering the securities laws should be performed "as much as possible, through this quasi-legislative promulgation of rules to be applied in the future."<sup>64</sup> Such a sentiment may mark an increased willingness to pressure administrative agencies to move to rulemaking at a point where such action is appropriate.<sup>65</sup> It has been argued that the ultimate result in *Wyman-Gordon*—the decision not to reverse the NLRB's adjudication even though the Board failed to properly promulgate rules—was dictated merely by a practical consideration: holding that rules made by adjudication could in no instance be enforced would throw the Board's work into chaos. The language of *Wyman-Gordon*, repeated in *Bell Aerospace*, regarding the choice between rulemaking and adjudication, however, may mean that the exclusively adjudicatory approach will not long be tolerated.<sup>66</sup> If an agency consistently avoids a rulemaking approach where clearly appropriate, the courts may decide to invalidate orders developed through adjudication in spite of the chaotic effect on the process of administration.<sup>67</sup>

### B. *The Use of Discretionary Powers as an Alternative to Rulemaking*

The division points to its discretionary power in arguing that it cannot be forced to develop, publish, and apply regulatory standards.<sup>68</sup> Indeed, the Ohio Securities Act does contemplate seemingly unfettered use of discretion. The division may allow registration by qualification of an issue "[i]f the division finds" it to be substantively fair.<sup>69</sup> Foreign real estate may be qualified for sale in Ohio "[i]f the division is of the opinion" that the offering is on substantively fair

---

<sup>63</sup> *Id.* at 203.

<sup>64</sup> *Id.* at 202.

<sup>65</sup> K. DAVIS, ADMINISTRATIVE LAW 607-08 (1970 Supp.).

<sup>66</sup> Bernstein, *supra* note 31 at 604.

<sup>67</sup> *Id.* at 620.

<sup>68</sup> OHIO SECURITIES BULLETIN, Vol. II, No. 4, at 2.

<sup>69</sup> OHIO REV. CODE § 1707.09(K) (1964).

terms.<sup>70</sup> And securities sold without compliance with the statute may be qualified after sale "if it appears to the division" that no investor has been defrauded or damaged.<sup>71</sup>

If the Commissioner's position is that the division's discretionary powers allow it to adopt and apply rules without compliance with the Ohio APA, he is ignoring the clear language of the APA. To accept such an argument would be to write into the law an exemption for the division, allowing it to adopt rules for the exercise of its discretion without hearing or publication. Yet, if the particular matter is a rule, compliance with the APA is mandated; exemptions from the Ohio act, as with the federal, are not easily implied.<sup>72</sup>

As with adjudication, the unstructured use of discretion is a poor substitute for properly promulgated rules, and generally should be abandoned in favor of rulemaking. For an example of the relationship between discretionary regulation and rulemaking, the division might look to the Securities and Exchange Commission. In its practice of issuing no-action letters, the SEC is operating in a discretionary capacity. A no-action letter means only that the Commission will not act on the particular situation involved, for any number of reasons, as, for example, the hardship imposed by demanding rigid compliance with the statute.<sup>73</sup> The letter may or may not result from the Commission's interpretation of the statute; it merely informs the recipient that no action will be taken. Yet, when a problem becomes so widespread that a discretionary approach is unwarranted, the SEC proceeds by rulemaking. The promulgation of rule 144,<sup>74</sup> for example, was in response to an increasing number of requests for no-action letters on the secondary distribution problem.<sup>75</sup> After the rule was promulgated, the SEC no longer considered the problem to be one in which the use of discretion, through no-action letters, was appropriate.<sup>76</sup>

### C. Remedies for Use of Non-Public Standards

The problem of discretion and adjudication as alternatives to rulemaking raises a basic question: whether the division can refuse

---

<sup>70</sup> OHIO REV. CODE § 1707.33(G) (Supp. 1974).

<sup>71</sup> OHIO REV. CODE § 1707.39 (1964).

<sup>72</sup> *Marcello v. Bonds*, 349 U.S. 302 (1955).

<sup>73</sup> Lockhart, *S.E.C. No-Action Letters: Informal Advice As a Discretionary Administrative Clearance*, 37 LAW & CONTEMP. PROB. 95 (1972).

<sup>74</sup> 17 C.F.R. § 230.144 (1974).

<sup>75</sup> Lockhart, note 73 *supra* at 96.

<sup>76</sup> SEC Securities Act Release No. 5223 (Jan. 11, 1972), CCH FED. SEC. L. REP. ¶ 78,487.

to make any rules to guide the conduct of the Ohio securities industry. The division formerly admitted that such action would be "irresponsible,"<sup>77</sup> and the industry would certainly agree that it would be unfair. But does the investing public or the securities industry have any remedy if such action is nevertheless taken?

The Ohio Securities Act provides a defrauded purchaser with two remedies against the seller. If the sale results from the falseness of any material statement in a selling document, the seller is liable to the purchaser for any loss or damages.<sup>78</sup> If the sale is in any way violative of any provision of the securities act, the investor has a right of rescission.<sup>79</sup> A case can be hypothesized, however, wherein a sale could be made on terms that are grossly unfair to the purchaser, yet the selling documents could be completely truthful. The unfairness of the terms would not necessarily be a violation of any provision of the act and therefore the purchaser would have no rescission remedy under the securities act. If there is no misrepresentation in the selling documents, then the purchaser would have no cause of action under the statutory fraud section.

If this security has been examined by the division and released for sale, the investor ought to be able to assume that the division is satisfied that the terms of the sale are not grossly unfair; by hypothesis, however, the terms have turned out to be unfair. Barred from asserting a cause of action against the seller, the purchaser may be able to proceed against the division for a failure to develop and publish standards for testing substantive fairness so that the industry and the public will know the extent of the protection resulting from the division's initial examination. The passage of the court of claims statute,<sup>80</sup> waiving the state's sovereign immunity, may attract such claims. The problems in such a claim are imposing. For example, can a claim be made against an officer for non-feasance of a statutory duty? If so, is there a duty imposed upon the division to use any rational basis for qualifying securities, breach of which should give rise to a claim for damages by an injured citizen? Such issues would be ones of first impression in the court of claims.

A problem with such a cause of action that has received some attention, however, and one which is relevant to the duties of the division, is the discretionary function doctrine developed under various government tort claims statutes. In a leading case under the

---

<sup>77</sup> OHIO SECURITIES BULLETIN, Vol. II, No. 4, at 2.

<sup>78</sup> OHIO REV. CODE § 1707.41 (1964).

<sup>79</sup> OHIO REV. CODE § 1707.43 (1964).

<sup>80</sup> OHIO REV. CODE § 2743.01 et seq. (Supp. 1974).

Federal Tort Claims Act,<sup>81</sup> the Supreme Court held<sup>82</sup> that the statutory discretionary function exemption<sup>83</sup> insulated public officers from liability arising out of their duties on a "planning" level, as differentiated from ordinary "operational" level duties. Such an analysis would seem to insulate the division from liability for failure to develop regulatory standards, because the division, as noted above, is vested with a great degree of discretion in administering the securities act.

A more recent decision interpreting the discretionary function exemption of a state statute may signal a new approach to the problem. In *Johnson v. California*,<sup>84</sup> the California Supreme Court held that the statutory exception, similar in wording to the federal, was not available to a state youth authority that had allowed a couple to adopt a boy with known homicidal tendencies, without warning the couple. Reviewing a claim arising from the boy's attack on the adoptive mother, the court said that only basic policy decisions are insulated from judicial review; failure to warn in the circumstances of the *Johnson* case was not the sort of function sought to be protected by the discretionary function doctrine. Exercise of discretionary functions of the sort which should be immune, the court noted, involves conscious consideration of the risks and benefits of a particular course of action. Such an analysis would deny the discretionary function defense to an agency official faced with a claim that he had failed altogether to exercise his power to protect the public. If the California analysis is followed in Ohio, it would mean that if the division made no inquiry into the fairness of an issue and that issue was released to the public, a claim by an injured investor would lie.

If the investing public at present has an inadequate remedy for failure to develop regulatory standards, an issuer is in an even less favorable position. An issuer seeking to market securities in Ohio has a legitimate need to know the standards that will be applied by the division in passing upon the merits of his offering. If the division has promulgated a rule covering the issuer's situation, he may have an opportunity for judicial review of that rule.<sup>85</sup> Also, if the division

---

<sup>81</sup> 28 U.S.C. § 2671 (1965).

<sup>82</sup> *Dalehite v. United States*, 346 U.S. 15 (1953).

<sup>83</sup> 28 U.S.C. § 2680(a). The discretionary function exemption may be statutory or, as in the case of certain state tort claim statutes, judge-made. *See, e.g., Alva Steamship Co. v. City of New York*, 405 F.2d 962 (2d Cir. 1969).

<sup>84</sup> 69 Cal.2d 782, 73 Cal. Rptr. 447, 240 P.2d 352 (1968).  
447 P.2d 352 (1968).

<sup>85</sup> OHIO REV. CODE § 119.11(1969) seems to give any affected person the right to judicial review of administrative rulemaking. That section however, has received a restrictive interpreta-



denies qualification, the issuer may have a right to judicial review.<sup>86</sup> Neither remedy, however, fulfills the issuer's need to know beforehand what he must do to comply with the statute.

A prospective issuer may seek to prove that, despite the lack of any published standards, a rule does exist which ought to be reviewable. In the *Oil Shale Corp.*<sup>87</sup> case, the district court found that a rule existed on the basis of a consistently applied and expressed policy. The facts of that case, however, were unusually one sided: the agency had followed a consistent course of conduct for twenty-five years and had addressed a number of letters to inquiring parties advising them of the policy. The burden of proving that a de facto rule exists in less clear circumstances would be difficult to meet. First, a party seeking review would have to discover what the policy was. Discovery of a policy could be prevented if the division had refused to give reasons for its actions in any given instance. Secondly, the party would have the problem of showing that the division has engaged in a course of conduct over a sufficiently long period of time so that the conduct would be deemed to be rulemaking.

Even if the remedies discussed above are available to those damaged by a refusal to promulgate rules, they become available only *after* the damage is done. The need still exists for a device to force the commissioner to adopt a systematic rulemaking procedure. An action in mandamus, for example, might lie to compel the division to make rules. As a condition to such an action, rulemaking would first have to be established as an act that is mandatory under the law.<sup>88</sup> The Ohio Securities Act says that the division "shall" prescribe forms and "shall" promulgate rules.<sup>89</sup> The word "shall" in a statute is usually interpreted as mandatory in nature,<sup>90</sup> especially where, as in the Securities Act, it is frequently repeated.<sup>91</sup> Furthermore, in the same section of the statute which conferred rulemaking power, the legislature said that the division "may" publish a list of licensed

---

tion. *Burger Brewing Co. v. Liquor Control Commission*, 34 Ohio St. 2d 93 (1973); *Fortner v. Thomas*, 22 Ohio St. 2d 13 (1970), and was recently declared void under the Ohio constitution. *Rankin-Thoman v. Caldwell*, 42 Ohio St. 2d 436 (1975). Judicial review now is available only under the declaratory judgment statute, OHIO REV. CODE § 2721.03 (Supp. 1974), and then only at the court's discretion. *Burger Brewing Co.*, *supra*. See Rutledge, *Administrative Review and the Ohio Modern Courts Amendment*, 35 Ohio State L.J. 41 (1974).

<sup>86</sup> OHIO REV. CODE § 1707.22 (1964).

<sup>87</sup> *Supra* note 26.

<sup>88</sup> OHIO REV. CODE § 2731.01 (1954).

<sup>89</sup> OHIO REV. CODE § 1707.20 (1964).

<sup>90</sup> *Dorrian v. Scioto Conservancy Dist.*, 27 Ohio St. 2d 102, 201 N.E.2d 834 (1971); *McCreech v. Brown*, 108 Ohio St. 454, 141 N.E. 69 (1923).

<sup>91</sup> *Cleveland R.R. Co. v. Brescia*, 100 Ohio St. 267, 126 N.E. 51 (1919).

dealers and salesmen. The construction of "shall" as mandatory is bolstered where the legislature uses that term in contradistinction to the permissive term "may."<sup>92</sup>

If it can be established that the division has a mandatory duty to promulgate rules, an action in mandamus would be answered with the defense that official discretion cannot be controlled by mandamus.<sup>93</sup> However, a writ of mandamus compelling the Commissioner to promulgate rules would not be controlling the use of discretion; such a writ would be moving him into action. When an officer refuses to act at all, mandamus will issue to compel the performance of a duty, even though the chosen course of action is within the officer's discretion.<sup>94</sup>

A second possible remedy would be legislative in nature. The Ohio APA would be greatly improved by the addition of a provision similar to section 4(C)<sup>95</sup> of the federal APA. This section grants any interested party the right to petition and agency for the issuance, amendment, or repeal of a rule. While the agency has no duty to respond affirmatively to such a petition, the fact that the agency was notified of the problem yet failed to act could be relevant to later agency adjudication on the same problem. In judicial review of such an adjudication, the fact of a denied petition for rulemaking might sway an Ohio court to penalize the agency by reversing an adjudication.

In the absence of a statutory or court imposed duty to engage in rulemaking, the securities industry must depend upon the good faith of the division in recognizing and acting on problems ripe for a legislative solution. Unhappily, the only factor which might force the division to promulgate rules, through the Ohio Securities Bulletin or otherwise, is the threat of scandal. The division has expressed concern over reports of persons representing themselves to issuers as having influence over the outcome of dealings with the division.<sup>96</sup> The Commissioner vigorously denied that any division personnel were involved, and reacted by restricting outside access to information held by the division. The only solution that would stop such rumors, however, is the orderly promulgation and publication of standards. Any agency which seeks to operate under nonpublic standards, or no stan-

---

<sup>92</sup> DeWoody v. Bixler, 136 Ohio St. 263, 25 N.E.2d 341 (1940).

<sup>93</sup> *Ex parte* Black, 1 Ohio St. 30 (1852).

<sup>94</sup> Federal Home Properties, Inc. v. Singer, 9 Ohio St. 2d 95, 223 N.E.2d 824 (1967); Gilder v. Industrial Commission, 100 Ohio St. 500, 127 N.E. 595 (1919); Lake County v. Ashtabula County, 24 Ohio St. 393 (1873).

<sup>95</sup> 5 U.S.C. § 553(C) (1970).

<sup>96</sup> OHIO SECURITIES BULLETIN, June 1973, at 1.

dards at all, invites the difficulty that the division is seeking to avoid. If only a small number of persons, through long association with the division or practice before it, have any idea of what standards the division uses in exercising its powers, then those persons do have some influence over the regulatory process. If standards are promulgated with input from those to be affected and published for the benefit of any interested party, then the opportunity to question the integrity of the process is greatly reduced.

### III. CONCLUSION

The Ohio Securities Bulletin is an admirable attempt to structure operations of the division under such nebulous concepts as "discretion" and "fairness." The division should recognize, however, that in publishing regulatory standards it is engaging in the sort of activity which the Ohio Administrative Procedure Act requires to be preceded by open information gathering. Compliance with the APA places an additional burden on the division, making a return to secrecy, ad hoc decision making, and unfettered use of discretion look attractive. The existence of legal remedies to prevent such a return is a matter of speculation. It is very much in the division's interests, as well as in the public's interest, to proceed with the development of regulatory standards under the protection provided by the Administrative Procedure Act.

*A. Theodore Gardiner*