Legal Backgrounder

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NEW YORK'S MARTIN ACT: EXPANDING ENFORCEMENT IN AN ERA OF FEDERAL SECURITIES REGULATION

by

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Who's afraid of the Martin Act? Today, the answer is most of Wall Street, and a healthy segment of corporate America.

Since Enron, New York's Attorney General Eliot Spitzer and Manhattan District Attorney Robert Morgenthau have made well-publicized use of New York's 1921 Martin Act,[1] a state "Blue Sky" law previously thought to have rather limited enforcement potential outside the prosecution of high-pressure securities boiler rooms and seriously fraudulent stock scams.

With the Enron, Worldcom, and other financial disasters beginning in the Fall of 2001, prosecutors at both the federal and state levels have been under intense public pressure to punish the individuals believed responsible, and to improve the overall regulatory scheme in order to prevent repetitions.

In Federal courts, the Enron and Arthur Andersen prosecutions held center stage, coupled with the Sarbanes-Oxley Act of 2002,[2] easily the most thorough revision of mandatory corporate governance practices in modern history. At the state level, the Enron reaction has been led by various Martin Act proceedings directed by Mr. Morganthau and Attorney General Spitzer with a broad selection of other State Securities Administrators.

What is this Martin Act, why is it such a fearsome enforcement tool, and why has it not been supplanted by the usually overriding federal regulatory regime in the securities area?

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[1] N.Y. GEN. BUS. LAW, Art. 23-A, § 352 *et seq.* (McKinney 1996). There is also an ongoing debate whether the consumer fraud provisions of the General Business Law § 349 extend to securities transactions. New York is one of the few states which have not adopted the Uniform Securities Act, which in some areas such as the regulation of securities agents, is more vigorous than the Martin Act.

[2] *See* R. McTamaney, *The Sarbanes-Oxley Act of 2002: Will it Prevent Future 'Enrons?'* LEGAL BACKGROUNDER (Wash. Lgl. Fndt.) Aug. 9, 2002.

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In the early days of the twentieth century, many fraudulent stock schemes were so transparent that they were said to have no more merit than "the blue sky above." In 1911 States began passing so-called "Blue Sky" laws to control bogus stock sales, and virtually all of the states had passed such laws by the time that the first federal securities laws were enacted in 1933 and 1934, in response to the Crash of 1929 and the ensuing Great Depression. The Martin Act was New York's Blue Sky law, passed in 1921. These state securities laws were left largely in place when the series of Federal securities laws were passed in the 1930s and 1940s.[3]

In the 1970s, then-New York Attorney General Lefkowitz brought Martin Act actions against a handful of improper securities offerings and to correct defective brokerage firm accounting. The law was also used occasionally against boiler room high-pressure sales operations. Even then, most of the New York cases were eventually ceded to the SEC for eventual enforcement or regulatory action, and when the SEC and the NASD assumed more active involvement with broker regulation and enforcement, the Martin Act went generally quiet, until Mr. Spitzer resurrected the law with a vengeance after Enron.

There now have been a series of Martin Act proceedings. Most prominently:

- A $100 million settlement with Merrill Lynch & Co. in 2002, based on alleged undisclosed analysts' conflicts of interest;
- District Attorney Morgenthau's cases against the Tyco executives;
- The $1.6 billion civil lawsuit against five executives of WorldCom and Qwest alleging bribes in the form of "spinning" shares in highly-sought IPOs in exchange for steering business to a broker, where analysts allegedly arranged payoffs by issuing flattering research reports;
- The $15 million fine paid by Citicorp's Jack Grubman to avoid criminal fraud charges; and
- The settlement being negotiated with New York's major brokerage firms agreeing to pay more than $1.4 billion for allegedly biased ratings on stocks to help win investment banking business. The ten firms would pay fines, sever links between research and investment banking, and fund independent stock research for investors. Regulators in California, Massachusetts, Alabama, Texas, New Jersey, Illinois and Utah all took parts of the investigation, and each will take parts of the recovery.

Supporters of the Attorney General's settlements have praised the imaginative and energetic use of a relatively dormant state law. Critics have emphasized that none of the investors supposedly damaged by any conflicted research will see any of the recoveries, and that only the naïve would characterize the brokers' free research as anything other than sophisticated marketing to support the brokers' profit-making businesses. But supporters at least ponder, and critics condemn, the settlements forced by a 1921 law that leaves most procedural due process by the wayside.

The Martin Act is a fierce sword in the hand of a zealous prosecutor because it was written in a day when defendants' rights were mere curiosities, then it was not refined by judges to modern standards because it lay so dormant, and now it has been recreated against defendants who are intensely interested in redirecting the klieg lights of post-Enron adverse publicity.

The Martin Act really became a sleeping giant in 1955, with the addition of criminal penalties. These are drastic remedies especially when coupled with the law's extremely broad "fraud" provisions, which are violated without proof (at least for misdemeanor violations) of "scienter," *People v. Federated Radio Corp.*, 244 N.Y. 33 (1926), that is the *willful and knowing* commission of an illegal act, without proof of intent to defraud, and even without direct proof that any stock was actually traded with any reliance by anyone on the actions alleged to be improper. In 1986, intentional violations were made felonies.

[3] "[I]n the absence of such a conflict, it is contemplated that the States and the Federal government shall exercise concurrent jurisdiction . . ." *Travelers Health Ass'n v. Com.*, 188 Va. 877, 897, 51 S.E. 2d 263 (1949), *aff'd* 339 U.S. 643 (1950).

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So, in several key respects, the Martin Act arguably is hardly a fraud statute at all, but rather it specifies virtually *per se* criminal and civil liability if the designated acts occur. An anomalous absence is any provision for civil damage suits by individuals, and the courts have consistently refused to imply one. *E.g.*, *CPC International Inc. v. McKesson Corporation*, 70 N.Y.2d 268 (1987).

The other end of the Martin Act's power is the extraordinarily broad administrative discovery permitted the prosecutors, and the prosecutors' pre-existing subpoena power, which seems always to discover a treasure trove of embarrassing e-mails stored away undetected until the subpoenas are served. *Ex parte* injunctive relief is also available, and was used against Merrill Lynch.[4] The usual injunction proceeding requires a showing of likely success on the merits — in Martin Act cases, the merits often are not yet even delineated in an answered Complaint.

Compare also the restitution penalty authorized by § 353 of the Martin Act, with the SEC's much more limited right to require disgorgement of illicit income actually received by the defendant. In the recent analyst cases, the SEC arguably would have been limited to recovering the analysts' companies' profits, which were far below the losses alleged in the Attorney General's claims to have been suffered by investors. With respect to direct damages, the Attorney General's authority is very limited in law, but not in reality. Under the N.Y.CPLR § 8303(a)(6), there can be a fine of $2,000 per defendant, hardly the many hundreds of millions which settling defendants have agreed to pay to stop the investigations.

The broad, pre-lawsuit discovery permitted to the Attorney General under § 354 of the Martin Act affords vast tactical advantages, as it places the defendants in the impossible quandary of wishing to cooperate so as to garner favorable discretion, while thereby waiving possible Fifth Amendment objections which might have been virtually automatic had the questions been asked post-Complaint. It also all but guarantees that sufficient evidence is available before the decision is taken formally to initiate the proceedings, and guarantees that maximum public relations pressures will be imposed on potential defendants, resulting in settlements which have been secured not only pre-judgment, but pre-filing.

The National Securities Markets Improvement Act ("NSMIA"), enacted in 1996, was the most sweeping reform of the U.S. securities laws since 1975. One of the principal aims of NSMIA was to pre-empt future State substantive securities regulation of securities offerings. Accordingly, NSMIA had generally been considered to have stripped the States' Blue Sky laws of most of their thunder, and to have transferred serious regulatory oversight over significant research analysts, those with assets under management of more than $25 million, away from the States and exclusively to the SEC.

However, NSMIA specifically preserved the states' rights "to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer [or an adviser], in connection with securities or securities transactions," and to license advisers' representatives with local offices. Is this a wide enough back door to admit the Martin Act? So far, the answer seems to be yes. *See Zuri-Invest AG v. Natwest Finance Inc.*, 177 F. Supp. 2d 189 (S.D.N.Y. 2001) (Common law claims survive).

The Sarbanes-Oxley Act of 2002 also evidenced a congressional intent to bring to the federal level the substantive regulation of many aspects of corporate governance, again raising the question whether securities industry regulation in general should not be the exclusive province of the SEC and the other Federal agencies which oversee those businesses on a coordinated, nation-wide basis. Sarbanes-Oxley did leave research

[4]"Status quo" injunctions can, under the circumstances, be just as damaging to the defendant as ultimate success on the merits. For example, in 1989 Power Securities Corp. effectively was put out of business when a § 354 order prohibited the firm from soliciting any New York business while the case went on. The SEC secured similar authority in the Penny Stock Reform Act of 1990, 15 U.S.C. § 77h-1, but the SEC's injunctive authority requires notice and a hearing, and has been used very sparingly.

analysts and their possible conflicts of interests for future study,[5] and perhaps an SEC position on preemption will emerge as part of that process.

So what exactly is a "fraud" case left for the States to continue post-NSMIA, and post-Sarbanes-Oxley? As discussed above, the Martin Act's definitions of fraud are extremely broad, and do not require *scienter*, which is a necessary element of a federal securities fraud case,[6] — intent to defraud, reliance, or causation. Beyond those critical requirements, the purposes and effects of the laws are virtually identical, but the distinctions can easily be dispositive in any particular case. There have been many cases holding or simply assuming that federal securities law do not preempt the Martin Act, but arguably, if the States' definition of the term is controlling, then the "fraud" exception from federal preemption is as broad as any State desires it.

Federal preemption can be expressly stated in a law or it can be implied, if Congress seems clearly to have intended to deal with a matter in a plenary manner. The Supremacy Clause of the U.S. Constitution mandates that federal laws "shall be the supreme Law of the Land." If Congress or a delegated agency intends to pre-empt the field, or if the law is so broad that the field is covered, or if state law conflicts, then the state statute or common law must yield.

For example, the 1975 amendments to the 1934 Securities Exchange Act were held to be such a broad grant of authority to the SEC to shape a new national market system that they preempted a suit based on undisclosed order flow payments. *Guice v. Charles Schwab & Co., Inc.*, 89 N.Y.2d 31 (1996). The fact that the federal securities laws had "savings" clauses leaving states the right to regulate did not save the case, since such savings clauses do not limit preemption where the state and federal provisions *conflict*, only where Congress intended to fully occupy the field.

So if a state's regulation, through the imposition of common-law tort liability or otherwise, adversely affects the ability of a federal administrative agency to regulate comprehensively and with uniformity in accordance with the objectives of Congress, "then the state law may be pre-empted even though 'collision between the state and federal regulation may not be an inevitable consequence.'" *See People v. Monex Int'l, Ltd.*, 86 Misc. 2d 320, 380 N.Y.Y.2d 504 (Sup. Ct. N.Y. County 1976 (CFTCA preemption of Martin Act does not affect pending proceedings).

To be sure, in prior cases, the Martin Act has been assumed *not* to be pre-empted by earlier federal securities laws, *e.g.*, *Bluebird Partners, L.P. v. FirstFidelity Bank, N.A.*, 297 App. Div. 2d 223, 746 N.Y.S. 2d 475 (1st Dep't 2002), but no case has specifically considered the combined impact of NSMIA plus SOX on that issue. Furthermore, the SEC was an active participant in the recent analyst cases, without public objection to the role played by New York. Perhaps it would have been foolish to publicly oppose any prosecutorial efforts in the current climate.

But is the Martin Act on such a collision course? Congressman Oxley, the co-author of Sarbanes-Oxley and the new Chairman of the SEC both seem to think so — both have said that the States need to be reined in to prevent further balkanized regulation in an area demanding national uniformity.

Empowered by his successes to date, Attorney General Spitzer has now proposed New York legislation to protect whistleblowers, increase penalties for securities fraud, and increase accountability for corporate officers and accounting firms, all familiar topics to students of Sarbanes-Oxley. Regardless of whether these new requirements are enacted, more will be heard of the Martin Act.

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[5]Sarbanes-Oxley amends the Securities Exchange Act of 1934 to require the SEC or the market self-regulatory organizations within one year after enactment to adopt rules designed to address securities analysts' conflicts of interest. The SEC's new Regulation AC also governs research analysts' research reports and public appearances.

[6]*See*, *e.g.*, *People v. Federated Radio Corp.*, 244 N.Y. 33 (1926) ("the words 'fraud' and 'fraudulent practices' should . . . be given a wide meaning so as to include all acts, although not originating in any actual evil design or contrivance to perpetrate fraud or injury upon others, which do by their tendency to deceive or mislead the purchasing public come within the purpose of the law").

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