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FRANK C. RAZZANO*

The Martin Act: An Overview

INTRODUCTION

ELIOT SPITZER HAS BEEN CALLED THE “ENFORCER,” the “sheriff of Wall Street,” and Wall Street’s “top cop.” How did he achieve so much with such a small staff in such a short time? The answer is that he had an incredible ally—the Martin Act.¹ Spitzer’s crusade began in June 2001 when he read an article in *The Wall Street Journal* about a pediatrician who had brought an arbitration against a brokerage house complaining about biased research.² After biased research, Spitzer attacked “spinning,” then the mutual fund industry, and, finally, the insurance industry.

His crusade was made possible by a particular law-enforcement statute in New York—the Martin Act—which confers upon the state’s Attorney General extremely broad law-enforcement powers. The statute, which has civil and criminal components, outlaws certain practices deemed detrimental to the public without requiring proof of intentional or negligent conduct. It does not even require proof that anyone was, in fact, defrauded. A brief synopsis of the Act is set forth below.

BACKGROUND

The Martin Act was passed in 1921. It covers two different areas of our economy—securities and real estate. This monograph will deal only with the securities aspect of the Act.

Unlike the “blue sky” laws³ of most states, which follow the Uniform Securities Act⁴ by establishing state securities commissioners administering a regulatory scheme, New York’s Martin Act eschews state regulation of securities and adopts a broad civil and criminal enforcement model that empowers New York’s Attorney General to enjoin and prosecute conduct that is deemed detrimental to the investing public without a showing of the elements of intent or scienter.

The Act gives the Attorney General, among other things, the powers to conduct investigations in private or in public, to obtain a temporary injunction in order to

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1. N.Y. GEN. BUS. LAW §§ 352–359-h (McKinney 1996).

2. Charles Gasparino, *Outlook for Analysts: Skepticism and Blame*, WALL ST. J., June 13, 2001, at C1.

3. See ROBERT W. HAMILTON & JONATHAN R. MACEY, *CASES AND MATERIALS ON CORPORATIONS, INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES* 419 (8th ed., Thompson West 2003).

4. Uniform Securities Act (2002).

THE MARTIN ACT

prevent the continuation of prohibited conduct during such investigations, and, at the end of the investigations, to seek restitution of funds and institute criminal actions for the imposition of fines and penalties. Thus, the Martin Act is a broad antifraud statute that empowers the Attorney General to take action against what he considers fraudulent conduct without having to prove that the defendant acted either intentionally or negligently, as is the case under section 17(a) of the Securities Act of 1933 and section 10(b) of the Securities Exchange Act of 1934.⁵

Private Actions

Unlike the blue sky laws in many states, the Martin Act does not authorize private lawsuits. In 1987, the New York Court of Appeals in *CPC International Inc. v. McKesson Corp.*⁶ held that no private right of action could be implied under the Martin Act.⁷ Based on *CPC International*, several courts have reasoned that the private action rationale precludes claims within the purview of the Martin Act, such as negligent misrepresentation and breach of fiduciary duty.⁸ Only the Fourth Department has suggested that common-law claims for breach of fiduciary duty and negligent misrepresentation are not precluded by the Martin Act.⁹ New York federal courts, however, have uniformly held that negligent misrepresentation claims in the securities context are precluded by the Act.¹⁰ In *Castellano v. Young & Rubicam, Inc.*,¹¹ the Second Circuit held that there is no implied private right of action for breach of fiduciary duty because to permit such an action would effectively permit a private action under the Martin Act, which is inconsistent with the Attorney General's exclusive enforcement of the Act.¹²

Criminal Proceedings

In 1955, the New York Legislature made violating the Martin Act a misdemeanor, and in 1986, violations of the Act committed intentionally were made felonies.¹³ Under section 358, the Attorney General is given the power to prosecute criminal offenses for violations of the Martin Act, and under section 359, he can grant im-

5. Section 17(a)(1) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (2000), and section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2000), contemplate scienter, but not subsections 17(a)(2) and (3) of the Securities Act of 1933, 15 U.S.C. § 77q(a)(2)-(3) (2000), which require negligence. *Aaron v. Sec. & Exch. Comm'n*, 446 U.S. 680, 690-97 (1980).

6. 514 N.E.2d 116 (N.Y. 1987).

7. *Id.* at 119.

8. *See, e.g.,* *Thompson v. Parkchester Apts. Co.*, 670 N.Y.S.2d 858 (N.Y. App. Div. 1998); *Eagle Tenants Corp. v. Fishbein*, 582 N.Y.S.2d 218 (N.Y. App. Div. 1992) (dismissing common-law claims where the elements were co-extensive with the Martin Act); *Horn v. 440 E. 57th Co.*, 547 N.Y.S.2d 1 (N.Y. App. Div. 1989); *Rondeau v. Wood*, 547 N.Y.S.2d 695 (N.Y. App. Div. 1989).

9. *See* *Scalp & Blade, Inc. v. Advest, Inc.*, 722 N.Y.S.2d 639 (N.Y. App. Div. 2001).

10. *See, e.g.,* *Granite Partners, L.P. v. Bear, Stearns & Co. Inc.*, 17 F. Supp. 2d 275, 292 (S.D.N.Y. 1998).

11. 257 F.3d 171 (2d Cir. 2001).

12. *Id.* at 190.

13. *See* N.Y. GEN. BUS. LAW art. 23-A Practice Commentaries at 13, 47 (McKinney 1996).

FRANK C. RAZZANO

munity to witnesses. From 2000 to 2002, the Bureau of Investor Protection and Securities of the Attorney General's Office has executed ten search warrants, arrested or indicted 116 people, and obtained seventy-eight pleas and convictions.¹⁴

Because the Martin Act is a law-enforcement statute, it was left largely undisturbed by the National Securities Markets Improvement Act of 1996, which preempted state substantive securities regulations, but preserved a state's rights "to investigate and bring enforcement actions with respect to fraud or deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions."¹⁵

DISCUSSION

Section 352: Prohibited Acts

Section 352 of the Martin Act declares the following acts fraudulent and provides the Attorney General with power to investigate the following:

1. Employing any device, scheme, or artifice to defraud;
2. Obtaining money or property by means of any false pretense, representation, or promise;
3. Making or attempting to make a fictitious or pretended purchase or sale of securities or commodities;¹⁶
4. Employing or seeking to employ any deception, misrepresentation, concealment, suppression, fraud, false pretense, or false promise for the purchase, exchange, investment advice, or sale of securities or commodities;¹⁷
5. Engaging in any practice or transaction or course of business relating to the purchase, exchange, investment advice, or sale of securities or commodities which is fraudulent, or in violation of law, or would operate as a fraud on the purchaser;
6. Selling or offering for sale or attempting to sell securities without registering as a broker, dealer, or salesman; or
7. Violating any provision of the Martin Act.

14. *Eliot Spitzer's 80-Year Old Surprise for Wall Street*, WALL ST. LAW., May 2002, at 9.

15. 15 U.S.C. § 77r(c)(1) (2000).

16. Compare unlawful manipulation under section 9 of the Securities Exchange Act of 1934, which requires a "purpose of inducing the purchase or sale of such security by others." *Id.* § 78i(a)(2).

17. The words *concealment* and *suppression* would suggest that an omission is covered without a duty to speak and would require revelation of all actual and potential conflicts of interest. *Cf.* *Bishop v. Commodity Exch., Inc.*, 564 F. Supp. 1557, 1565 (S.D.N.Y. 1983) (noting that under the Martin Act the term *fraud* encompasses all deceptive practices contrary to plain rules of common honesty); *DuPont v. Brady*, 646 F. Supp. 1067, 1074 (S.D.N.Y. 1986) (finding that deceptive conduct covers omissions), *rev'd on other grounds*, 828 F.2d 75 (2d Cir. 1987).

THE MARTIN ACT

The Attorney General may subpoena witnesses in aid of his investigation under section 352 and compel attendance before him, a magistrate, or a court, and require production of books, papers, and records relevant to the inquiry. Such power of subpoena and examination does not terminate when an action is brought by the Attorney General.¹⁸ Disobeying a subpoena without reasonable cause is a misdemeanor.

Disclosure by a person examined as a witness of the name of any witness examined or any other information obtained upon such inquiry without the Attorney General's permission is a misdemeanor.¹⁹

Although courts have held that a person under investigation does not have a right to counsel in a Martin Act investigation, the Attorney General as a matter of practice allows the witness to be accompanied by counsel of his own choice.²⁰

Section 352-c makes it criminal to use or employ any of the following acts and practices for purposes of inducing or promoting the issuance, distribution, exchange, sale, negotiation, or purchase of securities or commodities:

1. Any fraud, deception, concealment, suppression, false pretense, or factitious or pretended purchase or sale;
2. Any promise or representation as to the future which is beyond reasonable expectation or unwarranted by existing circumstances;
3. Any representation or statement which is false, where the person making such representation or statement knew the truth, or with reasonable effort could have known the truth, or made no reasonable effort to ascertain the truth, or did not have knowledge concerning the representation or statement made;²¹
4. Engaging in any artifice, agreement, device, or scheme to obtain money, profit, or property by any aforementioned means;
5. For an entity engaged in the sale of securities or commodities, representing that it is an "exchange," unless that entity is registered with the SEC or has been designated as a contract market by the Commodities Futures Trading Commission; or
6. Intentionally engaging in a systematic ongoing course of conduct with the intent to defraud ten or more persons.

18. Compare federal grand jury subpoenas, which cannot be used to develop evidence after indictment or the use of Securities and Exchange Commission (SEC) investigative subpoenas to develop evidence after a proceeding or action has commenced.

19. Compare federal grand jury and SEC practices, which have no such requirements. If this provision were enforced post-indictment or institution of a civil proceeding, could it survive a Fifth Amendment due process or Sixth Amendment challenge?

20. See, e.g., *In re MacNamara*, 218 N.Y.S. 57, 66 (N.Y. Sup. Ct. 1926), *aff'd*, 218 N.Y.S. 811 (N.Y. App. Div. 1926); *H. Hentz & Co. v. Lefkowitz*, 256 N.Y.S.2d 724 (N.Y. App. Div. 1965), *aff'd*, 208 N.E.2d 462 (N.Y. 1965).

21. This seems to create strict liability for uttering a false statement.

FRANK C. RAZZANO

Pursuant to section 359-g(a), violating an injunction procured under the Martin Act is contempt of court, a misdemeanor subject to a civil penalty of \$3,000, unless the contemtor was previously convicted of a Martin Act violation, or in the previous five years was convicted of a securities crime for which a sentence to a term of imprisonment of more than one year was authorized, or was found in contempt of the Martin Act previously, in which case the contempt is a Class E felony.

Thus, the number of prohibited acts outlined by the Martin Act far exceeds the three fraudulent practices outlined in section 17(a) of the Securities Act of 1933²² and Rule 10b-5,²³ promulgated by the SEC under section 10(b) of the Securities Exchange Act of 1934,²⁴ which proscribe the following:

1. Employing any device, scheme, or artifice to defraud;
2. Obtaining money or property by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statement made, in light of the circumstances under which it was made, not misleading; or
3. Engaging in any transaction, practice, or course of business which operates or would operate as a fraud or deceit on the purchaser.

Under section 352-d, any person who violates section 352-c can be separately prosecuted for acts constituting such felonies as conspiracy and petty larceny.

Intent

A showing of neither intent nor scienter is required to prove a violation of the Act and sustain civil liability or criminal culpability, unless a felony is charged. The purpose of the Act is to allow the Attorney General to prosecute acts and practices beyond intentional fraud.²⁵

Coverage of Act

In order to obtain coverage over all broker-dealers, salesmen, partners, officers or directors of broker-dealers, or investment advisers doing business in the State of New York, section 352-b of the Martin Act irrevocably appoints the Secretary of State as the agent for services of a summons, complaint, subpoena, subpoena duces tecum, notice, order, judgment, etc., in any action, investigation, or proceeding brought or conducted by the Attorney General.

22. 15 U.S.C. § 77q(a) (2000).

23. 17 C.F.R. § 10b-5 (2000).

24. 15 U.S.C. § 78j(b) (2000).

25. *People v. Barysh*, 408 N.Y.S.2d 190, 193-94 (N.Y. Sup. Ct. 1978); *People v. Photocolor Corp.*, 281 N.Y.S. 130, 135 (N.Y. Sup. Ct. 1935).

THE MARTIN ACT

Confidential Investigations

Under section 352, the Attorney General can require any person to file a written statement under oath as to the facts or circumstances concerning the subject matter the Attorney General is investigating and require that any data or information the Attorney General deems relevant be produced. The Attorney General is granted the power to subpoena witnesses, compel their attendance, and examine them under oath either at his office or before a magistrate, a court of record, or a judge or justice. If the person subpoenaed fails to appear without reasonable cause or to be sworn, or to produce books and records when ordered to do so, he or she is guilty of a misdemeanor.

The Attorney General may conduct these proceedings in secret. Pursuant to section 352(5), it is a misdemeanor for anyone examined as a witness to disclose to any person other than the Attorney General the name of any witness examined or information obtained. This rule is unlike a federal grand jury practice under Federal Rule of Criminal Procedure 6(e) or the SEC practice with respect to formal orders of investigation.

Public Investigations

Under section 354, unlike section 352, the Attorney General may conduct a public investigation simply by filing an application with a state supreme court for an order directing persons to appear before a justice of the supreme court or referee to answer questions and to produce documents. The state justice has no discretion and must grant the application. The application need only show that on information and belief the testimony is material and necessary.

In order to maintain the status quo while the investigation proceeds, the court can also grant a preliminary injunction or a restraining order until the witness is examined or until such further order of the court as may appear proper and expedient. The Act does not provide any method to challenge the facts and conclusion of a section 354 order, nor does the injunction expire when a plenary proceeding begins.²⁶

On April 8, 2002, the Supreme Court in New York County granted an ex parte application of Attorney General Spitzer pursuant to section 354 requiring a broker-dealer to make disclosures to investors about its relationship with investment banking clients.²⁷ The Attorney General had been conducting the investigation in a confidential manner under section 352,²⁸ and the broker-dealer had been cooperating with the investigation when Attorney General Spitzer sought the ex parte investiga-

26. *Attorney-General of New York v. Katz*, 434 N.E.2d 712, 713 (N.Y. 1982).

27. Order Pursuant to General Business Law § 354, *In re Spitzer*, No. 02-401522 (N.Y. Sup. Ct. Apr. 8, 2002), available at http://www.oag.state.ny.us/press/2002/apr/apr08b_02.html (last visited Apr. 4, 2006).

28. The Attorney General can simultaneously conduct both section 352 and section 354 investigations, as long as the witness in the private section 352 inquiry is not already subject to a section 354 order. *In re Abrams*, 611 N.Y.S.2d 422, 424 (N.Y. Sup. Ct. 1994).

tion to “educate the investing public” and to require further testimony to be subject to “public scrutiny.” The next month, Attorney General Spitzer and the broker-dealer announced a settlement in which the broker-dealer agreed to sever any link between compensation of its analysts and investment banking business, create a new investment review committee to approve all research recommendations, establish a monitor to ensure compliance, disclose in research reports whether a company that is the subject of coverage is a banking client, and pay \$100 million.

Section 353: Civil Actions by the Attorney General

Under section 353 of the Martin Act, when the Attorney General believes that someone is engaged in, or is about to engage in, any practice or transaction declared to be fraudulent, he may bring an action to enjoin that person. In the application for a permanent injunction, if the Attorney General shows that the defendant has refused to be sworn, or to be examined, or to answer a material question, or to produce a book or record relevant to an inquiry when duly ordered to do so by the officer or judge conducting the inquiry, such refusal is prima facie proof that such defendant is or has been engaged in fraudulent practices as set forth in such application and a permanent injunction may issue without any further showing by the Attorney General. The court may award a sum not to exceed \$2,000 as an additional allowance.²⁹

If the Attorney General shows that a person has been convicted of a felony or any other criminal offense involving a security, a state supreme court can issue a permanent injunction awarding the Attorney General the relief applied for and deemed appropriate without further proof.

Finally, the state Attorney General may include in his application a request for restitution of money or property obtained directly or indirectly as the result of such fraudulent acts. Restitution is conceptually broader than the SEC’s ability to obtain disgorgement as ancillary relief. For example, the SEC can seek disgorgement of commissions earned as a result of a broker’s touting a stock but not the value of the securities purchased.

Dissolution of Injunctions

Section 359-g(3) permits an injunction to be dissolved or modified. A five-year waiting period is required, and an application cannot be made by someone who has been convicted of a felony, or where an injunction was granted incident to a crime that led to a conviction, or where the party enjoined has been convicted of a crime involving securities. To obtain dissolution or modification, the applicant must give the Attorney General sixty days’ notice and must post a surety bond to

29. The staff of the SEC obtains no such prima facie case from a refusal to testify. Instead, it may only ask the court to draw an adverse inference from an invocation of the Fifth Amendment. See *Baxter v. Palmigiano*, 425 U.S. 308, 318–19 (1975).

THE MARTIN ACT

pay all costs and expenses of the Attorney General's investigation. After the investigation, the Attorney General can consent to the application, oppose it, or make recommendations to be included in any modification. Finally, an evidentiary hearing is then held.

Section 353-a: Receivers

At any stage of a proceeding, the Attorney General can ask that a receiver be appointed for any and all property the defendant derived from a fraudulent practice. This includes all property with which the fraudulently derived property has been mingled (if it can no longer be identified because of the commingling) together with all books, records, and accounts relating to the same.

Misdemeanors and Felonies

A violation of section 352-c is a misdemeanor, unless the person intentionally engages in any scheme constituting a systematic ongoing course of conduct with the intent to defraud ten or more persons or obtain property from ten or more persons by false or fraudulent pretense, representation, or promise, in which case he is guilty of a Class E felony. Additionally, any person who intentionally engages in fraud, deception, concealment, suppression, false pretense, or fictitious or pretended purchase or sale, or who makes any material false representation or statement with the intent to deceive or defraud, while engaged in inducing or promoting the issuance, distribution, exchange, sale, negotiation, or purchase of securities or commodities, and thereby wrongfully obtains property of a value in excess of \$250, is guilty of a Class E felony.

Under section 358, the Attorney General may prosecute Martin Act offenders or the Attorney General may in his discretion transmit evidence of a violation to the district attorney of the county or counties in which the violation has occurred, who "shall forthwith" proceed to prosecute.³⁰

Finally, under section 359, the Attorney General may confer immunity.

CONCLUSION

Eliot Spitzer was able to scope the SEC in the analyst research investigation, the spinning inquiry, and the mutual fund trading scandal because he had an ally the SEC did not—the Martin Act, which confers upon the New York State Attorney General broad enforcement powers. Although passed in 1921, the Act was little used in modern times until Spitzer dusted off its cobwebs. Unlike the blue sky laws of other states, the Martin Act gives the New York Attorney General broad civil and criminal authority not only to stop fraudulent conduct but to enjoin conduct the Attorney General deems detrimental to the public interest.

30. N.Y. GEN. BUS. LAW § 358 (McKinney 1996).