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WHITE-COLLAR CRIME

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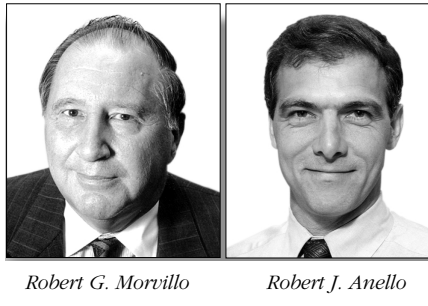
Securities, Investigations and Prosecutions Under the Martin Act

THERE WAS a time, when a party whose attorney successfully had persuaded a federal prosecutor to forego a securities fraud prosecution, could breathe a sigh of relief and put concern over criminal liability behind. But no longer. In recent months, Manhattan District Attorney Robert Morgenthau and New York Attorney General Eliot Spitzer, as well as state prosecutors from other jurisdictions, have let it be known that the federal government does not have a monopoly on securities law enforcement. In fact, if the past year is any indication, potential securities fraud defendants may have as much to worry about from state prosecutors as they do from the United States Attorney's Office or the Securities Exchange Commission. The New York State securities law, with its unique set of procedural mechanisms, gives state prosecutors a number of tools that federal prosecutors do not have and with which the defense bar must now be familiar. Moreover, this emerging pattern of multi-jurisdictional enforcement has resulted in what some government officials have criticized as the "balkanization" of securities laws and raises serious double jeopardy concerns.

Recent Martin Act Investigations and Cases

New York's "blue sky" statute, known

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as the Martin Act,¹ widely is considered one of the toughest securities laws in the country. Although occasionally in the past² prosecutors employed it to fight large-scale securities fraud, until recently, it had been used primarily in boiler-room prosecutions and individual cases of fraud. Starting last year however, state prosecutors have made aggressive use of the Martin Act in their investigations of corporate accounting scandals and charges of investment banking conflicts of interests. Among the recent high-profile uses of the Martin Act are Attorney General Spitzer's investigation into whether stock analysts were operating under conflicts of interest when they issued reports on companies that were also clients of their firm's investment banking business, and his lawsuit filed in September against executives of five communications companies alleging that they had received lucrative initial public offering shares from brokerage firms in exchange for their firms' underwriting business. The Manhattan district attorney's office recently brought criminal charges under the

Martin Act against three former executives of Tyco International Ltd., alleging that they defrauded investors by failing to disclose millions of dollars in loans, bonuses and gifts received by company executives and by misrepresenting information concerning their sales of Tyco stock. Although these defendants face other serious charges, including grand larceny and enterprise corruption, the Martin Act felony charges alone carry a penalty of up to four years in prison.

The Martin Act contains a far broader definition of fraud than do the federal securities statutes. It enumerates a litany of behavior that comes within its definition of fraudulent practices, including deceptions, misrepresentations and representations beyond reasonable expectation in connection with the issuance, purchase, exchange, investment advice or sale of securities.³ New York federal and state courts alike have construed its coverage broadly, finding that the terms fraud and fraudulent practices embrace all deceitful practices contrary to plain rules of honesty.⁴

The most striking aspect of the Martin Act, and that which sets it apart from most other securities laws, is that liability under the act does not depend on the purchase or sale of any security. Nor does the act contain a requirement of scienter, intent, reliance or damages for either civil or criminal misdemeanor liability.

Investigative Authority

Both the attorney general and the local district attorney offices may institute prosecutions alleging criminal violations of the Martin Act. Under the Martin Act, however, the attorney general has been afforded two separate methods of investigation. He may conduct a confidential investigation, pursuant to §352, or a public investigation under §354. He may pursue both types of investigations simultaneously.⁵ Under §352, the attorney general can conduct a private investigation upon suspicion that there has been or threatens to be some fraudulent practice in connection with a security or if he "believes it to be in the public interest that an investigation be made." That section authorizes him to require the submission of sworn written statements from an entity or anyone associated with it, but its primary mechanism is a procedure known as a Martin Act hearing.

Martin Act Hearing

Under §352(2), the attorney general can subpoena witnesses, compel their attendance, examine them under oath and require the production of any relevant books or papers. The statute provides that anyone who fails to comply with a Martin Act subpoena, whether by failing to appear, produce requested records or answer questions posed at the hearing is guilty of a misdemeanor. Moreover, the failure of a potential defendant or an officer of a potential defendant to comply with a Martin Act subpoena constitutes prima facie proof that the defendant has engaged in the suspected fraudulent practices and, standing alone, provides the basis for entry of a permanent injunction.⁶

Parties may invoke the Fifth Amendment right against self-incrimination at a Martin Act hearing. If the attorney general directs a party who has invoked the Fifth Amendment to respond, answers given or documents produced by

the witness cannot be used again him or her in a subsequent criminal proceeding. The statute provides no right to counsel at a Martin Act hearing, and, because these proceedings are considered investigative rather than adjudicative, at least one court has held that no constitutional right to counsel exists.⁷ Nevertheless, the attorney general's practice has been to permit witnesses to be represented at Martin Act hearings, and courts have held that the attorney general may not interfere with the choice of counsel once a witness has been accorded the privilege of representation.⁸ Martin Act hearings are confidential. In contrast to state and federal grand jury proceedings, the statute prohibits even the witnesses from disclosing questions asked, answers given or persons present

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at the hearing. Any such disclosure is punishable as a misdemeanor.⁹ A Martin Act witness has no right to a transcript of the proceeding.¹⁰

The attorney general also can proceed by way of a public investigation under §354, by seeking an order from a state Supreme Court Justice directing that witnesses appear before the court or produce documents. The attorney general may file such a request before commencing an action and may include with the request an application for a preliminary injunction or stay, which the court may grant if it finds it "proper or expedient." Attorney General Spitzer recently proceeded under this provision, obtaining an injunction against a brokerage firm based on allegations to which the firm was given no chance to respond.¹¹ The shock value and potential

business damage of having a criminal investigation conducted in public gives the attorney general awesome power.

Criminal and Civil Remedies

No private right of action exists under the Martin Act,¹² leaving the attorney general as the sole individual who can invoke the statute's remedial provisions. Under §353 the attorney general may seek to enjoin any fraudulent act in which he believes any person or entity has engaged or threatens to engage. He also may seek restitution of any funds or property obtained either directly or indirectly by any fraudulent practice.

The criminal provisions of the statute are set forth in §352-c, which makes it illegal for any person or entity, engaged in the promotion, issuance, distribution, exchange, sale, negotiation or purchase of a security to employ any fraud, deception, concealment, suppression, false pretense, promise or representation as to the future that is beyond reasonable expectation or unwarranted by existing circumstances. The statute distinguishes between misdemeanor and felony liability based solely on the intent of the defendant. No scienter is required for a misdemeanor conviction,¹³ whereas a defendant who commits one of the proscribed acts with the intent to deceive or defraud can be found guilty of a Class E felony.¹⁴ In the federal system, the regulators and prosecutors are, for the most part, separated. Giving a single agency civil, regulatory and criminal power creates the potential that the criminal power will be exploited to achieve civil or regulatory settlements.

Tension, Federal Enforcers

If Wall Street is taken aback by the aggressiveness with which the states are pursuing securities fraud violations, so too are the federal securities law enforcers, who have long dominated the field. Several lawmakers have been

outspoken in their criticism of such state activism. Corporate reformer Representative Michael G. Oxley, R-Ohio, and recently appointed SEC Chairman William H. Donaldson both have referred to the recent spate of state securities regulation efforts as the "balkanization" of securities law,¹⁵ and Representative Richard Baker, R-La., called for Mr. Spitzer to step aside and let the SEC handle the inquiry into analysts conflicts of interests "because of the need for uniformity in our national securities markets." Mr. Spitzer has fired back at the feds, accusing Mr. Oxley of undercutting his own purported goal of defending our system of "capital formation" by opposing strong state laws and aggressive enforcement. He also has issued a press release observing that the congressional subcommittee chaired by Mr. Baker had failed to elicit any of the evidence necessary to bring about reform and that "no other regulatory body stepped forward to prevent the abuse from occurring."

The Martin Act has existed side by side with the federal securities laws since their passage. As the court in *State v. Justin*¹⁶ recently observed, "in fine federalist fashion, the 1934 Act was designed to supplement rights and duties created by state 'blue sky' laws, not supercede them." But with the state of New York taking a more active role in securities law enforcement, the overlap of federal and state regulation subjects actors in the securities world to two sets of rules and two different masters. New York State's statutory double jeopardy provision protects against the assertion of Martin Act charges against a defendant who already has been prosecuted on federal securities charges arising out of the same transaction.¹⁷ CPL §40.20 provides that a person may not be twice prosecuted for the same crime nor separately prosecuted for two offenses based upon the same act or criminal transaction except under certain limited circumstances. That provision was

enacted however, precisely because the federal Double Jeopardy Clause does not bar successive federal and state prosecutions.¹⁸ The Supreme Court repeatedly has held that "two identical offenses are not the 'same offense' within the meaning of the Double Jeopardy Clause, if they are prosecuted by different sovereigns."¹⁹ Although dissenters have argued that the "safeguard against double jeopardy was intended to establish a broad national policy against federal courts trying or punishing a man a second time after acquittal or conviction in any court,"²⁰ the Court's majority consistently has reasoned that federal law enforcement efforts would be hindered if an initial state prosecution could serve as a bar to subsequent federal action.²¹

The Justice Department has adopted an internal policy, known as the "Petite Policy," which precludes federal charges following a prior state prosecution based on substantially the same acts or transactions, unless the matter involves a substantial federal interest that was left demonstrably not vindicated by the prior prosecution and an assistant attorney general approves the subsequent federal prosecution.²² One of the stated purposes of this policy is to "protect persons charged with criminal conduct from the burdens associated with multiple prosecutions and punishments for substantially the same act(s) or transaction(s)." Although this policy provides some measure of protection against a federal prosecution following state criminal charges, it offers no guarantees. As an internal policy, the Petite Policy confers no substantive rights on a defendant.²³ Moreover if state prosecutors continue to bring Martin Act charges in cases where federal regulators perceive a strong federal interest, federal prosecutors may conclude that federal interests are not sufficiently vindicated by the state prosecutions, particularly in light of the relatively light prison sentences available under the Martin Act. With such a

close overlap between the federal and state securities schemes and the potential for fierce competition between federal and state prosecutors, fairness dictates that defendants not be whipsawed between the two sovereigns. Few would object to any branch of law enforcement rooting out those who commit securities fraud. However, a legitimate concern exists that aggressive local prosecutors will preempt national securities law policy in a manner that is injurious to the stability of our markets and financial institutions

(1) N.Y. Gen. Bus. Law §352, et seq.

(2) See Tamara Loomis, "The New York Securities Statute has made Headlines Before," *New York Law Journal* Nov. 14, 2002.

(3) *People v. Lexington Sixty-First Associates*, 38 NY2d 588, 595 (1976) ("[T]he terms 'fraud' and 'fraudulent practices' [are] to be given a wide meaning so as to embrace all deceitful practices contrary to the plain rules of common honesty.")

(4) See, e.g., *People v. Federated Radio Corp.*, 244 NY2d 33 (1926); *Bishop v. Commodity Exchange, Inc.*, 564 FSupp 1557 (SDNY 1983).

(5) *In the Matter of Abrams*, 160 Misc2d. 824 (Sup. Ct. N.Y. Co. 1994).

(6) §353

(7) *In the Matter of Kanterman*, 76 Misc2d. 743 (Sup. Ct. N.Y. Co. 1973).

(8) See, e.g., *Hentz & Co. v. Lefkowitz*, 256 NYS2d 724 (1965).

(9) §352(5); *Kanterman*, 76 Misc2d 743.

(10) *Gutterman v. Lefkowitz*, 92 Misc2d 583 (Sup. Ct. N.Y. Co. 1977)

(11) That injunction was obtained against the brokerage firm of Merrill Lynch and required the firm to provide its customers with disclosure of any actual or anticipated investment banking links between Merrill Lynch and the companies covered by its analysts.

(12) *CPC International Inc. v. McKesson Corp.*, 70 N.Y.2d 268 (1987).

(13) §352-c(4)

(14) §352-c(6)

(15) See James Toedman, "A Pledge to Clean Up Mess," *Newsday*, Feb. 6, 2003; Wendy Davis, "Up Against Wall Street," *ABA Journal*, September 2002.

(16) 237 FSupp2d (WDNY 2002).

(17) See *Kaplan v. Ritter*, 71 NY2d 222 (1987).

(18) *People v. Rivera*, 60 NY2d 110 (1983).

(19) *Heath v. Alabama*, 474 US 82(1985); *United States v. Lanza*, 260 US 377 (1922).

(20) *Abbate v. United States*, 359 US 187 (1959) (Black, J., dissenting).

(21) *United States v. Lanza*, 260 US 377.

(22) *United States Attorneys' Manual*, Chapter 9-2.031.

(23) See *United States v. Williams*, 181 F Supp 2d 267 (S.D.N.Y. 2001).

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