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New York State's Martin Act: A Primer

New York State's venerable Martin Act gives New York law enforcers an edge over the Securities and Exchange Commission. Eliot Spitzer, the New York Attorney General, made that clear when he recently brought a number of well publicized civil and criminal complaints charging violations of the Act by hedge funds, investment advisers and others engaged in what is alleged to be market timing and late trading in mutual fund shares. The Martin Act, as interpreted by New York courts, gives the New York State Attorney General exceptionally broad enforcement authority to bring both civil and criminal action without a showing of scienter or intent to defraud.

The Martin Act, originally passed in 1921, is one of the many state "Blue Sky" laws adopted in the early years of the twentieth century. It was amended in 1982, and is codified in Article 23-A of the New York General Business Law.[1] Sections 352 and 353 of the Act taken together, give the Attorney General the power to regulate, investigate and take enforcement action against securities fraud, including seeking equitable and monetary remedies.

Appendix A summarizes the misdemeanor and felony criminal provisions of the Martin Act. The rest of this memorandum traces the case law development of the requirements necessary to establish that a fraud has occurred under the Martin Act. Notably, scienter, reliance and damages need not be demonstrated. Instead, the only elements needed to establish a Martin Act violation are a misrepresentation or omission of material fact when engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase of securities.

The Elements of A Martin Act Violation Are a Misrepresentation or Omission, and Materiality.

Common law fraud in New York and federal securities fraud under (SEC) Rule 10b-5 require essentially the same elements. Pitts v. Am. Express Bank Int'l, 911 F. Supp. 710, 719 (S.D.N.Y. 1996). Those elements are: "(1) misrepresentation of a material fact; (2) the falsity of that misrepresentation; (3) scienter, or intent to defraud; (4) reasonable reliance on that representation; and (5) damages caused by such reliance." Id.

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[1] N.Y. Gen Bus. Law §§ 352-c & 353 (McKinney 1996).

However, fraud under the Martin Act does not require all of these elements. In what is perhaps the seminal case on the scope and purpose of the Martin Act, the Court of Appeals of New York in People v. Federated Radio Corporation noted that the act is remedial in character, and explained:

> In a broad sense, the term [fraudulent practice] includes all deceitful practices contrary to the plain rules of common honesty. The purpose of the law is to prevent all kinds of fraud in connection with the sale of securities and commodities and to defeat all unsubstantial and visionary schemes in relation thereto whereby the public is fraudulently exploited. The words 'fraud' and 'fraudulent practice,' in this connection should, therefore, 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.

Federated Radio, 244 N.Y. 33, 38-39 (1926). Thus, Federated Radio established that the fraud proscribed by the Martin Act is defined more broadly than traditional fraud.

Later cases have further clarified that the common law fraud elements of scienter, reliance and damages are not required in order to demonstrate a violation of the Martin Act. State v. Sonifer Realty Corp., 212 A.D.2d 366, 367 (1st Dept. 1995) ("[T]he fraudulent practices targeted by the statute need not constitute fraud in the classic common law sense, and reliance need not be shown in order to obtain relief.") (citing People v. Royal Sec. Corp., 165 N.Y.S.2d 907, 909 (Sup. Ct. N.Y. County 1955)); People v. Barysh, 408 N.Y.S.2d 190, 193 (Sup. Ct. N.Y. County 1978) (holding that the Martin Act does not require reliance or scienter); Royal Sec. Corp., 165 N.Y.S.2d at 909 (scienter, reliance, and damages are not needed for Martin Act violation). Therefore, it appears that the only elements remaining in a Martin Act violation (assuming jurisdiction and that the conduct was engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase of securities) are: (1) misrepresentation of a material fact; and (2) falsity. Moreover, as the cases below demonstrate, these elements are broadly interpreted to include omissions as well as misrepresentations. Thus, the elements of a Martin Act violation appear to be:[2] (1) a misrepresentation or omission; (2) that is material. The application of these elements, and the exclusion of the other traditional fraud elements, are discussed below.

Scienter and Intent to Defraud Are Not Required for Civil or Criminal Violations of the Martin Act.

Civil Violations of the Martin Act.

Civil actions under the Martin Act have no requirement of scienter. Section 353 makes no mention of intent, but instead simply prohibits fraudulent practices. N.Y. Gen Bus. Law §353(1) (McKinney 1996) (authorizing action for "practices or transactions heretofore referred to as and declared to be fraudulent practices"). Courts in civil Martin Act cases have held that "fraud" under the Martin Act "includes all deceitful practices contrary to the plain rules of common honesty and all acts tending to deceive or mislead the public, ***whether or not the product of scienter or intent to defraud***." 7040 Colonial Road Assocs. Co., 671 N.Y.S.2d 938, 941-42 (Sup. Ct. N.Y. County 1998) (emphasis added). Thus, neither the

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[2] A search of federal and New York state law revealed no cases in which the court expressly gave the elements of a Martin Act violation as such.

language of the statute nor case law appear to require scienter or intent in order to find a civil violation of the Martin Act.

Criminal Violations Under the Martin Act.

In People v. Barysh, the New York County Supreme Court concluded that "no intent to defraud is required for a violation of the [Martin Act]." Barysh, 408 N.Y.S.2d at 193. The defendants in Barysh were specialists on the American Stock Exchange ("AMEX") charged with entering option trades in the transaction journal of the AMEX when no such trades had in fact occurred. Id. at 193. The defendants' motions to dismiss their misdemeanor (section 352-c(1)) criminal indictments under subsection 1 of the act raised the "novel and substantial" issue at the time of whether the Martin Act required intent to defraud to sustain a misdemeanor criminal prosecution. Id. After reviewing the legislative history of the Act, the court concluded that "[t]he statute, on its face, is directed at acts or practices, and not at any particular mental state on the part of the actor." Id.

Specific intent to defraud is also not required to support a felony conviction under the Martin Act. People v. Sala, 258 A.D.2d 182, 193 (3rd Dept. 1999), aff'd 95 N.Y.2d 254, 258-59 (2000). Subsections 5 and 6 of section 352-c both prohibit "intentionally engaging" in fraud, but this requirement has been interpreted as the intent to act, not the intent to defraud. Id. The Sala defendants contested their felony fraud convictions under the Martin Act under Section 352-c(6), claiming that they lacked the requisite fraudulent intent. Id. at 193. The court upheld the convictions, holding that:

> Contrary to defendant's contentions, neither scienter nor an intent to defraud need be proven in order to establish liability under the Martin Act. Rather the People only need prove that the defendant committed an intentional act constituting fraud, which under the Martin Act "includes all deceitful practices contrary to the plain rules of common honesty and all acts tending to deceive or mislead the public."

Id. at 193 (citations omitted).

Reliance Is Not a Necessary Element of a Martin Act Violation.

Reliance is another element of common law fraud that is not required for a violation of the Martin Act. As the court explained in Sonifer Realty, "the fraudulent practices targeted by the statute need not constitute fraud in the classic common law sense, and reliance need not be shown in order to obtain relief." Sonifer Realty, 212 A.D.2d at 367 (citing Royal Sec. Corp., 165 N.Y.S.2d at 909); People v. Barysh, 408 N.Y.S.2d at 193 (Sup. Ct. N.Y. County 1978) (holding that the Martin Act does not require reliance or scienter); Royal Sec. Corp., 165 N.Y.S.2d at 909 (scienter, reliance, and damages are not needed for Martin Act violation).

Fraud, Misrepresentations and Omissions.

Although the Martin Act generally prohibits "fraud" and "fraudulent practices," in connection with the offer, sale or purchase of securities, it does not define those terms, which "have been given a broad meaning." People v. Landes, 192 A.D.2d 1, 5 (3rd Dept. 1993). "Fraud" and "fraudulent practices" under the Martin Act may be proven either by misrepresentations or omissions. People ex rel. Vacco v. World Interactive Gaming Corp., 714 N.Y.S.2d 844, 853 (Sup. Ct. N.Y. County 1999) ("It is well settled that fraud exists not only where there has been an affirmative misstatement of a material fact, but also where there has been an omission of a material fact.") Indeed, there does not appear to be much, if any, doctrinal separation between the concepts of omissions, misrepresentations, deceit and fraud under the Martin

Act. Rather, all of these acts seem to fall under the umbrella of "deceitful practices contrary to the plain rules of common honesty," as enumerated in Federated Radio. Federated Radio, 244 N.Y. at 38. Thus, the definition of fraud is broadly construed in order to effect the purpose of the law. People v. Cadplaz Sponsors, Inc., 330 N.Y.S.2d 430, 432 (Sup. Ct. N.Y. County 1972). "The words 'fraud' and 'fraudulent practice' as used in the act are given a wide meaning to include all deceitful practices contrary to the plain rules of common honesty. Its purpose is to defeat any scheme where the public is exploited. . . . All acts tending to deceive or mislead the public come within its umbrella." Id. The below cases illustrate situations in which courts have found fraud through misrepresentations or omissions, or where the AG has brought charges of fraud.

The defendants in Sala held their company out as an objective financial planning institution that employed expert advisors to create individual investment strategies, but channeled investments into the same three risky investments while misrepresenting the substantial commissions the company was earning. People v. Sala, 258 A.D.2d at 186-87. The defendants had been convicted of schemes to defraud, grand larceny, and felony securities fraud under the Martin Act section 352-c(6). Id. at 188. The court held that the convictions were properly based on failure to disclose commissions, fees, and risks, and the misrepresentation of the nature of the services rendered by the advisors. Id. at 194.

The defendant in Landes was indicted for six counts of grand larceny, six counts of felony fraud (section 352-c(6)) and one count of misdemeanor fraud (section 352-c(1)) under the Martin Act, and for the sale of unregistered securities. Landes, 192 A.D.2d at 3. The indictments stemmed from the defendant's alleged oral representations to investors that they would receive shares of stock in a new corporation, and that their investments would be placed in an escrow account and used solely to buy product for which the defendant was attempting to establish distribution in the U.S. Id. at 3-4. The defendant claimed that he made no such promises and that he felt free to use the funds for his own purposes while he was attempting to establish distribution for the product. Id. A jury convicted the defendant of one count of misdemeanor fraud, and acquitted him as to all other fraud charges. Id. at 3. The court upheld the conviction, stating that a finding of fraud may be based upon an omission if there is a substantial likelihood that disclosure of the omitted fact would have been significant in deliberations of a potential investor. Id. at 4. The court continued, holding that the jury could have found fraud based on the defendant's oral misrepresentations to the investors regarding placing their funds in a special account to be used solely to purchase product, and the nondisclosure of his contrary intent to exercise complete discretion on the disposition of those funds. Id. at 4.

Although the court ultimately found that the actions charged in Colonial Road Associates were time-barred, the discussion of the charges in the case shows that the AG brought a civil action under the Martin Act against the sponsor of real estate securities based on misrepresentations and omissions made by the sponsor. Colonial Road Assocs., 671 N.Y.S.2d at 942. First, the AG claimed that shortly after transferring title, the defendants began to default on maintenance payments, which was contrary to their representation in the offering plan[3] that they had sufficient resources to meet the maintenance payments. Id. The AG also alleged that the defendants failed to hold an election of directors for more than a year after the transfer of title, although the offering plan stated that such an election would be held within 30 days of title transfer. Id. Additionally, the AG claimed that the defendants failed to abide by representations in the offering plan that they would establish and fund a reserve fund pursuant to law. Id.

[3] Under New York Law, a promoter of real estate is required to register an offering plan with the AG, which carries a continuing obligation that the plan is current and truthful. 7040 Colonial Road Assocs., 671 N.Y.S.2d at 941 (citing 13 N.Y.C.R.R. 18).

Finally, the AG further charged that the defendants fraudulently failed to disclose the death of one of the general partners of the sponsor. Id. Although these claims were never decided, they are additional examples of the types of omissions and misrepresentations that the AG may consider to be violations of the Martin Act.

Materiality.

Misrepresentations and omissions must be material to constitute violations of the Martin Act. See State v. Rachmani, 71 N.Y.2d 718, 725-26 (1988); E. F. Hutton & Co., Inc. v. Penham, 547 F. Supp. 1286, 1297 (S.D.N.Y. 1982) ("Section 352-c and New York's common law fraud, like their securities counterparts which sound in fraud, both require proof of a misrepresentation of a material fact"). In Rachmani, the Court of Appeals of New York adopted the standard for materiality used by federal courts. Id. at 726. The Court of Appeals stated that the accepted standard for materiality was as follows:

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. * * * It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed *actual significance* in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "*total mix*" of information made available.

Id. at 726 (emphasis in original) (quoting TSC Indus. v. Northway, Inc., 426 U.S. 438 (1976)).

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APPENDIX A

Sections 352-c and 353 of the Martin Act.

The Martin Act is codified in Article 23-A of the General Business Law, which includes Sections 352 and 353. N.Y. Gen. Bus. Law §§352-53 (McKinney 1996). The Martin Act regulates the purchase and sale of securities in New York, and provides criminal and civil penalties for its violation.[4] Id. The Act originally was passed in 1921, but was amended in 1955 to include Section 352-c, which contains the Act's criminal provisions. People v. Landes, 84 N.Y. 2d 655, 660 (1994) ("Landes II"). In 1982, the Martin Act was amended again to include the felony provisions in subsections five and six of Section 352-c. N.Y. Gen. Bus. Law § 352-c (McKinney 1996). It has not been amended since. Id.

Section 352-c.

The Martin Act contains both misdemeanor and felony criminal provisions. N.Y. Gen Bus. Law §352-c (McKinney 1996). Subsections one and two of Section 352-c delineate misdemeanor offenses. Id. at §352-c(1) & (2). Subsections five and six define related applicable felony offenses. Id. at §352-c(5) & (6).

Section 352-c(1) makes the following actions misdemeanors when engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase of securities:

> (a) Any fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale;
> (b) Any promise or representation as to the future which is beyond reasonable expectation or unwarranted by existing circumstances;
> (c) Any representation or statement which is false, where the person who made such representation or statement:
> (i) knew the truth; or
> (ii) with reasonable effort could have known the truth; or
> (iii) made no reasonable effort to ascertain the truth; or
> (iv) did not have knowledge concerning the representation or statement made;

N.Y. Gen Bus. Law §352-c(1) (McKinney 1996).

[4] This memorandum assumes that the offering of shares in mutual funds qualifies as the offering for sale of securities under the Martin Act. This memorandum does not address the jurisdictional reach of the Martin Act.

Section 352-c(2), in pertinent part, provides:

> It shall be illegal and prohibited . . . to engage in any artifice, agreement, device or scheme to obtain money, profit or property by any of the means prohibited by this section.

N.Y. Gen Bus. Law §352-c(2) (McKinney 1996).

New York law defines a "misdemeanor" as "an offense, other than a 'traffic infraction,' for which a sentence to a term of imprisonment in excess of fifteen days may be imposed, but for which a sentence to a term of imprisonment in excess of one year cannot be imposed." N.Y. Penal Law §10.00(4) (McKinney 1997).

Subsections five and six of Section 352-c involve felony offenses. N.Y. Gen. Bus. Law §352-c(5) & (6) (McKinney 1996). Section 352-c(5) makes the following a class E felony:

> Intentionally engag[ing] in any scheme constituting a systematic ongoing course of conduct with intent to defraud ten or more persons or to obtain property from ten or more persons by false or fraudulent pretenses, representations or promises, and so obtain[ing] property from one or more of such persons while engaged in inducing or promoting the issuance, distribution, exchange, sale, negotiation or purchase of any securities or commodities.

N.Y. Gen Bus. Law §352-c(5) (McKinney 1996).

Similarly, subsection six makes the following a class E felony:

> intentionally engag[ing] in fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale, or [to] make[] any material false representation or statement with intent to deceive or defraud, while engaged in inducing or promoting the issuance, distribution, exchange, sale, negotiation or purchase of securities.

N.Y. Gen Bus. Law §352-c (6) (McKinney 1996).

New York law defines a "felony" as "an offense for which a sentence to a term of imprisonment in excess of one year may be imposed." N.Y. Penal Law §10.00(4) (McKinney 1997). Felonies are classified into classes A through E for sentencing purposes. Id. at §55.05(1). Class E felonies carry the lightest minimum and maximum sentences. See id. The default sentence for a class E felony is an indeterminate sentence with a maximum of four years, and a minimum of between one year and sixteen months (one third of the maximum four years). Id. at §70.00(1-3). The sentencing provisions, however, allow for a sentence of less than one year in some situations:

> When a person, other than a second or persistent felony offender, is sentenced for a class D or class E felony . . . and the court, having regard to the nature and circumstances of the crime and to the history and character of the defendant, is of the opinion that a sentence of imprisonment is necessary but that it would be unduly harsh to impose an indeterminate or determinate sentence, the court may impose a definite sentence of imprisonment and fix a term of one year or less.

Id. at §70.00(4).

Section 353.

Section 353, in pertinent part, allows the AG to file suit against anyone who:

> [H]as engaged in, is engaged or about to engage in any of the transactions heretofore referred to as and declared to be fraudulent practices.

N.Y. Gen. Bus. Law §353(1) (McKinney 1996). Section 353 authorizes the AG to seek a permanent injunction barring the person or entity charged from selling, offering to sell securities. Id. Section 353 also allows the AG to seek restitution from any fraudulent practices. Id. at §353(3) (McKinney 1996). Thus, Section 353 provides for civil enforcement of the Martin Act by authorizing the AG to seek equitable and monetary remedies.