



# **ENFORCEMENT PROCEEDINGS**

UNDER NEW YORK'S  
***MARTIN ACT***



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*Widely considered the most severe blue sky law in the country, the Martin Act arms the New York Attorney General with extraordinarily broad powers to investigate and combat securities fraud. The Martin Act has spurred many of the biggest actions against financial firms in recent years, making it more important than ever for counsel to understand the statute and its implications.*

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Originally passed in 1921, the Martin Act gives the New York Attorney General expansive law enforcement powers to conduct investigations of securities fraud and bring civil or criminal actions against alleged violators of the Act. It is colloquially known as a “blue sky” law, a term first used by the US Supreme Court in *Hall v. Geiger-Jones Co.* (242 U.S. 539, 550 (1917)). The term arose from debates surrounding Kansas’s first securities law, where proponents argued in favor of protecting investors against securities backed by nothing but the blue skies of Kansas.

The Martin Act applies to:

- The offer, sale or purchase of securities and commodities within or from New York (*N.Y. Gen. Bus. Law* §§ 352, 352-c).
- Real estate offerings involving condominiums and cooperative apartments within or from New York (see *N.Y. Gen. Bus. Law* §§ 352-e to 352-eeee).

Unlike other securities legislation, including the federal securities laws, the Martin Act did not establish a state regulatory agency, but instead vested the attorney general with sole responsibility for its implementation and enforcement (see *Kralik v. 239 E. 79th St. Owners Corp.*, 799 N.Y.S.2d 433, 435 (2005)). Because its purpose is to protect the investing public as a whole and redress harm suffered by individual investors as a result of fraud, the Act authorizes the attorney general to pursue both equitable and monetary relief.

A once largely-dormant law used only against small-time violators, it was former Attorney General Eliot Spitzer who began wielding the full powers of the Act against some of the biggest names on Wall Street. Since then, his two successors, Andrew Cuomo and Eric Schneiderman, have similarly used the Act to investigate and pursue actions against major financial firms. For example, Schneiderman has used the Martin Act to pursue what he calls “Insider Trading 2.0” to investigate fraudulent practices involving early access to market information.

This article provides an overview of enforcement proceedings under the Martin Act, including:

- The elements of a violation under the Act.
- The various powers the Act confers on the attorney general.
- The rights of witnesses and defendants under the Act.
- Defenses and appeals.
- Whether the Act provides a private right of action.

## ELEMENTS OF A VIOLATION

The Martin Act prohibits fraud or misrepresentation in the public offer, sale and purchase of securities and commodities (see *N.Y. Gen. Bus. Law* §§ 352, 352-c). It is remedial in nature and liberally construed (*People v. Hasslinger*, 771 N.Y.S.2d 589, 590-91 (3d Dep’t 2004)). The Act is interpreted to prohibit all deceitful practices (*Hasslinger*, 771 N.Y.S.2d at 591), as well as false promises, which means the attorney general can prosecute attempted fraud, even if there was no fraudulent transaction (see *N.Y. Gen. Bus. Law* § 352).

To prove a violation under the Act, the state must prove a misrepresentation or omission of a material fact or other conduct which deceives or misleads the public, or even tends

to deceive or mislead the public, in the sale or promotion of a security within or from New York (see *People v. Federated Radio Corp.*, 244 N.Y. 33, 38-39 (1926); *People v. Charles Schwab & Co.*, 971 N.Y.S.2d 267, 270 (1st Dep’t 2013)).

Importantly, the state is not required to prove:

- Scienter (or intent to defraud), except in connection with felonies (see *N.Y. Gen. Bus. Law* § 352-c(5), (6); *Federated Radio Corp.*, 244 N.Y. at 38-39; *People v. Sala*, 695 N.Y.S.2d 169, 177 (3d Dep’t 1999), *aff’d*, 716 N.Y.S.2d 361, 363 (2000); *People v. Barysh*, 408 N.Y.S.2d 190, 193 (Sup. Ct. N.Y. Co. 1978)) (see below *Defenses and Appeals*).
- An actual purchase or sale or damages (reliance) resulting from the fraud (*N.Y. Gen. Bus. Law* § 352-c(1)(c); *State v. Sonifer Realty Corp.*, 622 N.Y.S.2d 516, 517 (1st Dep’t 1995)).

By contrast, actions for common law fraud and under the federal securities laws require proof of scienter, reasonable reliance and damages (see *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976); *Pitts, Ltd. v. Am. Express Bank Int’l*, 911 F. Supp. 710, 715-16, 719 (S.D.N.Y. 1996); *Jo Ann Homes at Bellmore, Inc. v. Dworetz*, 302 N.Y.S.2d 799, 803 (1969)).



Search [The Rise and Reformation of Private Securities Litigation](#) for more on the pleading requirements under the federal securities laws, including scienter and reliance.

## ENFORCEMENT POWERS

The Martin Act vests the attorney general with wide-ranging enforcement powers. The attorney general may, where appropriate, commence:

- Investigations (either confidential or public) into fraudulent practices (*N.Y. Gen. Bus. Law* §§ 352, 354-55).
- Civil proceedings for injunctive relief or restitution (*N.Y. Gen. Bus. Law* § 353).
- Criminal prosecutions (*N.Y. Gen. Bus. Law* § 358).

Additionally, the attorney general has authority under the Act to:

- Require sworn written statements concerning the subject matter of an investigation and other data deemed relevant (*N.Y. Gen. Bus. Law* § 352(1)).
- Issue subpoenas statewide to:
  - compel attendance of witnesses and examine them under oath in connection with an investigation (*N.Y. Gen. Bus. Law* §§ 352(2), 352-a(1)); and
  - require production of documents deemed relevant or material to an investigation (*N.Y. Gen. Bus. Law* §§ 352(2), 352-a(1)).
- Seek a court order to compel the appearance of witnesses to answer questions or produce documents in connection with an investigation (*N.Y. Gen. Bus. Law* § 354).
- Grant immunity to witnesses (*N.Y. Gen. Bus. Law* § 359) (see below *Rights of Witnesses and Defendants*).

## INVESTIGATIONS

Under Sections 352, 354 and 355 of the New York General Business Law, the attorney general is granted authority to

investigate fraudulent practices in anticipation of and to preempt illegal activities without beginning a formal action. The decision whether to conduct an investigation is left entirely to the discretion of the attorney general and is not reviewable by the courts (see *People v. Bunge Corp.*, 302 N.Y.S.2d 785, 788 (1969)).

When conducting an investigation, the attorney general is not required to demonstrate probable cause or disclose the details of the investigation (see *People v. Thain*, 874 N.Y.S.2d 896, 900 (Sup. Ct. N.Y. Co. 2009)). In fact, the attorney general has discretion to keep the investigation confidential to avoid unwarranted market reaction (see *N.Y. Gen. Bus. Law* § 352(5); *First Energy Leasing Corp. v. Attorney General*, 505 N.Y.S.2d 855, 858 (1986)). The attorney general can therefore conduct:

- Confidential investigations (*N.Y. Gen. Bus. Law* §§ 352(1), 352-a(1)).
- Public investigations (*N.Y. Gen. Bus. Law* §§ 354-55).

### Confidential Investigations

The attorney general can carry out a confidential investigation to assess whether a violation of the Martin Act has taken place, is taking place or is about to take place (see *N.Y. Gen. Bus. Law* § 352(1); *First Energy Leasing Corp.*, 505 N.Y.S.2d at 858).

To conduct a confidential investigation, the attorney general can use the subpoena power granted under the Act to compel the non-public appearance of witnesses at the attorney general's office for questioning under oath (see *N.Y. Gen. Bus. Law* § 352(2)). These are known as Martin Act hearings. The attorney general also has the power to obtain data and information deemed relevant to the investigation and can do so by issuing a subpoena requesting a sworn affidavit (*N.Y. Gen. Bus. Law* § 352(1)-(2)).

Failure to comply with the attorney general's request without reasonable cause is a misdemeanor (*N.Y. Gen. Bus. Law* § 352(4)). New York courts have held that advice of counsel and hardship do not constitute reasonable cause to avoid answering a subpoena or request under Section 352 of the New York General Business Law (see *People v. Forsyth*, 439 N.Y.S.2d 808, 809-10 (Sup. Ct. N.Y. Co. 1981)). Additionally, witnesses

generally are not permitted to disclose information pertaining to Martin Act hearings (*N.Y. Gen. Bus. Law* § 352(5)) (see below *Criminal Liability*).

### Public Investigations

To conduct a public investigation, the attorney general must seek an ex parte order from the court, known as a Section 354 order, which can compel a person either to appear before the court to testify or produce records.

The application for the order may:

- Be made before an action is started.
- Include a request for a preliminary injunction.
- Be based solely on the attorney general's information and belief that public testimony under judicial supervision is material and necessary.

(*N.Y. Gen. Bus. Law* § 354.)

Although the New York Civil Practice Law and Rules (CPLR) generally apply to civil actions under the Martin Act (see *N.Y. Gen. Bus. Law* § 357), the CPLR provisions for pre-action depositions do not apply to Section 354 orders (*N.Y. Gen. Bus. Law* § 354). However, the testimony must be before a judge or designated referee (*N.Y. Gen. Bus. Law* § 355; see also *First Energy Leasing*, 505 N.Y.S.2d at 857).

### CIVIL ACTIONS FOR INJUNCTIVE RELIEF AND RESTITUTION

The attorney general's primary weapon under the Martin Act is the ability to obtain preliminary and permanent injunctive relief against defendants selling or offering to sell securities in New York. Violation of an injunction is a misdemeanor, punishable by a cumulative civil penalty of \$3,000 per violation (*N.Y. Gen. Bus. Law* § 359-g(1)(a)).

The attorney general may seek a preliminary injunction to prevent suspected violations of the Act pending an investigation (*N.Y. Gen. Bus. Law* § 353(1)). To obtain a preliminary injunction, the attorney general must meet the traditional standard for preliminary injunctions by showing:

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The attorney general is granted authority to investigate fraudulent practices in anticipation of and to preempt illegal activities without beginning a formal action. The decision whether to conduct an investigation is left entirely to the discretion of the attorney general and is not reviewable by the courts.

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- A likelihood of success on the merits.
- Irreparable injury if the injunction is not granted.
- A balancing of the equities.

(See *State v. Fine*, 534 N.Y.S.2d 357, 358 (1988).)



Search [Provisional Remedies in New York: Initial Considerations and Drafting the Required Documents for Preliminary Injunctive Relief](#) for more on applying for preliminary injunctive relief in New York state court.

The attorney general may also seek to enjoin permanently a defendant from selling or offering to sell securities in New York, based on the following grounds:

- An actual violation of the Act (*N.Y. Gen. Bus. Law* §§ 352-i; 353(1)).
- The failure of the defendant to respond to questions or produce documents when ordered to do so, without any further showing by the attorney general (*N.Y. Gen. Bus. Law* § 353(1)).
- The failure of a foreign corporation to respond to a notice for documents or testimony issued by the attorney general (*N.Y. Gen. Bus. Law* § 352-a(2)).
- A prior conviction of a felony or criminal offense involving securities (*N.Y. Gen. Bus. Law* § 353(2)).

A permanent injunction can be vacated or modified. To do so, an affected person may apply to the New York Supreme Court at least five years after the date of the injunction and must give the attorney general at least 60 days' notice. The attorney general may conduct an investigation to determine whether to consent to or oppose the application. The applicant assumes responsibility for all costs and expenses involved in the investigation. Following the attorney general's submission, the court holds an evidentiary hearing and then issues a final order dissolving or modifying the injunction, or denying the application. The Act expressly prohibits the court from granting temporary relief from the original injunction while an application for dissolution or modification is pending. (See *N.Y. Gen. Bus. Law* § 359-g(3).)

Under the Act, the court may not vacate or modify an injunction where:

- The injunction was granted as an incident to a crime for which the applicant was convicted (*N.Y. Gen. Bus. Law* § 359-g(3)(a)).
- The applicant has been convicted of a felony or a crime that would be a felony if committed in the State of New York since the issuance of the injunction (*N.Y. Gen. Bus. Law* § 359-g(3)(b)).
- The applicant has been convicted at any time of any crime involving stocks, bonds, investments, securities or like instruments (*N.Y. Gen. Bus. Law* § 359-g(3)(c)).

(See *People v. Honeckman*, 480 N.Y.S.2d 829, 832-33 (Sup. Ct. N.Y. Co. 1984).)

However, the court retains its inherent power to modify its decrees where the criminal conviction has vanished, as a result of a pardon or reversal on appeal (*Honeckman*, 480 N.Y.S.2d at 833).

In addition to injunctive relief, the court may order restitution of any money or property obtained directly or indirectly by the fraudulent practice charged under the Act (*N.Y. Gen. Bus. Law* § 353(3)). The attorney general may request that a receiver be appointed to take control of all property fraudulently obtained by the defendant (*N.Y. Gen. Bus. Law* § 353-a; *Bunge Corp.*, 302 N.Y.S.2d at 790). The appointment of a receiver is within the discretion of the trial court and not reviewable by the New York Court of Appeals (*People v. Lexington Sixty-First Assocs.*, 381 N.Y.S.2d 836, 840-41 (1976)).

## CRIMINAL LIABILITY

The attorney general may assume a prosecutorial role and pursue criminal violations of the Martin Act (*N.Y. Gen. Bus. Law* § 358), including both misdemeanors and Class E felonies. Evidence of criminal offenses uncovered during an investigation may be presented by the attorney general to a grand jury (*People v. Thomas*, 512 N.Y.S.2d 618, 619-20 (Sup. Ct. N.Y. Co. 1986)).

Misdemeanors under the Act include:

- Any fraud, deception, concealment, suppression, false pretense or fictitious or pretended purchase or sale of securities (*N.Y. Gen. Bus. Law* § 352-c(1)(a)).
- Any unreasonable or unwarranted promise or representation regarding the future as related to securities (*N.Y. Gen. Bus. Law* § 352-c(1)(b)).
- Any false statement made to induce or promote the issuance, distribution, exchange or sale of securities or commodities for which the person who made the statement:
  - knew the truth;
  - reasonably could have known the truth;
  - made no reasonable effort to ascertain the truth; or
  - did not have knowledge concerning the representation made. (*N.Y. Gen. Bus. Law* § 352-c(1)(c).)
- Engaging in a device or scheme to profit by any of the means prohibited by the Act (*N.Y. Gen. Bus. Law* § 352-c(2)).
- Representing oneself or one's entity as an "exchange," unless registered with the Securities and Exchange Commission (*N.Y. Gen. Bus. Law* § 352-c(3)).
- Failure to obey a subpoena from the attorney general without reasonable cause (*N.Y. Gen. Bus. Law* § 352(4)).
- Disclosure of information pertaining to an investigation, except as directed by the attorney general (*N.Y. Gen. Bus. Law* § 352(5)).
- Violation of an order staying or enjoining any practices or transactions (*N.Y. Gen. Bus. Law* § 359-g(1)(a)).
- Any act declared illegal and prohibited by Section 352-c (*N.Y. Gen. Bus. Law* § 352-c(4)).
- Any other violation of the Act, unless otherwise designated a felony (*N.Y. Gen. Bus. Law* § 359-g(2)).

Misdemeanors are punishable by a fine of up to \$500 or imprisonment of up to one year, or both (*N.Y. Gen. Bus. Law* § 359-g(2)).

## Interplay between Confidential and Public Investigations

One high-profile example of the interplay and impact of the attorney general's investigative powers under the Martin Act can be found in the 2001 to 2002 investigation of Merrill Lynch & Co. by then-Attorney General Eliot Spitzer.

Prompted by a private action brought by an investor who claimed the loss of \$500,000 as a result of relying on investment advice received from one of the financial firm's analysts, Spitzer's office conducted a confidential investigation of the firm. Spitzer invoked the Act to request a lengthy interview with the analyst accused in the private action and later subpoenaed every e-mail sent by the analyst since 1997. Based on those e-mails, Spitzer alleged that the firm had been in violation of New York securities laws.

The two sides attempted to reach a settlement, but negotiations stalled. In response, Spitzer opted to file a

public Section 354 order. Within one week of Spitzer's press release concerning the allegations, Merrill Lynch lost \$5 billion in market value. One month later, the parties reached a settlement that cost the financial firm \$100 million, in addition to many new compliance and monitoring requirements. (See *Press Release, New York State Office of the Attorney General, Spitzer, Merrill Lynch Reach Unprecedented Agreement to Reform Investment Practices (May 21, 2002)*.)



Other violations of the Act may constitute Class E felonies, such as when a defendant:

- Violates the Act a second time (*N.Y. Gen. Bus. Law § 359-g(1)(a)*).
- Intentionally violates the Act to defraud or obtain property from ten or more persons, and obtains property from one or more of those persons (*N.Y. Gen. Bus. Law § 352-c(5)*).
- Intentionally violates the Act and obtains more than \$250 of property (*N.Y. Gen. Bus. Law § 352-c(6)*).
- Violates the Act and was previously convicted within five years of any crime in New York or of any offense outside of New York involving the fraudulent sale of securities for which a prison sentence of more than one year was authorized (*N.Y. Gen. Bus. Law § 359-g(1)(a)*).

Class E felonies carry a penalty of up to four years of imprisonment (see *N.Y. Penal Law § 70.00(2)(e)*).

### RIGHTS OF WITNESSES AND DEFENDANTS

Much of the force of the Martin Act comes by way of the investigative powers conferred on the attorney general. As a result, some of the protections for witnesses and defendants traditionally found in court proceedings are not fully available under the Act.

For example, because confidential proceedings under Section 352 of the New York General Business Law are investigative, rather than adjudicative, a subpoenaed witness does not have a constitutional right to assistance of counsel (see *First Energy Leasing, 505 N.Y.S.2d at 858*). However, the attorney general usually will permit counsel to attend a Martin Act hearing but not make objections (see *Kanterman v. Attorney General, 350*

*N.Y.S.2d 516, 519-20 (Sup. Ct. N.Y. Co. 1973)*). Further, witnesses are not entitled to a transcript of the proceeding (*Kanterman, 350 N.Y.S.2d at 519*).

A witness may challenge a Section 352 subpoena by a motion to quash. To defeat this motion, the attorney general must demonstrate "his authority, the relevance of the items sought, and some factual basis for his investigation" (*Thain, 874 N.Y.S.2d at 900*).

Public proceedings, on the other hand, are subject to judicial supervision (*N.Y. Gen. Bus. Law § 354*). As discussed above, the attorney general must make an application to a court to compel a witness to appear for questioning or produce documents (see above *Public Investigations*). A court will order a Section 354 examination only where the attorney general shows upon "information and belief" that the witness's testimony is "material and necessary" (*N.Y. Gen. Bus. Law § 354; Gonkjur Assocs. v. Abrams, 451 N.Y.S.2d 747, 749-50 (1st Dep't 1982)*). The examination must be before a judge or referee, and witness transcripts must be filed (*N.Y. Gen. Bus. Law §§ 354-55; First Energy Leasing, 505 N.Y.S.2d at 857-59*).

Additionally, a witness may assert the privilege against self-incrimination at any stage of a confidential or public proceeding. However, the attorney general may compel the witness to give evidence by granting immunity to that witness (*N.Y. Gen. Bus. Law § 359; see also People ex rel. Kenny v. Adams, 292 N.Y. 65, 71-72 (1944); Dunham v. Ottinger, 243 N.Y. 423, 438 (1926); People v. Linick, 430 N.Y.S.2d 495, 499-500 (Sup. Ct. N.Y. Co. 1980), rev'd on other grounds, 434 N.Y.S.2d 423 (1st Dep't 1981)*).

Defendants who have asserted a lack of intent to violate the Act have been unsuccessful because the Act does not require intent or scienter for a conviction. A belief that a transaction was proper is not a defense.

## DEFENSES AND APPEALS

There are no statutory defenses to a charge of a violation of the Martin Act. The two defenses commonly asserted are:

- **Lack of intent.** Defendants who have asserted a lack of intent to violate the Act have been unsuccessful because the Act does not require intent or scienter for a conviction (see *Federated Radio Corp.*, 244 N.Y. at 38-39). A belief that a transaction was proper is not a defense, as the Act is “directed at acts or practices, and not at any particular mental state on the part of the actor” (*Barysh*, 408 N.Y.S.2d at 193).
- **The statute of limitations.** A defendant may assert that an action brought under the Act is barred by the statute of limitations. Although the Act does not contain its own statute of limitations, courts have generally applied the six-year limitations period for common law fraud to alleged violations of the Act (see *CPLR § 213(8)*; *Podraza v. Carriero*, 630 N.Y.S.2d 163, 169 (4th Dep’t 1995); *State v. Bronxville Glen I Assocs.*, 581 N.Y.S.2d 189, 190 (1st Dep’t 1992)).



Search [Statutes of Limitation: New York](#) for information on the statutes of limitation in New York for various claims.

A defendant may appeal a judgment under the Act. However, if an injunction is ordered, an appeal does not automatically stay the injunction. Rather, a defendant must obtain a stay order from a justice of the Appellate Division with notice to the attorney general. (*N.Y. Gen. Bus. Law § 359-g(1)(c)*.) In line with the broad protective purpose of the Act, with this statutory process, the legislature set a high bar for an accused violator to obtain relief from an injunction.

## NO PRIVATE RIGHT OF ACTION

For years following the passage of the Martin Act, one of the questions that remained open was whether the Act contemplated a private right of action for those injured by securities fraud. The New York Court of Appeals settled this issue in 1987, holding that there is no private right of action. The court noted that the legislature did not expressly authorize a private right of action and an implied private right of action is inconsistent with the enforcement mechanism created by the Act. (*CPC Int’l Inc. v. McKesson Corp.*, 519 N.Y.S.2d 804, 807 (1987).)

However, the Act does not preempt private common law claims founded in fraud or otherwise, such as claims for breach of fiduciary duty and gross negligence, as long as the claim is not based exclusively on a violation of the Act. A private common law claim can proceed even if there is overlap with the Act. (*Assured Guar. (UK) Ltd. v. J.P. Morgan Inv. Mgmt. Inc.*, 939 N.Y.S.2d 274, 276, 279-80 (2011).)