

# THE SECURITIES LAW REFORM AND PROTECTION ACT OF 1985: NEW JERSEY'S RESPONSE TO PENNY STOCK ABUSE

## I. Introduction

Anyone who has invested in the stock market has dreamed of finding that one magic stock that will turn a modest investment into a king's ransom. In search of this magic stock, people have invested in small, speculative companies with hopes that they will be the IBM or American Express of tomorrow. The securities of these upstart companies are known as "penny stocks" because they are offered and traded at low prices, ranging from one cent to five dollars a share or unit.<sup>1</sup> Many of these companies are legitimate entities run by honest managers with hopes of future success. Likewise, most of the brokers and underwriters involved with these penny stocks are honest and reputable. Unfortunately, there are an unscrupulous few who use the typical investor's dream to the detriment of unsuspecting and often unsophisticated investors.

In January 1985, a series of newspaper articles in the Newark Star Ledger detailed instances of investors being defrauded by brokers selling stocks of sham companies.<sup>2</sup> In some instances, the companies had no business purpose, no customers, no products and had management with little or no business experience.<sup>3</sup> Some of the officers, directors or major stockholders of these companies had histories of prior violations of securities laws or

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<sup>1</sup> Sometimes securities of new small issues are sold in units. These units may consist of, for example, one share of common stock with a warrant to purchase additional common stock at a stated time in the future at a stated price.

<sup>2</sup> See generally Cohen, *Penny Stock Haven, Jersey's Weak Laws Give Promoters A Free Rein*, The Star-Ledger (Newark, NJ), Jan. 20, 1985 at 1, 26; Cohen, *Investors Gamble On The Unknown When They Buy "Blind Pool" Stocks*, The Star-Ledger (Newark, NJ), Jan. 21, 1985 at 1, 8; Cohen, *Dental Clinic Venture Carries Big "IF" on Licensing*, The Star-Ledger (Newark, NJ), Jan. 22, 1985 at 1, 22; Cohen, *SEC Violations Common Among Some "Penny Stock" Insiders*, The Star-Ledger (Newark, NJ), Jan. 23, 1985 at 10; Cohen, *Weak State Securities Law Leaves The Small Investor Open To Loss*, The Star-Ledger (Newark, NJ), Jan. 24, 1985 at 1, 30 [hereinafter collectively cited as "Articles"].

<sup>3</sup> Cohen, *Penny Stock Haven*; Cohen, *Investors Gamble on Unknown*, *supra* note 2.

other criminal convictions or indictments.<sup>4</sup> Often the brokers who sold these securities also had histories of prior offenses.<sup>5</sup> Yet, these companies raised large sums of money through public offerings of stock.<sup>6</sup>

The articles stated that these brokers used high pressure sales tactics and spoke of great potential profits.<sup>7</sup> The investors were advised to "get in" early before the price of the stock skyrocketed.<sup>8</sup> Often, the purchasers were not provided with a prospectus which would have disclosed important information about the company offering the securities. A prospectus would have alerted investors about the speculative nature of the business, the absence of a business plan or the lack of products.<sup>9</sup> As a result of this lack of disclosure, some people invested large sums of money, even life savings, based solely upon the brokers' sales tactics.<sup>10</sup> These brokers pushed the securities on investors who were unable to understand, or worse, unable to absorb the financial risks involved.<sup>11</sup> This practice is contrary to brokers' professional standards.<sup>12</sup>

After a period of pushing a stock and causing its price to

<sup>4</sup> *Supra* note 3; see also Cohen, *SEC Violations Common*, *supra* note 2.

<sup>5</sup> See *supra* note 4.

<sup>6</sup> See *supra* note 4.

<sup>7</sup> Cohen, *Penny Stock Haven*, *supra* note 2; Cohen, *State Accuses Penny Stock Firm of Shady Tactics*, *The Star-Ledger* (Newark, NJ), May 30, 1985 at 1, 21.

<sup>8</sup> Cohen, *Penny Stock Haven*; Cohen, *Weak State Securities Law*, *supra* note 2.

<sup>9</sup> *Supra* note 8. According to the articles, the federal prospectus for these penny stocks fully disclosed the entire risk and contained warnings that the stock should not be purchased unless the investor is prepared to lose all of his money.

<sup>10</sup> Cohen, *State Accuses Penny Stock Firm*, *supra* note 7.

<sup>11</sup> *Id.* See also Cohen, *Penny Stock Haven*, *supra* note 2.

<sup>12</sup> New York Stock Exchange Rule 405, N.Y.S.E. Guide (CCH) ¶ 2405; American Stock Exchange Rule 411, American Stock Exchange Guide (CCH) ¶ 9431; National Association of Securities Dealers Rules of Fair Practice Art. III, § 2, NASD Manual (CCH) ¶ 2152.

See generally Bines, *Setting Investment Objectives: The Suitability Doctrine: Part I*, 4 SEC. REG. L.J. 276 (1976); Bines, *Setting Investment Objectives: The Suitability Doctrine: Part II*, 4 SEC. REG. L.J. 418 (1977); Cohen, *The Suitability Rule and Economic Theory*, 80 YALE L.J. 1604 (1971); Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445 (1965).

In general, the suitability doctrine requires that, in recommending a purchase or sale of a security, a broker-dealer have reasonable grounds to believe that the investment is suitable to the customer's needs and financial situation. A policy statement by the NASD Board of Governors requires a broker to obtain information concerning a customer's other holdings before recommending speculative, low-priced securities. NASD Manual (CCH) ¶ 2152.

increase, the insiders<sup>13</sup> sold their interests at large profits.<sup>14</sup> Such sales caused the price to plummet, leaving the unaware investors with worthless pieces of paper.<sup>15</sup>

These types of abuses are not new to the investment community. In 1911, states began passing "blue sky" laws to regulate securities and protect investors.<sup>16</sup> After the infamous stock market crash of 1929, the federal government entered into securities regulation with the Securities Act of 1933 (1933 Act)<sup>17</sup> and the Securities Exchange Act of 1934 (1934 Act).<sup>18</sup> Congress elected not to preempt the area, but rather, specifically allowed concurrent state and federal regulation of the securities industry.<sup>19</sup>

Uniformity of blue sky laws was provided in 1956, when the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved the Uniform Securities Act (1956 Uniform Act).<sup>20</sup> In August 1985, the NCCUSL adopted a revised Uniform Securities Act (1985 Uniform Act).<sup>21</sup> In 1960, New Jersey adopted the 1956 Uniform Act, except for its provisions regarding the registration of securities.<sup>22</sup> New Jersey passed the Real Estate Syndication Offerings Law in 1963, which required the registration of New Jersey real estate offerings.<sup>23</sup> In 1967, New Jersey enacted the Uniform Securities Law (Uniform Law) which adopted all of the provisions of the 1956 Uniform Act.<sup>24</sup> The

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<sup>13</sup> The term "insiders" is often used in the context of securities regulations. In this instance, insiders generally refers to major stockholders, directors, executive officers and others closely associated with them. See generally Articles, *supra* note 2.

<sup>14</sup> Cohen, *Penny Stock Haven*, *supra* note 2.

<sup>15</sup> *Id.*

<sup>16</sup> 1911 Kan. Sess. Laws 133. The name "blue sky" laws refers to state securities laws that were adopted to protect investors from "speculative schemes which have no more basis than so many feet of 'blue sky'." *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917).

<sup>17</sup> Securities Act of 1933, ch. 38, 48 STAT. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (1982)).

<sup>18</sup> Securities Exchange Act of 1934, ch. 404, 48 STAT. 881 (codified as amended at 15 U.S.C. §§ 78a-78kk (1982)).

<sup>19</sup> Securities Act of 1933, § 18, 15 U.S.C. § 77r (1982); Securities Exchange Act of 1934, § 28(a), 15 U.S.C. § 78bb(a) (1982).

<sup>20</sup> UNIF. SEC. ACT. (1956), 7B U.L.A. 509-687 (1985). Some amendments were made in 1958.

<sup>21</sup> UNIF. SEC. ACT. (1985), 7B U.L.A. 16-51 (Supp. 1986).

<sup>22</sup> 1960 N.J. Laws 75, N.J. STAT. ANN. §§ 49:3-1 to -26 (repealed 1967).

<sup>23</sup> 1963 N.J. Laws 192, N.J. STAT. ANN. §§ 49:3-27 to -46 (repealed 1986).

<sup>24</sup> 1967 N.J. Laws 93, N.J. STAT. ANN. §§ 49:3-47 to -76 (West 1970 & Supp. 1985).

Uniform Law provided for extensive exemptions, which, in effect, required only intrastate offerings to be registered.<sup>25</sup>

As a result of the Star Ledger articles, the New Jersey public became acutely aware of securities fraud in the state.<sup>26</sup> Many questions were raised as to how these fraudulent activities were allowed to occur and what, if anything, was being done to stop them.<sup>27</sup> Thus, as New Jersey's securities laws received heavy criticism, they came under the close scrutiny of the Legislature.<sup>28</sup>

In response to this pressure, New Jersey passed the Securities Law Reform and Protection Act of 1985 (Securities Reform Act).<sup>29</sup> This Act amends the state's 1967 Uniform Securities Law in an effort to provide protection for investors and to increase enforcement of its provisions.<sup>30</sup> This note will examine the development of the Securities Reform Act and its effect on the securities laws in New Jersey.

## II. Legislative Reaction

In February 1985, the Assembly Banking and Insurance Committee held a hearing on penny stock trading.<sup>31</sup> The Star-Ledger reports<sup>32</sup> and this hearing<sup>33</sup> revealed particular factors that contributed to abuses. First, the lack of funding and resources of the Securities Bureau prevented effective investigation of fraud and adequate enforcement of New Jersey's securities laws.<sup>34</sup> Second, the Securities Bureau was unable to monitor most of the securities sold in the State due to the extensive regis-

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<sup>25</sup> *Id.* §§ 49:3-50, -60.

<sup>26</sup> See generally Cohen, *Assembly Orders Penny Stock Probe*, The Star-Ledger (Newark, NJ), Feb. 5, 1985 at 1, 22; Cohen, *Kean, Legislators Seek Tighter Rules On Penny Stock To Protect Investors*, The Star-Ledger (Newark, NJ), Feb. 17, 1985 at 17; Cohen, *Officials Ask Toughening Of Penny Stock Laws*, The Star-Ledger (Newark, NJ), Feb. 21, 1985 at 1, 36.

<sup>27</sup> See *supra* note 26.

<sup>28</sup> See *supra* note 26.

<sup>29</sup> Act of Jan. 9, 1986, ch. 405, 1985 N.J. Laws 405 (codified at N.J. STAT. ANN. §§ 49:3-48 to -76).

<sup>30</sup> Senate Labor, Industry and Professions Committee Statement to S-2715, 201st Leg. 2d Sess. (1985).

<sup>31</sup> *New Jersey Assembly Banking and Insurance Committee Meeting to Conduct a Study of the Trading of Penny Stock*, (Newark, N.J., Feb. 20, 1985) [hereinafter cited as "Hearing"].

<sup>32</sup> Articles, *supra* note 2.

<sup>33</sup> *Hearing, supra* note 31.

<sup>34</sup> *Hearing, supra* note 31, at 31-43 (testimony of James McLelland Smith, Chief

tration exemptions.<sup>35</sup> Third, many investors purchased penny stocks without the benefit of a prospectus and instead relied upon the brokers' representations.<sup>36</sup> Finally, many of those closely involved in the sale of the abusive penny stocks had backgrounds of violations of securities and antifraud laws.<sup>37</sup>

In response to these deficiencies and abuses, three bills were introduced into the New Jersey Legislature in early 1985. Each of these bills proposed different solutions to the problems associated with penny stock offerings. Although there were common provisions among all of the bills, each focused on different areas of regulation. The following is a discussion of the various proposals for securities law reform considered by the Legislature.

#### A. *The Original Russo Bill: S-2715*

The first piece of legislation was Senate Bill 2715 (S-2715), introduced on February 14, 1985 by Senator John F. Russo (D-10) into the Committee on Labor, Industry and Professions.<sup>38</sup> This bill ultimately became the Act signed into law, but not before it went through substantial changes. These changes are discussed later in this note.

As originally introduced, this bill increased fines for violations, raised the degree of criminal offenses for violations and changed the statute of limitations from two years after contract date to two years after discovery.<sup>39</sup> In addition, the bill instituted an enforcement fund which would provide the Securities Bureau

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of New Jersey Securities Bureau); Articles, *supra* note 2. The Securities Bureau is under the Division of Consumer Affairs, Department of Law and Public Safety.

<sup>35</sup> See *supra* note 34. Prior to the Securities Reform Act, New Jersey's securities laws allowed exemptions from registration for all securities issued except intrastate offerings and real estate syndication offerings. See *supra* note 25 and accompanying text.

<sup>36</sup> *Hearing, supra* note 31, at 16-28 (testimony of David Sheehan, Esq., of Crummy, Del Deo, Dolan, Griffinger and Vecchione, Newark, NJ), 45-60 (testimony of Frank J. Wilson, Executive Vice President and General Counsel of NASD); Articles, *supra* note 2.

<sup>37</sup> *Hearing, supra* note 31, at 58-63 (testimony of John Pinto, Senior Vice President, Compliance of NASD); Articles, *supra* note 2.

<sup>38</sup> S-2715, 201st Leg. 2d Sess. (1985), introduced Feb. 14, 1985.

<sup>39</sup> *Id.* §§ 1-2. Discovery is that time when a plaintiff discovered or should have discovered that he had a cause of action. See, e.g., *Lopez v. Swyer*, 62 N.J. 267, 300 A.2d 563 (1973).

with additional funding.<sup>40</sup>

One provision of the bill allowed a purchaser of an initial public offering to cancel a purchase if a prospectus was not received before the purchase.<sup>41</sup> To be entitled to this right, however, the purchaser would have to give the broker-dealer notice of cancellation within ten days after purchase.<sup>42</sup> This provision was less protective than the 1933 Act, which has a one-year statute of limitations for rescission actions for violations of prospectus delivery requirements.<sup>43</sup> An amendment to the later version of the bill made it unlawful to violate the 1933 Act's prospectus delivery requirements.<sup>44</sup>

### B. *The Paterniti Bill: A-3246*

On February 25, 1985, Assembly Bill 3246 (A-3246) was introduced by Assemblyman Thomas J. Paterniti (D-18).<sup>45</sup> Although this bill increased civil and criminal penalties and changed the statute of limitations in the same manner as S-2715,<sup>46</sup> Paterniti's bill was substantially different.

The bill removed the registration exemptions for federally registered securities and securities exempt from federal registration.<sup>47</sup> Thus, all securities offered in New Jersey would have to be registered with the Securities Bureau unless exempt under section 3 of the Uniform Law.<sup>48</sup>

Bill A-3246 sought to change the parties' burden of proof in a civil action for misrepresentation under New Jersey blue sky laws. The defendant would have the burden of proving that any misrepresentation was made without the defendant's knowledge and that in the exercise of reasonable care, the defendant could

<sup>40</sup> S-2715, *supra* note 38, § 3.

<sup>41</sup> *Id.*, § 4.

<sup>42</sup> *Id.*

<sup>43</sup> Securities Act of 1933, §§ 12-13, 15 U.S.C. §§ 771-77m (1982).

<sup>44</sup> S-2175, 201st Leg. 2d Sess. (1985), as amended by Senate Committee, Oct. 17, 1985.

<sup>45</sup> A-3246, 201st Leg. 2d Sess. (1985), introduced Feb. 25, 1985.

<sup>46</sup> *Id.*, §§ 3-4.

<sup>47</sup> *Id.*, § 2.

<sup>48</sup> Section 3 of the New Jersey Uniform Law lists various specific exempt securities and transactions, such as government securities, bank deposits, etc. N.J. STAT. ANN. § 49:3-50 (West Supp. 1985, amended by 1985 N.J. Laws 405).

not have known of the misrepresentation.<sup>49</sup> Under existing New Jersey law, the plaintiff is required to prove that the defendant had knowledge of the untruth and intended to deceive the plaintiff,<sup>50</sup> an element commonly known as scienter.<sup>51</sup> In addition, the bill sought to delete the scienter language from the definition of fraud.<sup>52</sup>

These changes would have lessened the plaintiff's burden of proof by imposing upon the defendant a due diligence requirement, similar to section 11 of the 1933 Act.<sup>53</sup> The plaintiff would have the benefit of a two-year statute of limitations under New Jersey law,<sup>54</sup> as opposed to a one-year limit under the 1933 Act.<sup>55</sup> In addition, the change in the definition of fraud may have made it easier for the Securities Bureau to deny or revoke the effectiveness of registration, which current law allows if fraud is involved in an offering.<sup>56</sup>

This bill did not get the support of the Assembly. Instead, Assembly Bill 3377 became the preferred bill in that house.

### C. *The Aduato Bill: A-3377*

On March 5, 1985, Assemblyman Stephen Aduato, Jr. (D-30) introduced Assembly Bill 3377 (A-3377), which was subsequently amended on June 20, 1985.<sup>57</sup> This bill was similar to the other two bills in that it changed the statute of limitations, established an enforcement fund and increased the civil and criminal fines and penalties.<sup>58</sup> In most other aspects, however, A-3377 was

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<sup>49</sup> A-3246, *supra* note 45, § 4.

<sup>50</sup> N.J. STAT. ANN. § 49:3-71(a)(2) (West 1970).

<sup>51</sup> Scienter is the intent to deceive or defraud. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

<sup>52</sup> A-3246, *supra* note 45, § 1.

<sup>53</sup> Securities Act of 1933, § 11, 15 U.S.C. § 77k (1982). Section 11 imposes liability on every person who signed the registration statement, every director, every named expert and every underwriter unless that person sustains the burden of proving that after reasonable investigation, that person did not know of the error or omission and had no reasonable ground to believe there was an error or omission. *Id.*

<sup>54</sup> N.J. STAT. ANN. § 49:3-71(e) (West 1970).

<sup>55</sup> Securities Act of 1933, § 13, 15 U.S.C. § 77m (1982).

<sup>56</sup> N.J. STAT. ANN. §§ 49:3-64, -69 (West 1970).

<sup>57</sup> A-3377, 201st Leg. 2d Sess. (1985), introduced Mar. 7, 1985, amended Jun. 20, 1985. The June amendments made some significant changes to the original bill. The discussion of A-3377 pertains to the bill as amended.

<sup>58</sup> *Id.*, §§ 5-6, 9.

quite different.

Bill A-3377, like the Paterniti bill, deleted the registration exemptions for federally registered and federally exempt securities.<sup>59</sup> The Aduato bill, however, expanded the existing exemption for New York Stock Exchange (NYSE) and American Stock Exchange (AMEX) securities to include National Market System securities as designated by the National Association of Securities Dealers, Inc. (NASD).<sup>60</sup> This "blue chip" exemption, as it is commonly known, was not limited to securities listed or approved for listing.<sup>61</sup> Any security meeting the standards for listing on the NYSE or AMEX, or eligible for national market system designation would be exempt.<sup>62</sup> In addition, certain mutual funds and unit investment trusts would be exempted.<sup>63</sup>

The most controversial provision of A-3377 involved a grant of power to the Securities Bureau to review the substantive features of a proposed offering.<sup>64</sup> This "merit-review" feature allowed an offering to be stopped if it would be unfair to purchasers or if the financial condition of the issuer would have a significant adverse effect on the offering.<sup>65</sup> Thus, this bill would have allowed some of the investment decisions of the public to be made by the Securities Bureau. Merit review would have allowed the Bureau to stop an offering or restructure it to meet the Bureau's standards of fairness.<sup>66</sup> In addition, the Bureau could stop an offering if the issuer or other persons involved in the offering had prior securities law violations.<sup>67</sup> These provisions would add to the Bureau's existing powers to stop an offering which: would work as a fraud; would involve unreasonable underwriters' and

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<sup>59</sup> *Id.*, § 3.

<sup>60</sup> *Id.*, § 2.

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> The ability of a securities bureau to review the substantive features of an offering is commonly known as "merit review." For discussions of merit review, see generally Bloomenthal, *Blue Sky Regulation and the Theory of Overkill*, 15 WAYNE L. REV. 1447 (1969); Makens, *Who Speaks For The Investor? An Evaluation Of The Assault On Merit Review*, 13 U. BALT. L. REV. 435 (1984); Sargent, *The Challenge To Merit Regulation—Part I*, 12 SEC. REG. L.J. 276 (1984); Sargent, *The Challenge To Merit Regulation—Part II*, 12 SEC. REG. L.J. 367 (1985).

<sup>65</sup> A-3377, *supra* note 57, § 4.

<sup>66</sup> See *supra* note 64.

<sup>67</sup> A-3377, *supra* note 57, § 4.

sellers' commissions; or would involve unreasonable promoter's profits or participation.<sup>68</sup>

Not surprisingly, the merit review provisions were opposed by various groups, such as the Securities Industry Association (SIA),<sup>69</sup> NASD,<sup>70</sup> the American Bar Association,<sup>71</sup> members of the investment banking community<sup>72</sup> and practicing attorneys.<sup>73</sup> In September 1985, a compromise amendment was proposed to limit merit review to stocks offered for under five dollars per share.<sup>74</sup> The amendment would have allowed pre-offering judgment by the Bureau, but would have narrowed the subjective discretionary power to low-priced penny stocks. Thus, the Bureau's power would have been limited to offerings identified as those involving most of the abuse.<sup>75</sup> However, this proposed amendment was rejected.<sup>76</sup>

The Adubato bill received Assembly support and was passed by that house in September 1985. The bill, however, did not receive the support of the New Jersey Senate because of the merit review provisions. The Senate, in response, turned its attention to the original Russo bill, S-2715.

#### D. Amendments to the Russo Bill

To strengthen the Russo bill with protective provisions similar to the proposals made in the Assembly bills, the Senate Committee made various amendments to S-2715 in October

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<sup>68</sup> N.J. STAT. ANN. § 49:3-64(a) (West 1970).

<sup>69</sup> *Hearing, supra* note 31, at 82-96 (testimony of William J. Fitzpatrick, Senior Vice President and General Counsel of SIA); Fitzpatrick, *New Jersey Blue Sky Law*, 115 N.J.L.J. 601 (May 23, 1985); Cohen, *Brokers Back Some Reform But Oppose Sweeping New Powers*, *The Star-Ledger* (Newark, NJ), Jun. 19, 1985 at 14; Cohen, *Securities Industry Steps Up Lobbying Against Investment Reform Bill*, *The Star-Ledger* (Newark, NJ), Aug. 18, 1985, at 7.

<sup>70</sup> *Hearing, supra* note 31, at 45-60 (testimony of Frank J. Wilson, *supra* note 36), 58-63 (testimony of John Pinto, *supra* note 37).

<sup>71</sup> Cohen, *Brokers Back Some Reform, supra* note 69.

<sup>72</sup> *Id.*

<sup>73</sup> *Hearing, supra* note 31, at 96-101 (testimony of Joseph Krassy, Esq., of Krassy & Heller); letter from William F. Campbell III, Esq., of Dillon, Bitar & Luther to Senator Russo (Nov. 4, 1985); Cohen, *Brokers Back Some Reform, supra* note 69.

<sup>74</sup> Cohen, *Tougher Securities Law Advances As Dems Reject GOP Revisions*, *The Star-Ledger* (Newark, NJ), Sep. 10, 1985, at 17.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

1985.<sup>77</sup>This new version retained certain features of the original S-2715, such as changing the statute of limitations to two years after discovery, increasing the civil and criminal fines and penalties and establishing an enforcement fund.<sup>78</sup>

The October amendments provided for some significant changes. Exemptions for federally registered or federally exempt securities were deleted.<sup>79</sup> On the other hand, the exemptions were expanded to include certain mutual funds and National Market System securities listed on the National Association of Securities Dealer's Automated Quotation System (NASDAQ).<sup>80</sup> Unlike the Aduabato bill, the blue chip exemption only applied to securities listed or approved for listing.<sup>81</sup>

The amendments provided for a quasi merit review. They included a list of factors that a court could consider in determining whether an act or omission would operate as a fraud.<sup>82</sup> These factors included: whether insiders received unreasonable amounts of stock at unreasonably low prices; whether officers or underwriters received unreasonable amounts of warrants; and whether the stock had voting rights.<sup>83</sup> There was also a catch-all clause that included any other facts a court deemed appropriate to consider.<sup>84</sup>

By adding this list of considerations, the amendments would allow for a judicially limited, merit-type review. While the Bureau could not stop an offering on its own, it would have the opportunity to prove to a court that the offering would work as a fraud, aided by the enumerated factors.<sup>85</sup> If there was sufficient evi-

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<sup>77</sup> S-2715, 201st Leg. 2d Sess. (1985), as amended by the Senate Committee amendments, Oct. 17, 1985.

<sup>78</sup> *Id.*

<sup>79</sup> *Id.*, § 6.

<sup>80</sup> *Id.*, § 3.

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*, § 4.

<sup>83</sup> *Id.* Other factors were: whether the offering price does not reasonably represent the value of the enterprise; whether the promoters invest any cash or tangible assets; and whether the issuer has specified the assets to be purchased, projects to be undertaken or the business to be conducted with at least 65% of the proceeds.  
*Id.*

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*

dence, a stop order or injunction could be issued.<sup>86</sup> Thus, in an attempt to prevent arbitrary or unjustified refusals by government bureaucrats, the discretion to stop offerings would be left to the courts.<sup>87</sup>

These "non-fraud" fraud factors do not necessarily constitute traditional fraud known in securities law.<sup>88</sup> The bill as passed did not retain these factors. If it had, the entire concept of securities fraud would have been changed. Moreover, this would have exposed legitimate transactions to delays from prosecution because of statutory fraud.<sup>89</sup> Examples of "non-fraud" fraud include the issuance of common stock with no voting power<sup>90</sup> and issuance of large amounts of options for employees and officers.<sup>91</sup>

Consistent with the "non-fraud" factors, the scienter requirement was deleted from the definition of fraud, as it was in

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<sup>86</sup> The bureau may stop an offering if it is unlawful or fraudulent. N.J. STAT. ANN. §§ 49:3-64, -69 (West 1970).

<sup>87</sup> Correspondence between Senator John F. Russo and the author (Apr. 16, 1986, May 28, 1986); telephone interview with Thomas Lindenfeld, Executive Assistant to Senate President, (April 18, 1986) [hereinafter cited as "Correspondence and telephone interview"].

<sup>88</sup> Securities law has generally required scienter for an action to be considered a fraud. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

<sup>89</sup> While the Bureau might not be successful in its prosecution or proceedings for stop orders, the statutory authority the Bureau possesses to seek stop orders can delay an offering and add to the costs of the offering. See N.J. STAT. ANN. §§ 49:3-64, -69 (West 1970) (providing the Bureau with stop order and injunctive remedies).

<sup>90</sup> Brown-Forman, maker of Jack Daniels and Southern Comfort, has nonvoting common stock; New York Times and American Greetings, maker of American Greeting Cards, have limited voting common stock. See Standard & Poors ASE Stock Reports 7385, 8680 (1985); Standard & Poors OTC Stock Reports 3095 (1985). Prior to its recapitalization, which was the source of the controversy in *Honigman v. Green Giant Co.*, Green Giant had forty-four shares of class A voting common stock and 428,988 shares of class B nonvoting common stock outstanding. 208 F. Supp. 754 (D. Minn. 1961), *aff'd*, 309 F.2d 667 (8th Cir. 1962), *cert. denied*, 372 U.S. 941 (1963).

<sup>91</sup> Upstart companies sometimes offer their officers and employees stock options as a form of compensation. Due to the lack of capital and poor cash flow, new, developing companies often do not have the funds to pay employees salaries which are competitive with the rest of the industry. In order to attract talented business managers, these companies offer their officers and employees large amounts of options to compensate for low salaries. Companies which have done this include Apple Computer (personal computers), Cullinet (computer software), and People Express (airline). See Stickney, *Starting Out With a Start-Up*, MONEY, Jun. 1984 at 86-90.

the Paterniti bill.<sup>92</sup> Unlike that bill, however, S-2715 left the plaintiff with the burden of proving scienter in a civil action.<sup>93</sup> The amendments also contained "bad boy" provisions similar to A-3377 which allowed the Bureau to stop an offering if the issuer or any one closely involved in the offering had prior convictions involving violations of securities, banking, insurance laws or fraud.<sup>94</sup>

The amendments also changed the original provisions for prospectus delivery. Rather than allowing a ten-day rescission period, the amendments made it unlawful to violate the 1933 Act's prospectus delivery requirements.<sup>95</sup> Another important amendment was the formation of a Securities Regulatory Study Commission to investigate the securities industry and practice in New Jersey.<sup>96</sup> There was also an amendment that would have allowed the Securities Bureau to hire outside attorneys or counsel to aid in the Bureau's legal matters.<sup>97</sup> This final amendment, however, was not adopted in the Securities Reform Act.

### *III. The Securities Law Reform and Protection Act of 1985*

On December 5, 1985, the Senate committee adopted its final amendments to S-2715. The bill was approved by both houses on December 9, 1985, and was signed into law on January 9, 1986.<sup>98</sup> While the bill retained some of the original provisions and October amendments, there were some significant changes prior to passage.

The Act grants none of the merit review powers proposed in the prior bills. The merit review provision of the Uniform Law which allowed the Bureau to deny offerings involving unreasonable amounts of compensation for underwriters and sellers or pro-

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<sup>92</sup> S-2715, Oct. amendments, *supra* note 77, § 2.

<sup>93</sup> *Id.*, § 14.

<sup>94</sup> *Id.*, § 10.

<sup>95</sup> *Id.*, § 4. The 1933 Act requires a prospectus meeting the 1933 Act's provisions to be delivered to a purchaser prior to or concurrent with the security. Securities Act of 1933, § 5, 15 U.S.C. § 77e (1982).

<sup>96</sup> S-2715, Oct. amendments, *supra* note 77, § 16. This was kept in the final version.

<sup>97</sup> *Id.*, § 11. No branch of New Jersey government can hire outside attorneys or counsel. N.J. STAT. ANN. § 52:17A-11 (West 1986).

<sup>98</sup> 1985 N.J. Laws 405 (codified at N.J. STAT. ANN. §§ 49:3-48 to -76).

moter's participation was deleted.<sup>99</sup> Furthermore, the existing provision in New Jersey's Uniform Law which allowed the Bureau to stop an offering which would work as a fraud was deleted.<sup>100</sup> In addition, the scienter requirement was retained in the definition of fraud.<sup>101</sup>

These changes indicate that the Legislature did not intend the Securities Bureau to have the subjective power to review offerings.<sup>102</sup> The provisions which formerly provided the Bureau with some discretion were limited to intrastate offerings, the only offerings which previously required registration in New Jersey. If these changes had not been made, the Bureau's review power would have covered a much broader range of offerings due to the change in the registration requirements, which are discussed below.<sup>103</sup> Thus, the Act allows all registrations that are properly registered to be offered, including intrastate offerings. In addition, the Act repealed the Real Estate Syndication Offering Law.<sup>104</sup> Thus, such offerings are now governed by the amended Uniform Law.

The Act empowers the Bureau to deny registration when persons involved in an offering have histories of certain types of violations.<sup>105</sup> The Bureau may revoke or deny registration if the issuer, any insiders, broker-dealers or other person directly or indirectly involved in the offering have convictions of specified laws.<sup>106</sup> The disqualifying offenses are convictions of embezzlement or any crime involving theft, forgery or fraudulent practices pertaining to securities, banking, insurance, commodities trading

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<sup>99</sup> *Id.*, § 10 (codified at N.J. STAT. ANN. § 49:3-64).

<sup>100</sup> *Id.*

<sup>101</sup> N.J. STAT. ANN. § 49:3-49(e) (West Supp. 1985).

<sup>102</sup> Correspondence and telephone interview, *supra* note 87.

<sup>103</sup> *See infra*, text accompanying notes 132-35.

<sup>104</sup> 1985 N.J. Laws 405, § 22.

<sup>105</sup> *Id.*, § 10 (codified at N.J. STAT. ANN. § 49:3-64); *see infra*, text accompanying note 107.

The definition of person includes an individual, a corporation, a partnership, an association, a joint-stock company, a trust where the interests of the beneficiaries are evidenced by a security, an unincorporated organization and a government unit. N.J. STAT. ANN. § 49:3-49(i) (West Supp. 1985).

<sup>106</sup> 1985 N.J. Laws 405, § 10 (codified at N.J. STAT. ANN. § 49:3-64). The insiders that the Act covers are partners, officers or directors of the issuer or any person occupying a similar status or performing similar functions or any person directly or indirectly controlling or controlled by the issuer. *Id.*

or anti-fraud laws.<sup>107</sup>

The Act retains the changes in the statute of limitations for civil actions proposed in all of the other bills. Thus, the statute of limitations under the Uniform Law is now two years from the time a plaintiff knew or should have known of the cause of action rather than from the contract date.<sup>108</sup> Under New Jersey law, the time when a plaintiff should have discovered a cause of action is judged by a standard of reasonable diligence and intelligence.<sup>109</sup>

The Act amended the Uniform Law by making it unlawful for any person to violate the prospectus delivery requirements of the 1933 Act.<sup>110</sup> Unlike the original S-2715, an express remedy is not provided for a purchaser. Any private cause of action must therefore be implied by the courts. A plaintiff will have a rescission action under the 1933 Act for violation of prospectus delivery requirements, but that right has a one-year limit as opposed to the two-year limit under New Jersey law.<sup>111</sup>

A plaintiff will have a difficult task convincing a court to imply such a private action. New Jersey's securities laws preserve the rights and remedies existing at law or equity, *but* do not provide for new private actions unless specified in the statutes.<sup>112</sup> This language has been held to prevent courts from implying private rights not expressly provided for by the statute.<sup>113</sup> Courts in other jurisdictions having blue sky provisions similar to New Jersey have also refused to imply a private action.<sup>114</sup> Thus, a plaintiff must overcome the language of the statute and the ad-

<sup>107</sup> *Id.* The laws can be state, federal or foreign laws. *Id.*

<sup>108</sup> *Id.*, § 14 (codified at N.J. STAT. ANN. § 49:3-71(e)).

<sup>109</sup> See *Royal Indemnity Co. v. Petrozzino*, 598 F.2d 816 (3d Cir. 1979); *O'Keeffe v. Snyder*, 83 N.J. 478, 416 A.2d 862 (1980); *Lopez v. Swyer*, 62 N.J. 267, 300 A.2d 563 (1973); *Hyland v. Kirkman*, 157 N.J. Super. 565, 385 A.2d 284 (1978). New Jersey's discovery approach was also adopted in the 1985 Uniform Act, although New Jersey's is more liberal. The 1985 Uniform Act's limitation is one year after discovery, but limited to three years after the event. UNIF. SEC. ACT. (1985) § 606, 7B U.L.A. 44 (Supp. 1986).

<sup>110</sup> 1985 N.J. Laws 405, § 4 (codified at N.J. STAT. ANN. § 49:3-52(d)).

<sup>111</sup> Securities Act of 1933, §§ 12-13, 15 U.S.C. §§ 771-77m (1982); see *supra* note 108 and accompanying text.

<sup>112</sup> N.J. STAT. ANN. § 49:3-71(h) (West 1970).

<sup>113</sup> See *In re Catanella and E.F. Hutton & Comp., Inc.*, 583 F. Supp. 1388 (E.D. Pa. 1984) (interpreting New Jersey blue sky law).

<sup>114</sup> *IDS Progressive Fund Inc. v. First of Michigan*, 533 F.2d 340 (6th Cir. 1976) (interpreting Michigan blue sky law); *Philbosian v. First Financial Securities Corp.*, 550 F. Supp. 61 (D. Colo. 1982) (interpreting Colorado blue sky law); *Hagert v.*

verse case law to convince a court to imply a private action. The fact that an express cause of action was originally considered but subsequently deleted adds weight to an argument that the creation of such a right was specifically rejected by the Legislature.<sup>115</sup>

A plaintiff may have a private action implied for violation of prospectus delivery requirements, however. New Jersey blue sky law preserves all rights and remedies existing at law or equity.<sup>116</sup> The official comment to the 1956 Uniform Securities Act states that the limiting provision provides no assurance that other civil liabilities will not be implied.<sup>117</sup> The foregoing "but" clause was designed to prevent the development of private actions under the 1956 Uniform Act's section 101 anti-fraud provisions.<sup>118</sup> The prospectus delivery requirement is not an anti-fraud provision that the "but" clause<sup>119</sup> was attempting to limit. The purpose of the prospectus delivery requirement is to protect purchasers of securities from investing without sufficient information about the issuer. Thus, a court may imply a private right to further the protection contemplated by the Legislature. In addition, a private action may be implied for a violation of a statute if the plaintiff is a member of the class the statute attempts to protect.<sup>120</sup> This was contemplated in the 1956 Uniform Act's official comment.<sup>121</sup> New York, for example, has implied private actions for violation of its blue sky laws.<sup>122</sup>

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Glickman, Lurie, Eiger & Co., 520 F. Supp. 1028 (D. Minn. 1981) (interpreting Minnesota blue sky law).

<sup>115</sup> See *supra* text accompanying note 41.

<sup>116</sup> N.J. STAT. ANN. § 49:3-71(h) (West 1970).

<sup>117</sup> UNIF. SEC. ACT (1956) § 410(h) official comment, 7B U.L.A. 644-45 (1985).

<sup>118</sup> *Id.* See also LOSS, COMMENTARY ON THE UNIFORM SECURITY ACT 151 (1976).

<sup>119</sup> N.J. STAT. ANN. § 49:3-71(h) (West 1970).

<sup>120</sup> See Restatement (Second) of Torts §§ 286-88 (1965). For New Jersey cases, see *Galvin v. Jennings*, 289 F.2d 15 (3d Cir. 1961); *Faces, Inc. v. Kennedy*, 185 N.J. Super. 113, 447 A.2d 592 (1981); *Csaranko v. Robilt, Inc.* 93 N.J. Super. 428, 226 A.2d 43 (1967).

<sup>121</sup> UNIF. SEC. ACT (1956) § 410(h) official comment, 7B U.L.A. 644-45 (1985).

<sup>122</sup> See *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112 (S.D.N.Y. 1974), *modified*, 540 F.2d 27 (2d Cir. 1976) (modified on other grounds); *American Bank & Trust Co. v. Barad Shaff Securities Corp.*, 335 F. Supp. 1276 (S.D.N.Y. 1972). While New Jersey courts are not bound by decisions of other jurisdictions, they do look to the other jurisdictions for aid in interpretation. See *GATX Terminals Corp. v. New Jersey Department of Environmental Protection*, 86 N.J. 46, 429 A. 2d 355 (1981); *In re Estate of Anne Boyd Lichtenstein*, 52 N.J. 553, 247 A.2d 320 (1968).

An area that was not changed by the Act is the regulation of investment adviser's compensation. In New Jersey, it is unlawful for an investment adviser to be compensated on the basis of the performance of the adviser's recommendations or the assets under management.<sup>123</sup> New Jersey's definition of an investment adviser includes any one who, for compensation, advises others about investing in, purchasing or selling securities.<sup>124</sup>

To illustrate, based upon the activities and the structure of a venture capital limited partnership, the general partners may be considered investment advisers under the New Jersey definition.<sup>125</sup> A venture capital limited partnership is one that usually has general partners investing the money of wealthy investors.<sup>126</sup> Venture capital enterprises usually invest in small, upstart companies and attempt to develop them into profitable organizations.<sup>127</sup> In return for their efforts, the general partners usually will receive a percentage of the partnership's profit.<sup>128</sup> General partners so compensated may be committing a criminal offense in New Jersey.<sup>129</sup>

The venture capital market provides a valuable source of capital for small companies unable to raise capital in other manners.<sup>130</sup> The regulation of adviser's compensation has a chilling

<sup>123</sup> N.J. STAT. ANN. § 49:3-53(b) (West 1970). The Investment Advisers Act of 1940 also prohibits such compensation, but only for those who are required to register. Investment Advisers Act of 1940 § 205, 15 U.S.C. § 80b-5 (1982). The SEC has recently granted an exemption for advisers managing wealthy investors. 50 Fed. Reg. 48,556 (1985) (to be codified at 17 C.F.R. § 275.205-3).

<sup>124</sup> N.J. STAT. ANN. § 49:3-49(g) (West Supp. 1985).

<sup>125</sup> In *Abrahamson v. Fleschner*, 568 F.2d 862 (2d Cir. 1977), *cert. denied*, 436 U.S. 913 (1978), the Second Circuit ruled that a partner in a venture capital limited partnership is an investment adviser under the Investment Advisers Act of 1940. The Investment Advisers Act's definition of an investment adviser is very similar to New Jersey's definition, thus a similar holding can be expected under New Jersey law. See Investment Advisers Act of 1940 § 202, 15 U.S.C. § 80b-2 (1982); *supra* text accompanying note 124.

<sup>126</sup> See generally J. DOWNES & J. GOODMAN, *BARON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS* (1985); J. WILSON, *THE NEW VENTURES: INSIDE THE HIGH-STAKES WORLD OF VENTURE CAPITAL* (1985); *VENTURE MAGAZINE*; Gupta & Rimmer, *Venture-Capital Partnership Offer A Chance To Cash In—And Big Risk*, *Wall Street Journal*, Mar. 5, 1986, at 21.

<sup>127</sup> See *supra*, note 126.

<sup>128</sup> See *supra*, note 126.

<sup>129</sup> N.J. STAT. ANN. § 49:3-53(b) (West 1970).

<sup>130</sup> See, e.g., A. SMITH, *VENTURE CAPITAL, THE COMPLETE GUIDE FOR INVESTORS* (1985); J. WILSON, *THE NEW VENTURES*, *supra* note 126; *HOW TO RAISE VENTURE*

effect in New Jersey and forces small upstart companies to seek capital investors outside of the state.<sup>131</sup>

#### A. Exemptions From Registration

The Act deletes the exemption formerly enjoyed by all issuers registered under the 1933 Act.<sup>132</sup> In addition, securities exempt from federal registration under sections 3(a) and 3(b) of the 1933 Act must now register in New Jersey.<sup>133</sup> Under prior law, limited offerings under section 3(b) of the 1933 Act were exempt.<sup>134</sup> The Act retains the exemption for transactions exempt under section 4 of the 1933 Act, which includes private placement exemptions.<sup>135</sup>

The Act, however, expands some of the existing exemptions. The purpose of the new exemptions is to eliminate the registration requirement for securities or issuers who are not the sources of penny stock abuse and who are large enough so that public information is readily available.<sup>136</sup> Furthermore, the new exemptions apply to issuers who are regulated or monitored in addition to 1933 Act registration.

The first new exemption is for securities designated or approved for designation as National Market System Securities on NASDAQ.<sup>137</sup> To qualify as a national market system security,

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CAPITAL (S. Pratt ed. 1982); R. ROBINSON, *Small Business and the Money and Capital Markets*, in *THE VITAL MAJORITY, SMALL BUSINESS IN THE AMERICAN ECONOMY* 39 (D. Carson ed. 1973); VENTURE MAGAZINE; Kelly, *Venture Capital: Engine of Growth and Innovation*, *BUS. AMER.*, Feb. 4, 1985 at 23.

<sup>131</sup> Letter from William F. Campbell to Senator Russo, *supra* note 73. New York requires investment advisers to register, but does not regulate their compensation. See N.Y. Gen. Bus. Law § 359eee (McKinney 1984 & Supp. 1986).

<sup>132</sup> 1985 N.J. Laws 405, § 6 (amending N.J. STAT. ANN. § 49:3-60). Many of the exemptions under § 3(a) of the 1933 Act are also exempt from New Jersey registration as exempt securities. N.J. STAT. ANN. § 49:3-50 (West Supp. 1985). See *supra* note 48.

Section 3(b) of the 1933 Act grants an exemption for limited offerings. 15 U.S.C. § 77c (1982). Limited offerings are small public offerings not exceeding \$5 million. The limited offering exemption was made to ease the burden of capital formation for small businesses. See R. JENNINGS & H. MARSH, *SECURITIES REGULATIONS, CASES AND MATERIALS* 259 (5th ed. 1982).

<sup>133</sup> See *supra* note 132.

<sup>134</sup> N.J. STAT. ANN. § 49:3-60 (West 1970) (amended by 1985 N.J. Laws 405, § 6).

<sup>135</sup> 1985 N.J. Laws 405, § 6 (amending N.J. STAT. ANN. § 49:3-60).

<sup>136</sup> Correspondence and telephone interview, *supra* note 87.

<sup>137</sup> 1985 N.J. Laws 405, § 3 (codified at N.J. STAT. ANN. § 49:3-50).

Rule 11Aa2-1(b) under the 1934 Act requires the issuer to be sufficiently large with widely held shares and sufficient trading volume.<sup>138</sup> In addition, NASD sets up a plan which requires SEC approval before a security is designated as a national market security.<sup>139</sup> The designation plan includes maintenance criteria which the issuer must meet to retain the national market designation.<sup>140</sup>

Another exemption involves open-end management investment companies (mutual funds) and unit investment trusts (UIT).<sup>141</sup> To be eligible for the exemption, the mutual fund or UIT must be registered under the Investment Company Act of 1940<sup>142</sup> and meet one of two criteria.<sup>143</sup> The first criterion requires that the issuer be managed by a depository institution exempt from registration under the Investment Advisers Act of 1940<sup>144</sup> or by an investment adviser registered under that Act.<sup>145</sup> If an investment adviser is involved, this adviser must have managed registered funds or UITs for three consecutive years before the offering.<sup>146</sup> The second criterion exempts issuers with a principal sponsor who, at all times during the three years preceding the offering, was the principal sponsor of registered mutual funds or UITs with aggregate assets exceeding \$100 million.<sup>147</sup>

The criteria that the mutual funds and UITs must meet are fairly stringent and require the fund to be managed by a person experienced in the field. The Legislature believed that issuers meeting these requirements were not the ones responsible for penny stock abuse in New Jersey.<sup>148</sup> Rather, the smaller funds were believed to be the source of fraud.<sup>149</sup>

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<sup>138</sup> 17 C.F.R. § 240.11Aa2-1 (1984).

<sup>139</sup> *Id.*

<sup>140</sup> *Id.*

<sup>141</sup> 1985 N.J. Laws 405, § 3 (codified at N.J. STAT. ANN. § 49:3-50).

<sup>142</sup> 15 U.S.C. §§ 80a-1 to -64 (1982).

<sup>143</sup> 1985 N.J. Laws 405, § 3 (codified at N.J. STAT. ANN. § 49:3-50).

<sup>144</sup> 15 U.S.C. §§ 80b-1 to -21 (1982).

<sup>145</sup> 1985 N.J. Laws 405, § 3 (codified at N.J. STAT. ANN. § 49:3-50).

<sup>146</sup> *Id.*

<sup>147</sup> *Id.*

<sup>148</sup> Correspondence and telephone interview, *supra* note 87.

<sup>149</sup> *Id.*

### B. *Registration of Securities*

A perceived cause of penny stock abuse in New Jersey of prime concern to the Legislature was the ability to sell securities in the state without the Securities Bureau's knowledge of the offering.<sup>150</sup> This situation was caused by the extensive registration exemptions. To provide a mechanism for monitoring securities sold in New Jersey, the Legislature decided to increase the types of securities subject to registration.<sup>151</sup> Since 1967, the only securities requiring registration in New Jersey were intrastate and real estate syndication offerings.

The only form of registration prior to the Act was registration by qualification.<sup>152</sup> This time-consuming process requires fairly detailed disclosure. If all filings required registration by qualification, the increased registration resulting from the changes in exemptions<sup>153</sup> would impose a heavy burden upon the Securities Bureau. Likewise, issuers registered under the 1933 Act could be duplicating their efforts when complying with both the New Jersey and federal requirements.

To lighten the Bureau's work load and simplify the registration process, the Act adds two additional types of registration: coordination and notification.<sup>154</sup> Both of these are analogous to provisions of the 1956 Uniform Act.<sup>155</sup> The stop order provisions, as amended by the Securities Reform Act, apply to all three types of registration.<sup>156</sup>

Registration by coordination is available for all offerings registered under the 1933 Act.<sup>157</sup> The issuer must file a consent to service of process, as well as the federal prospectus and all amendments with the Securities Bureau.<sup>158</sup> The registration becomes effective simultaneously with the federal registration, provided the following conditions are met: no stop order is in effect; the registration statement has been on file for the specified pe-

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<sup>150</sup> See *supra* text accompanying note 35.

<sup>151</sup> 1985 N.J. Laws 405, § 6 (amending N.J. STAT. ANN. § 49:3-60).

<sup>152</sup> See N.J. STAT. ANN. § 49:3-61 (West 1970).

<sup>153</sup> See *supra* text accompanying notes 132-35.

<sup>154</sup> 1985 N.J. Laws 405, §§ 7-8 (codified at N.J. STAT. ANN. §§ 49:3-61.1 to -61.2).

<sup>155</sup> UNIF. SEC. ACT (1956) §§ 302-03, 7B U.L.A. 555-60 (1985).

<sup>156</sup> See N.J. STAT. ANN. § 49:3-64 (West 1970) (amended by 1985 N.J. Laws 405, § 10).

<sup>157</sup> 1985 N.J. Laws 405, § 7 (codified at N.J. STAT. ANN. § 49:3-61.1).

<sup>158</sup> *Id.*

riod; and the amendments containing the maximum and minimum offering prices and underwriting compensation have been on file for two days.<sup>159</sup> In addition, the registrant must promptly notify the Bureau of the effectiveness of the federal registration and file a post-effective price-amendment.<sup>160</sup>

The registrant does not have to seek affirmative clearance from the Bureau, although it should consider whether circumstances may prevent automatic effectiveness under section 7(c) of the Securities Reform Act.<sup>161</sup> Likewise, the Securities Bureau is saved the burden of granting clearance.<sup>162</sup> Failure to meet all of the required conditions prior to the effectiveness of the federal registration, however, renders the New Jersey registration ineffective.<sup>163</sup> Furthermore, if the registrant fails to promptly notify the Bureau of the effective federal registration and file the post-effective price amendment, the registration can be suspended or, moreover, declared retroactively ineffective.<sup>164</sup> Any sales during a period when the registration statement is not effective entitles all purchasers to rescission.<sup>165</sup> The New Jersey registration need not become effective simultaneously with the federal registration, however, if the registrant does not plan to sell the public offering immediately in New Jersey.<sup>166</sup> A later effective date is allowed, as long as the offering in New Jersey is part of the same offering covered by the federal registration.<sup>167</sup>

Registration by notification is available to issuers meeting specified tests.<sup>168</sup> Since the procedures are less complex than registration by qualification, it is the preferred registration method. While registration by notification is also available for issuers registered under the 1933 Act,<sup>169</sup> federally registered securities will

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<sup>159</sup> *Id.*

<sup>160</sup> *Id.*

<sup>161</sup> See LOSS, COMMENTARY ON THE UNIFORM SECURITIES ACT 55 (1976).

<sup>162</sup> *Id.*

<sup>163</sup> 1985 N.J. Laws 405, § 7 (codified at N.J. STAT. ANN. § 49:3-61.1)

<sup>164</sup> *Id.*

<sup>165</sup> N.J. STAT. ANN. § 49:3-71(a) (West 1970) (amended by 1985 N.J. Laws 405, § 14).

<sup>166</sup> See UNIF. SEC. ACT (1956) § 303(a) official comment, 7B U.L.A. 560 (1985); LOSS, COMMENTARY ON THE UNIFORM SECURITIES ACT 47-48 (1976).

<sup>167</sup> *Supra* note 166.

<sup>168</sup> 1985 N.J. Laws 405, § 8 (codified at N.J. STAT. ANN. § 49:3-61.2). See *infra* text accompanying notes 170-71.

<sup>169</sup> 1985 N.J. Laws 405, § 8 (codified at N.J. STAT. ANN. § 49:3-61.2)

normally forego this procedure due to the availability of the less complex coordination method.

To be eligible for registration by notification, the issuer or its predecessors must have been in continuous operation for five years.<sup>170</sup> Furthermore, the issuer must not be in default on any fixed payments during the current or preceding three fiscal years, and it must meet specified earnings levels during the past three fiscal years.<sup>171</sup> The registration statement must contain a declaration indicating the registrant's eligibility for registration by notification.<sup>172</sup> In addition, if any part of the offer is on behalf of a non-issuer distributor, the name and address of that person, along with the amount and purpose of the offering must be disclosed.<sup>173</sup>

The Act does not contain a provision similar to the 1956 or 1985 Uniform Acts which expressly allows the Bureau to stop an offering because an ineligible issuer is seeking registration by notification.<sup>174</sup> This should not pose any problems for the Bureau, however. A stop order may be issued if a registration statement is materially incomplete.<sup>175</sup> Any issuer seeking but not eligible for registration by notification may only register by coordination or qualification. Therefore, unless the registrant has complied with the requirements for registration by coordination or qualification, the registration would be materially incomplete and subject to a stop order.

The Act also requires filing for offerings that are exempt from New Jersey registration due to a federal exemption,<sup>176</sup> primarily private placements. The issuer must file a report of the offering within thirty days after completion of the offering.<sup>177</sup> This filing is not a registration and, thus, is not a prerequisite for issuance.

An alternative that would provide the Bureau with knowl-

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<sup>170</sup> *Id.*

<sup>171</sup> *Id.*

<sup>172</sup> *Id.*

<sup>173</sup> *Id.*

<sup>174</sup> UNIF. SEC. ACT (1956) § 306, 7B U.L.A. 575 (1985); UNIF. SEC. ACT (1985) § 306, 7B U.L.A. 34 (Supp. 1986).

<sup>175</sup> N.J. STAT. ANN. § 49:3-64 (West 1970) (amended by 1985 N.J. Laws 405, § 10).

<sup>176</sup> 1985 N.J. Laws 405, § 6 (codified at N.J. STAT. ANN. § 49:3-60).

<sup>177</sup> *Id.* A \$250 filing fee is required.

edge of offerings would be to enforce the Bureau's statutory authority to require the filing of all prospectuses, sales literature and similar materials for securities being sold in New Jersey.<sup>178</sup> In *Data Access Systems, Inc. v. State*, the New Jersey Supreme Court held that the Bureau may require the filings even for exempt securities; the Bureau is limited only in that such filings are not prerequisites for offerings that do not require New Jersey registration.<sup>179</sup> A less burdensome method of monitoring is therefore available, although it does not provide the revenues of registration fees.<sup>180</sup>

The Act does not have any transition rules for securities issued after the Act's effective date of April 9, 1986.<sup>181</sup> The Securities Bureau, however, has promulgated transition procedures for securities issued in New Jersey subsequent to April 8, 1986.<sup>182</sup> Under the Bureau's procedures, all offerings effectively registered with the SEC before April 9, 1986 need not be registered in New Jersey.<sup>183</sup>

Similarly, shelf registrations which are effectively registered with the SEC prior to April 9, 1986 do not need New Jersey registration for securities sold in the state pursuant to that registration.<sup>184</sup> However, the Bureau has taken quite a different stand on shelf registrations filed after the Securities Reform Act's effective date. For shelf registrations effective with the SEC after April 8, 1986, the Bureau will require separate New Jersey registration for each offering.<sup>185</sup> This negates part of the purpose of a shelf registration.<sup>186</sup> However, the Bureau will allow the same prospec-

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<sup>178</sup> N.J. STAT. ANN. § 49:3-63 (West 1970).

<sup>179</sup> 63 N.J. 158, 167-68, 305 A.2d 427, 432-33 (1973).

<sup>180</sup> The Act increased the filing fees from 1/10 of 1% with a \$50 minimum and \$1,000 maximum to \$1,000. 1985 N.J. Laws 405, § 9 (codified at N.J. STAT. ANN. § 49:3-62).

<sup>181</sup> 1985 N.J. Laws 405, § 23.

<sup>182</sup> Notice of Transition Procedures Under New Jersey Amended Securities Law, issued by New Jersey Securities Bureau, Mar. 24, 1986 [hereinafter cited as Transition Procedures]. The Securities Bureau may adopt rules and orders necessary to carry out the provision of New Jersey's securities law. N.J. STAT. ANN. § 49:3-67 (West 1970).

<sup>183</sup> Transition Procedures, *supra* note 182.

<sup>184</sup> *Id.* Shelf registrations are one time registrations which cover offerings made on a delayed or continuous basis in the future. See 17 C.F.R. § 230.415 (1985).

<sup>185</sup> Transition Procedures, *supra* note 182.

<sup>186</sup> The purpose of shelf registrations is to provide flexible, speedy and less expensive offerings and to help an organization obtain funds at the lowest possible

tus to cover subsequent offerings, provided there are no material changes after the initial registration that would make the prospectus inaccurate.<sup>187</sup>

The Bureau's procedures state that offerings which are not exempt in New Jersey after April 8, 1986 will require registration.<sup>188</sup> Thus, any non-exempt securities offered subsequent to the Act's effective date will require registration, notwithstanding the fact that the offering may have commenced prior to April 9, 1986. This particularly affects limited offerings which are no longer exempt in New Jersey due to changes made by the Securities Reform Act.<sup>189</sup>

### C. *Enforcement*

One of the major reasons for securities abuses in New Jersey is the lack of Securities Bureau resources available for enforcement.<sup>190</sup> To address this problem, the Act creates a Securities Enforcement Fund.<sup>191</sup> This fund is revolving and non-lapsing, and will receive all fees and fines collected by the Bureau.<sup>192</sup> The fund will be used to build up the resources of the Bureau to aid in its efforts to investigate possible violations and enforce New Jersey's securities laws.<sup>193</sup> This fund is especially important in light of the SEC's recent policy which delegates more fraud investigation and enforcement to state agencies.<sup>194</sup>

This funding provision, more than any other, may help provide New Jersey investors with the protection sought by the Legislature. The Bureau has always had the power to prosecute any

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cost. See Supplementary Information to Rule 415, SEC Securities Act Release No. 33-6499, 48 Fed. Reg. 52,889 (1983); Harmon, *Rule 415 and the Changing Market Place*, 14 INST. ON SEC. REG. 51 (1983).

With filing fees increased to \$1,000, New Jersey shelf registrations may become an expensive form of financing if many periodic offerings are going to be made. The additional filing costs will reduce some of the benefits gained by shelf registrations.

<sup>187</sup> Transition Procedures, *supra* note 182.

<sup>188</sup> *Id.*

<sup>189</sup> See *supra* notes 132-34 and accompanying text.

<sup>190</sup> See *supra* text accompanying note 34.

<sup>191</sup> 1985 N.J. Laws 405, § 15 (codified at N.J. STAT. ANN. § 49:3-66.1).

<sup>192</sup> *Id.*

<sup>193</sup> *Id.*

<sup>194</sup> Cohen, *SEC Urges More State Zeal on Stock Scams*, The Star-Ledger (Newark, NJ) Mar. 6, 1986 at 13.

fraudulent act involving a security.<sup>195</sup> In addition, the Bureau already had the power to revoke or suspend the registration of a broker-dealer or investment adviser who was considered unethical or dishonest.<sup>196</sup> The Bureau had considerable leeway in making such a determination.<sup>197</sup> The Bureau did not have, however, the funding or resources available to carry out investigations to enforce these provisions.<sup>198</sup> The designation of all money collected by the Bureau into the Enforcement Fund, the increase in fees and penalties and the additional revenue created by the increased registration requirements should significantly bolster the Bureau's resources. The Legislature must be watchful, however, to ensure that excessive amounts of the increased revenues are not used simply to process the appreciated volume of registration statements that will be filed with the Bureau.

As previously mentioned, the Act empowers the Bureau to stop an offering involving issuers or persons closely involved in the offering who have histories of violations.<sup>199</sup> In addition, the Act allows the Bureau to bar any person with prior convictions from being a partner, director or officer of an issuer, or occupying a similar status or performing a similar function.<sup>200</sup> The Bureau may also bar a person with prior convictions from directly or indirectly controlling the issuer, being under common control with the issuer or being controlled by the issuer.<sup>201</sup> Furthermore, the Act allows the Bureau to prohibit a person with prior convictions from being a broker-dealer, agent or investment adviser in New Jersey.<sup>202</sup> These convictions are the same as those which may deny an issuer registration; embezzlement or theft, forgery or fraud under securities, banking, insurance, commodities trading or anti-fraud laws.<sup>203</sup>

The Bureau already had the power to deny, suspend or re-

<sup>195</sup> N.J. STAT. ANN. §§ 49:3-52, -68, -69 (West 1970).

<sup>196</sup> *Id.* § 49:3-58.

<sup>197</sup> *See Higgins v. New Jersey Securities Bureau*, 100 N.J. Super. 266, 241 A.2d 660 (1968).

<sup>198</sup> *See supra* text accompanying note 34.

<sup>199</sup> *See supra* text accompanying notes 105-07.

<sup>200</sup> 1985 N.J. Laws 405, § 11 (codified at N.J. STAT. ANN. § 49:3-56(d)).

<sup>201</sup> *Id.*

<sup>202</sup> *Id.* The Act requires the Bureau to provide a hearing prior to prohibiting a person from being involved in New Jersey's securities industry. *Id.*

<sup>203</sup> *Id.* These laws can be state, federal or foreign laws. *Id.*

voke the registration of a broker-dealer, investment adviser or persons closely associated with one.<sup>204</sup> The reasons for these sanctions include conviction for securities violations, bad character and engagement in dishonest securities practices.<sup>205</sup> Some case law appears to give the bureau wide discretion in determining character and allows consideration of various types of prior convictions.<sup>206</sup> One might argue that by explicitly listing the types of convictions for which a person may be barred, the Bureau's discretion is thereby limited. The new provisions regarding broker-dealers, agents and advisers,<sup>207</sup> however, appear to provide the Bureau with further grounds for denial of a broker's or adviser's registration. Support for this lies in the Act's overall purpose to prevent securities abuse and strengthen the Securities Bureau.<sup>208</sup> In addition, the provisions in prior law that provided the Bureau with discretion were not changed in any manner.

The Act increases the fines and penalties for violation of its provisions. Willfull violations have been upgraded from misdemeanors to third degree crimes.<sup>209</sup> The fines for violations have increased from a \$200 to a \$10,000 maximum for the first offense and from a \$500 maximum to a \$20,000 maximum for the second offense.<sup>210</sup> The penalty for all subsequent offenses has been raised from \$500 to \$20,000.<sup>211</sup>

Another important provision of the Act is the establishment of a Securities Regulation Study Commission.<sup>212</sup> This fifteen

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<sup>204</sup> See *supra* text accompanying notes 196-97.

<sup>205</sup> N.J. STAT. ANN. § 49:3-58 (West 1970).

<sup>206</sup> Higgins, 100 N.J. Super. 266, 241 A.2d 660 (1968).

<sup>207</sup> See *supra* text accompanying notes 202-03.

<sup>208</sup> See Correspondence and telephone interview, *supra* note 87; Cohen, *Tough Rules Approved On Penny Stock Firms*, The Star-Ledger (Newark, NJ), Dec. 10, 1985 at 1, 52; Cohen, *Governor Will Sign Bill To Crack Down On Shady "Penny Stock" Promoters*, The Star-Ledger (Newark, NJ), Jan. 9, 1986, at 26.

The real effect of the new provision seems to be the finality of a Bureau decision to deny an applicant a broker-dealer license. The new provisions under the Act appear to give the Bureau the absolute power to prohibit the licensing of a broker-dealer convicted of one of the offenses stated in the Act. Under the existing provisions, an applicant could challenge the Bureau's denial, although this challenge could be difficult to sustain. See N.J. STAT. ANN. 49:3-58 (West 1970); Higgins, 100 N.J. Super. 266, 241 A.2d 660 (1968).

<sup>209</sup> 1985 N.J. Laws 405, § 13 (codified at N.J. STAT. ANN. § 49:3-70).

<sup>210</sup> *Id.*

<sup>211</sup> *Id.*

<sup>212</sup> *Id.*, § 16.

member commission will inquire into current practices and abuses in the securities industry in New Jersey; examine methods of enforcing securities laws effectively; and review the recently promulgated 1985 Uniform Securities Act.<sup>213</sup>

The creation of the Commission should aid the Legislature in regulating the technical area of securities laws. The Securities Reform Act makes many changes in the Uniform Law that will have significant impact on the New Jersey Securities Bureau, as well as issuers, underwriters, broker-dealers and others involved in securities. The ramifications on New Jersey's securities industry are difficult to predict. The Commission should be able to examine the Act's effects and determine any further legislation that is needed.

### *VIII. Conclusion*

With the Securities Reform Act, the New Jersey Legislature set out to provide better protection for the investing public. To accomplish this, the Legislature included several provisions in the Act to prevent the fraud existing in the New Jersey penny stock market.

The Act's registration requirements provide a solution to the Bureau's inability to monitor the securities being sold in the state. A less burdensome manner could have been to require the filing of all offering literature and prospectuses with a filing fee instead of requiring a formal registration. The time and effort which is needed to process registrations deprives the Bureau of resources that could be used for investigation and enforcement. The registration process may not be overly burdensome if most of the registrations are by coordination, however. Accordingly, the Study Commission should examine whether the full registration process is as beneficial as the Legislature intended.

The Act may be best remembered for the provision it did not contain—merit review. This author believes that the exclusion of that provision was a wise decision by the Legislature. Investment decisions are best left to a fully informed public. Moreover, since new offerings comprise only a very small portion of securities trading, merit review would have addressed only a small portion of securities fraud.

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<sup>213</sup> *Id.*, § 17.

Overall, the Act should aid in the protection of New Jersey investors. The Act provides the Bureau with some powerful tools. The ability to prevent prior offenders from being involved with the securities market should reduce the presence of repeated offenders in New Jersey. At the same time, the business of honest, reputable issuer and brokers will be unaffected. The effectiveness of this provision, of course, will lie in its enforcement.

The Legislature recognized that the key to any law's success is enforcement. The most powerful laws provide little benefit to the public if there is insufficient enforcement. The Enforcement Fund should help provide the Bureau with resources that are needed to protect New Jersey investors. While penny stock fraud can never be eliminated, nor controlled overnight, it can be curtailed in time, but only with strong enforcement efforts and effective use of the Bureau's funds.

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