State of New Jersey
OFFICE OF ADMINISTRATIVE LAW

ORDER – PARTIAL

SUMMARY DECISION

OAL DKT. NO. BOS 1796-02

IN THE MATTER OF:

CLEARING SERVICES OF AMERICA, INC.
JEFFREY P. CAHN,
ESTATE OF LOUIS R. MERCALDO,
RACHEL E. NEUFELD,
WILLIAM SCHANTZ, and
GERARD SHERLOCK.

Donald J. Mehan, Jr., Esq., member of the Missouri Bar, admitted *pro hac vice,* appearing for Clearing Services of America, Inc. (Moline, Shostak & Mehan, LLC, attorneys). Attorney of Record: **Richard C. Szuch,** Esq. (Lowenstein Sandler, attorneys)

Jeffrey P. Cahn, *pro se*

Michael N. Onufrak, Esq., appearing for Louis R. Mercaldo, William Schantz and Gerard Sherlock (White & Williams, LLP, attorneys)

Rachel E. Neufeld, *pro se*

John P. Miscione, Deputy Attorney General, appearing for New Jersey Bureau of Securities (Peter C. Harvey, Attorney General of New Jersey, attorney)

BEFORE **STEPHEN G. WEISS**, ALJ:

STATEMENT OF THE CASE AND PROCEDURAL HISTORY

This matter was transmitted to the Office of Administrative Law (OAL) by the Bureau of Securities (Bureau) as a contested case in February 2002. In it, the Bureau alleges that respondent Clearing Services of America, Inc. and the individual respondents, had engaged in conduct violative of *N.J.S.A.* 49:3-47 *et seq.*; to wit, soliciting, offering and selling certain promissory notes which were unregistered. Sanctions including civil monetary penalties and revocation of registrations were sought. The administrative complaint subsequently was amended and that amendment was transmitted to the OAL on September 3, 2002.

Several counts were set forth in the amended administrative complaint essentially as follows: (a) respondents directly or indirectly solicited the purchase of, offered for sale or sold unregistered securities in violation of § 60 of the Securities Law; (b) respondents did not solicit the purchase, offer to sell or sell the promissory notes through Clearing Services, Inc., the broker dealer through whom they were licensed in New Jersey, therefore violating § 56 of the Law; (c) respondents failed to provide necessary information to purchasers and potential purchasers regarding the financial condition, *etc.* of the issuers, or made misleading statements or omitted certain information regarding the same; (d) respondents Clearing Services, Inc. and Jeffrey Cahn violated § 58A of the Law in that they knew or should have known of the aforesaid violations but failed to take timely or sufficient action with respect to the same thereby failing reasonably to supervise; (e) Clearing Services, Inc., as broker dealer of the individual respondents, was secondarily liable for their violations; and (f) respondents Cahn and Clearing Services, Inc. failed to cooperate with the Bureau with respect to its investigation of the circumstances in violation of *N.J.A.C.* 13:47A-14.16(b).

Following transmittal to the OAL the Bureau moved for partial summary decision on "liability" and oral argument was conducted before the undersigned Administrative

Law Judge in connection with the motion. Briefs and certifications both in support of and in opposition to the motion were filed. In its brief in support of its motion for partial summary decision, the Bureau set forth facts which it asserted, and which I agree, were not materially in dispute. They are substantially set forth in full below (citations to appendices and certifications omitted):

1. Beginning in 1998 and continuing into 1999, certain persons identified herein, from or within New Jersey, either (a) effected or (b) assisted in effecting or (c) induced others to effect or to assist in effecting, the offer and sale of more than one million dollars ($1,000,000) of promissory notes issued and guaranteed by the entities listed below:

Issuer	Guarantor
American Capital Corporation	Star Insurance Co.
Caffe Diva Group Limited	New England Surety International, Inc.
Corlogic Corporation	New England Surety International, Inc.
Digizap Technologies, Inc.	New England Surety International, Inc.
Millennium 2000, Inc.	Global Insurance Company, Ltd.
Pacific Air Transport	New England Surety International, Inc.
Sun Broadcasting Systems, Inc.	Global Insurance Company, Ltd.
World Vision Entertainment, Inc.	Star Insurance Co.

One of the persons, Gerard Sherlock, was also involved during 1998 in the offer and sale of "Equipment Management Agreements" issued by Alliance Leasing Corporation.

2. The principal of the promissory notes became due and payable nine months from the date of their issuance and each bore interest which could be paid monthly as the purchaser might elect at above-market rates.

3. The promissory notes were not registered with the Bureau.

4. Some of the issuers paid interest and principal as each became due on the first promissory notes issued. Ultimately, however, all of the issuers failed to pay at least some of the interest and all of the principal on the promissory notes.

5. The guarantors also failed to make good on their guarantees, with the result that the purchasers suffered significant losses.

6. The persons identified in paragraph one, however, were fully compensated for their efforts in furtherance of the sale of the promissory notes, pursuant to the terms of their agreements with the issuers. Their compensation was a percentage of the amount invested which greatly exceeded such percentage paid on the sale of notes of larger, better-known issuers. For example, 13 percent of the gross investment would be paid on the initial sale of American Capital Corporation, and 11 percent on renewals.

7. The persons referred to in paragraph one were either officers, shareholders, employees or independent contractors of Senior Financial Services, LLC, a limited liability company organized under the laws of the State of New Jersey with offices at Barclay Pavilion West, Suite 207, Route 70 East, Cherry Hill, New Jersey 08032.

8. Senior Financial was owned to the extent of at least 50 percent by respondent William R. Schantz, and to the extent of at least 25 percent by respondent Gerard V. Sherlock, who were Senior Financial's president and vice-president, respectively.

9. The persons referred to in paragraph one (sometimes hereinafter Respondent-Agents) and the approximate amount of promissory notes each had a role in selling are:

Jay Eric Chanin[1]	21 notes totaling	$ 511,953
Louis R. Mercaldo	3 notes totaling	135,000
Rachel E. Neufeld	4 notes totaling	73,000
William R. Schantz	7 notes totaling	369,917
Gerard V. Sherlock	6 notes totaling	222,469
		$1,312,339

10. Senior Financial described itself as a loose association of independent individuals who marketed financial products, including insurance, with each individual sharing product information and various overhead expenses.

11. At all pertinent times, the individuals described in paragraph nine were registered with the New Jersey Department of Insurance and licensed to sell insurance products.

12. Each individual affiliated with Senior Financial marketed to his or her own clients and, in the case of most non-insurance products – specifically including the promissory notes – received the entire commission resulting from a sale. Senior Financial disclaimed having any direction or control – and, therefore, responsibility – for the marketing techniques or representation of the individuals affiliated with the firm.

13. In or about December 1998 and January 1999, Schantz and Sherlock, together with Chanin, went to Florida and met with the principals of Millennium 2000, Inc., Sun Broadcasting Systems, Inc. and World Vision Entertainment, Inc. Also in or about December 1998 and January 1999, Schantz and Sherlock, together with Chanin, went to Costa Rica and met with Clifford Lees, who was introduced to them as president of two of the entities which guaranteed the promissory notes, Global Insurance Company, Ltd. and Star Insurance Co.

[1] Chanin did not file an Answer and no case involving his activities has been transmitted to OAL for a decision as to him. See, letter of March 25, 2002, from DAG Miscione. However, to the extent his activities involved other respondents, he is mentioned herein.

14. Despite Senior Financial's disclaimer of responsibility, in March 1999, Sherlock, in a memo to all "agents and representatives" of Senior Financial, advised that the firm would no longer support the sale or solicitation of promissory notes owing to negative publicity and that the firm would no longer process any notes.

15. Sherlock's memo implied that it would be imprudent for "agents and representatives" to solicit or sell promissory notes independent of Senior Financial.

16. Despite Sherlock's advice, Chanin and Neufeld continued to solicit the purchase and assist in effecting the purchase of the promissory notes, with Chanin attending to the processing of the notes, having set up a mailing address different from Senior Financial's for this purpose. Further, in April 1999, Schantz was offered the opportunity to market the promissory notes of American Capital Corporation by its president, Clifford Lees, the same person who had introduced Schantz, Sherlock and Chanin in Costa Rica as president of the guarantors Global Insurance Company, Ltd. and Star Insurance. As a consequence of Lees' offer, by October 1999, Chanin, Mercaldo, Schantz and Sherlock had induced purchasers of $1.2 million of promissory notes to assign them to an affiliate of American Capital in anticipation of the issuance of a like amount of American Capital promissory notes. Although Schantz, Chanin and Lees communicated with each other through at least December 1999, the American Capital promissory notes were never issued.

17. The Respondent-Agents were registered with the Bureau as agents of Clearing Services, a broker-dealer registered with the Bureau with offices at 77 Westport Plaza, Suite 263, St. Louis, Missouri 63146.

18. Clearing Services was Respondent-Agents' broker-dealer throughout the period the promissory notes were offered and sold, except for Neufeld who began her association with Clearing Services in August 1999, having been an agent of First Investors Corp., from December 1995 until July 1999. As of July 1999, Clearing

Services had more than 200 registered representatives, 42 of whom were registered with the New Jersey Bureau of Securities as agents, but Clearing Services maintained no branch offices in New Jersey.

19. The Respondent-Agents did not, however, effect the sale of the promissory notes through Clearing Services, nor did they apprise Clearing Services of their the sale of the promissory notes.

20. Respondent-Agents earned commissions from transactions they carried out through Clearing Services as follows:

Agent	1998	1999	2000	Agent Total
Sherlock	$2,219	$31,589	$5,050	$38,858
Schantz	3,692	7,692	2,117	13,501
Chanin	2,518	4,136	13,199	19,853
Neufeld	0	916	6,204	7,120
Mercaldo	0	198	85	113
Yearly Total	**$8,429**	**$44,531**	**$26,485**	**$79,445**

21. At all pertinent times, Jeffrey P. Cahn, Clearing Services' Director of Compliance, was the person charged with responsibility for, among other things, supervising Respondent-Agents to insure their compliance with securities laws, regulations and practices as prescribed by the jurisdictions in which they conducted business and by self-regulatory organizations in the securities industry.

22. Respondent-Agents Chanin and Neufeld did not tell prospective purchasers that the promissory notes were subject to regulations as securities by the states, the federal government or any self-regulatory organization in the securities industry, nor did Respondent-Agents Mercaldo, Schantz and Sherlock broach the status of the notes as securities with prospective purchasers. Neither Clearing Services, Respondent-Agents' broker-dealer, nor Cahn, Clearing Services' Director of Compliance, knew whether or not the Respondent-Agents told

prospective purchasers that the promissory notes were subject to such regulation as securities.

23. Respondent-Agents Chanin and Neufeld, in effecting or assisting in effecting the sale of the promissory notes, did not disclose or sufficiently disclose or otherwise materially misstated, the following information:

(a) the intended uses of the proceeds of the promissory notes;

(b) the nature and extent of any risks associated with those uses;

(c) the financial statements of the issuers of the promissory notes;

(d) the history, financial condition, access to capital, operating results and outlook for the businesses the issuers engaged in;

(e) the ability of the issuers to pay interest and to repay the principal at maturity;

(f) the fact that the notes were securities;

(g) the fact that the notes were guaranteed; and

(h) the ability of the guarantors to pay interest or repay principal in the event the issuers were to default.

24. Respondent-Agents Mercaldo, Schantz and Sherlock discussed with prospective purchasers only Item (b) – the nature and extent of any risks associated with the intended uses of the proceeds of the promissory notes – as to which they told each investor that there was minimal risk since the notes were guaranteed. With regard to Items (f) and (h), Respondent-Agents Mercaldo, Schantz and Sherlock relied on their "beliefs" that the notes were not securities and that the guarantors could honor their guarantees.

25 With respect to the remaining five Items – (a), (c), (d), (e) and (f) – Respondent-Agents Mercaldo, Schantz and Sherlock relied on such information as was

contained in the marketing literature and in copies of the guarantees given to purchasers.

26. Neither Clearing Services, their broker-dealer, nor Cahn, the Director of Compliance, knew whether or not Chanin and Neufeld or any of the other Respondent-Agents disclosed, sufficiently disclosed or otherwise materially misstated the above information.

27. Respondent-Agents also used written materials in effecting or assisting in effecting the sale of the promissory notes. Respondent-Agents Mercaldo, Schantz & Sherlock relied entirely on those written materials – marketing materials and the guarantees – to inform prospective purchasers with respect to:

    (a) the intended uses of the proceeds of the promissory notes;

    (c) the financial statements of the issuers of the promissory notes;

    (d) the history, financial condition, access to capital, operating results and outlook for the businesses the issuers engaged in;

    (e) the ability of the issuers to pay interest and to repay the principal at maturity; and

    (f) the fact that the notes were guaranteed.

28. Neither Respondent-Agents' broker-dealer nor the broker-dealer's Director of Compliance knew whether or not Respondent-Agents used written materials.

29. The written materials did not disclose, did not sufficiently disclose or otherwise materially misstated, among other things, the information listed in paragraph 23, above. For example, certain of the written materials intended to convey that the promissory notes were not subject to regulation as securities. As a specific illustration, the Beneficiary Designation Form of Millennium 2100, Corporation read: "These notes are 'Commercial Notes' under exempt security status."

30. The marketing materials and guarantees Respondent-Agents Mercaldo, Schantz and Sherlock relied upon did not disclose, did not sufficiently disclose or otherwise materially misstated the information necessary for a prospective purchaser to make an informed decision on whether or not to invest in the notes.

31. Neither Clearing Services nor Cahn knew what the materials contained.

32. The information in question was material to an investor's decision to accept or reject an offer to sell the promissory notes.

33. Clearing Services maintained a Compliance and Supervision Manual (sometimes hereinafter Manual) acknowledging its affirmative obligation as a broker-dealer to supervise the activities of its associated persons and to insure compliance with the rules and regulation of, among others, the states in which its associated persons conduct business.

34. The Manual, in accordance with the rules of the National Association of Securities Dealers (NASD) provided that no agent could be employed by or accept compensation from any person other than Clearing Services, as a result of any business activity unless Clearing Services gave its prior written approval.

35. To insure compliance, the Manual also required agents, upon employment, to execute a document indicating their understanding of this prohibition, and to periodically declare in writing the existence, nature and extent of all such activity.

36. To guard against agents declaring falsely, the Manual further required that at least annually, a meeting or interview be held with each agent, who then was required to sign a statement confirming his or her attendance at such meeting.

37. Respondent Cahn denied this requirement "upon information and belief," and Clearing Services denied having sufficient information to form a belief as to this portion of its own Manual.

38. Clearing Services implemented the requirement that Respondent-Agents make periodic declarations of outside activities during the period they sold the promissory notes by having obtained a Registered Representative Compliance Agreement and an Outside Business Activity Notification Form from each as follows:

(a) **Mercaldo**, December 29, 1998, showing no outside activity.

This was contradicted by Mercaldo's having sold a note of Millennium 2000, Inc., in December 1998, in the amount of $30,000. Shortly thereafter Mercaldo sold two more notes, one in January and one February 1999.

(b) **Chanin,** March 30, 1999, showing no outside activity.

This was contradicted by Chanin's having sold six notes from November 1998 through March 29, 1999, the day before he executed the form.

(c) **Schantz,** March 30, 1999, showing 70 percent of his time devoted to the activities of Charitable Concepts, Inc., of which he is shown to be a 60 percent owner and from which outside activity he is shown to be receiving $100,000 annually.

This was contradicted by Schantz' having sold seven notes from November 1998 through January 1999.

(d) **Sherlock**, March 30, 1999, showing 70 percent of this time devoted to the activities of Charitable Concepts, Inc., of which he is shown to be a 40 percent owner and from which outside activity he is shown to be receiving $80,000 annually.

This was contracted by Sherlock's having sold five notes from November 1998 through March 1999.

(e) **Neufeld,** July 30, 1999, showing no outside activity.

This was contradicted by Neufeld's having been involved with Chanin in the sale of 17 notes from November 1998 through June 1999, the month before she executed the form.

(g) **Chanin**, June 5, 2000, showing 65 percent of his time devoted to the activities of Senior Financial Services, Inc., which outside activity is shown to have begun in July 1998, and from which activity he is shown to be receiving $45,000 to $50,000 annually.

This is contradicted by Chanin's First Outside Business Activity Notification Form in relation to which Cahn and Clearing Services either overlooked or ignored the obvious and significant inconsistency between the two declarations.

39. There was not substantial compliance by Cahn or Clearing Services with the firm's requirement of an annual meeting or interview with each agent, to be documented by the agent's signing a statement except, arguably, in the case of Chanin.

40. Chanin appears to have been sent, and to have completed and returned in November 1998, a Compliance Evaluation form, three months after becoming a Clearing Services agent. According to the "information and belief" of Clearing Services' current vice-president for compliance – Chanin participated in a compliance interview via telephone on March 15, 1999.

41. In the case of telephone interviews, however, the requirement of Manual §12.7 that "[t]he registered representative . . . sign a statement evidencing attendance at such [interview]" was not adhered to, Cahn asserting that ". . . a separate written statement was not necessary, because [he] made the appropriate notations on [his] computer system."

42. The only other Respondent-Agent to have completed and returned a Compliance Evaluation form was Sherlock in November 1998, months after having become a Clearing Services agent.

43. The only other Respondent-Agent to have participated in a compliance interview via telephone – also according to the "information and belief" of the current vice-president for compliance – was Mercaldo who is also said to have done so in March 1999, one month after having become an agent of the firm. Again, the requirement of Manual §12.7 was not adhered to, based upon Cahn's assertion that ". . . [it] was not necessary . . . ."

44. No other Respondent-Agent completed a Non-Registered Branch Office Examination Checklist such as that evidencing the conference between Cahn and Chanin in June 2000.

45. Thus, the firm's requirement of an annual meeting or interview was not met as to Neufeld during the more than six months she was a Clearing Services agent, nor as to Schantz during the more than 19 months that he was. Nor was it met as to Mercaldo or Sherlock after their first times, during the 17 months (March 1999 to September 2000) and the 14 months (December 1998 to February 2000), respectively, that each continued to be a Clearing Services agent.

46. Moreover, Cahn and Clearing Services took little or incomplete, and ultimately ineffective, action on receiving at least four indications that Respondent-Agents might be engaging in outside activities as follows:

(a) The first indication that Respondent-Agents might be engaging in outside activities occurred in the summer of 1999 when Clearing Services received advice from First Investors, the broker-dealer with whom Neufeld had been affiliated immediately prior to her association with Clearing Services, that she may have been involved with Chanin in the sale of promissory notes.

(b) In fact, beginning in November 1998, Chanin and Neufeld had collaborated in selling 16 promissory notes of four issuers in the face amount of $397,000.

(c) On receiving First Investors' advice, Clearing Services through Cahn, its Director of Compliance, made inquiry of Chanin and Neufeld by telephone and was assured that ". . . such was not the case . . ." and that their actions were "unintentional." Cahn questioned Chanin and Neufeld further, after which he issued Letters of Caution to each of them directing them to cease and desist from any future sales.

(d) Responding to Cahn's call, Chanin deliberately faxed him material regarding only four of the 18 persons to whom he and Neufeld had sold notes, in an effort to deceive Cahn regarding the number of sales.

(e) Cahn and Clearing Services did nothing to independently validate what they were told by Chanin and Neufeld, taking their word that their actions were unintentional, isolated incidents and not subject to being repeated.

(f) Despite issuance of the Letters of Caution, Neufeld thereafter, while still an agent of Clearing Services, sold promissory notes on at least four more occasions at Chanin's direction.

(g) Further, despite Cahn's admonition in the Letters of Caution that he ". . . fully expect[ed] . . . you, to comply with the policies and procedures of Clearing Services . . . ." Cahn and Clearing Services took no action to determine whether any of the other three Respondent-Agents the firm had at Senior Financial – to whose offices Chanin's and Neufeld's Letters of Caution were addressed – may have been involved in the same or similar activity when in fact each of them had been so engaged, some of them since August 1998. Nor did Cahn or Clearing Services take any such action with respect to the firm's other 42 agents registered in New Jersey, including Respondent-Agents except Neufeld, in July 1999.

(h) Respondent-Agents were so engaged at that very moment with the result that, by October 1999, Mercaldo, Schantz and Sherlock as well as Chanin had induced purchasers of $1.2 million of promissory notes, to assign them to an affiliate of American Capital in anticipation of the issuance of a like amount of American Capital promissory notes.

47. The second indication that Clearing Services' agents at Senior Financial might have engaged in outside activities was given in February 2000, when NASD wrote Clearing Services regarding Sherlock's sales of "Equipment Management Agreements" issued by Alliance Leasing Corporation in August and September 1998.

48. Cahn on behalf of Clearing Services responded to the NASD by denying prior knowledge of Sherlock's activities and advising that Sherlock had been discharged based on his having confirmed the NASD's information.

49. Once again, on receiving advice of possible outside activity by Respondent-Agents at Senior Financial – from a second source regarding a third individual affiliated with the firm – Cahn and Clearing Services took no action to determine whether any of the other Respondent-Agents had been involved in the same or similar activity when, in fact, other Respondent-Agents had.

50. The NASD also elicited the information that Clearing Services had amended its requirement of an annual, on-site meeting with the Respondent-Agents; namely, that there needs to have been a sufficient level of "production" before the firm would make an annual on-site visit to the Respondent-Agents' office.

51. The NASD letter implied that the last such visit occurred in 1997. Cahn on behalf of Clearing Services responded that the next on-site audit was not scheduled until Spring/Summer of 2000, at Senior Financial's then-current production level.

52. Respondent-Agents and Clearing Services earned more than *de minimis* commissions from transactions Respondent-Agents carried out through Clearing Services as their commissions totaled almost $80,000, more than $50,000 of which was earned in 1998 and 1999.

53. Whatever the level of Senior Financial's production may have been, Cahn and Clearing Services, having received a second notice of possible outside activity there, still did not conduct an on-site visit.

54. The third indication that the Respondent-Agents might be engaging in outside activities occurred in April 2000 when Cahn discovered that, despite the direction to her to cease and desist, Neufeld had been involved in the sale of promissory notes in December 1999.

    (a) As a result of that discovery, a telephone conversation took place among Neufeld, Cahn and Neufeld's then-attorney, in which Neufeld told Cahn that all of the Clearing Services agents who were affiliated with Senior Financial had been involved in selling the promissory notes. During, or shortly after, that conversation, Neufeld faxed to Cahn a list of all of her clients who had purchased promissory notes.

    (b) Nevertheless, the firm took no further action, for example, with respect to Chanin – whose complicity with Neufeld had been hinted at in the notice from First Investors and whose association with Clearing Services was not terminated until 2001 – or with respect to the other Respondent-Agents either.

55. A fourth indication that the Respondent-Agents might be engaging in outside activities took the form of Chanin's June 2000 Outside Business Activity Notification Form revealing that he had been involved in outside business activity with Senior Financial; namely, solicitation and sale of life insurance products to the extent of 65 percent of his time since July 1998.

(a) This Notification to Cahn and Clearing Services was, on its face, inconsistent with a prior Notification from Chanin in March 1999 that he was not involved in any outside business activities.

(b) Neither Cahn nor Clearing Services took any action to resolve Chanin's conflicting declarations. Nor did this further indication of outside activity on the part of its agents at Senior Financial prompt Clearing Services or Cahn to make any investigation or inquiry.

56. By letter dated January 11, 2001, addressed to Cahn in his capacity as Clearing Services' Director of Compliance, the Bureau advised it was conducting an investigation into the sale of the promissory notes and, among other things, requested copies of certain documents.

57. Cahn replied by letter of February 5, 2001, enclosing what he described as "responsive documents" and concluding: "It is intended that this correspondence constitute a complete and final response to your letter dated January 11, 2001."

The documents enclosed with Cahn's letter were copies of the following items:

Letters of Caution to Chanin and Neufeld;

Chanin's Registered Representative Compliance Agreement, dated June 2000;

Chanin's Outside Business Activity Notification Form, dated June 2000;

Chanin's Registered Representative Compliance Agreement, dated March 1999;

Chanin's Outside Business Activity Notification Form, dated March 1999;

Chanin's Outside Brokerage Account Notification Form, undated;

Chanin's Acknowledgment of Receipt of the Manual, dated March 1999;

The Singletons' Letter to Cahn of April 2000;

The Singletons' Complaint filed in Camden County Superior Court;

Complaint of Pickering, Richardson, Laurenzi and D'Angelo Sr., filed in Camden County Superior Court.

58. In response to the January 11, 2001 Bureau request for a copy of the Compliance and Supervision Manual, Cahn sent a copy which specified that an on-site review of each branch office be held annually.

59. Despite Cahn's declaration that his February 5, 2001 letter and its enclosures constituted a complete and final response, the copy of the Manual Cahn sent did not contain a July 1998 amendment of the Manual specifying that an on-site inspection of a branch office was to be held annually only in the case of a net payout of at least $50,000.

60. In further response to the January 11, 2001 Bureau request for copies of compliance reviews conducted with each of the individual Respondent-Agents, Cahn sent only forms executed by Chanin but, even in Chanin's case, he omitted the Non-Registered Branch Office Examination form completed when Cahn interviewed Chanin in June 2000. Cahn also omitted the Registered Representative Compliance Agreements and the Outside Business Activity Forms executed by Mercaldo, Neufeld, Schantz and Sherlock, as well as a spreadsheet listing the names of agents and the dates on which he maintained their annual compliance meetings took place.

DISCUSSION

The approach to be taken in determining motions for summary judgment was redefined by the New Jersey Supreme Court in *Brill v. The Guardian Life Insurance Company of America, et al.*, 142 *N.J.* 520 (1995) where the Court elaborated upon the standards established in *Judson v. People's Bank and Trust Co. of Westfield*, 17 *N.J.*

67 (1954). Under the *Brill* standard a motion for summary disposition may be granted only where there are no "genuine disputes" of "material fact." The determination as to whether disputes of material fact exist is made after a "discriminating search" of the record, consisting of affidavits, certifications, documentary exhibits and any other evidence filed by the movant and any such evidence filed in response to the motion, with all reasonable inferences arising from the evidence being accorded to the opponent of the motion.

The facts upon which the party opposing the motion relies to defeat the motion must be something more than, "facts which are immaterial or of an insubstantial nature, a mere scintilla, fanciful, frivolous, gauzy or merely suspicious, . . .," *Judson, supra.* at 75 (citations omitted), and *Brill* focuses upon the analytical procedure for determining whether a purported dispute of material fact is "genuine" or is simply of an "insubstantial nature." *Brill, supra.* at 530. It observes that the same process used to decide motions for a directed verdict is used to resolve summary judgment motions; to wit, whether the evidence presents a sufficient disagreement to require submission to a jury or whether it is so one-sided that a party must prevail as a matter of law. In searching the proffered evidence to determine the motion, a judge must be guided by the applicable substantive evidentiary standard of proof which would apply at trial on the merits, whether there is a preponderance of the evidence or clear and convincing evidence. If a careful review under the pertinent standard establishes that no reasonable fact finder could resolve the disputed facts in favor of the party opposing the motion, then the uncontradicted facts thus established can be examined in the light of the applicable substantive law to determine whether or not the movant is entitled to judgment as a matter of law. However, where the proofs are such that reasonable minds could differ as to the material facts, the motion must be denied and a full evidentiary hearing held. In this case, using that analysis, I agree for reasons which follow that the undisputed facts support entry of a partial summary decision in the Bureau's favor.

N.J.S.A. 49:3-49(m) defines "securities" to include "any note." See also, Securities Act of 1933, 15 *U.S.C.* § 77 B (1) (the federal equivalent) which also includes

notes in the definition of a "security." However, although both the New Jersey and federal statutes include "any note" as a security instrument, they do not define the term "note" itself. In *Tcherepini v. Knight,* 389 *U.S.* 332 (1967), the United States Supreme Court observed that even a casual reading of the Securities Act of 1934 revealed that Congress did not intend to adopt a narrow or restrictive concept of security in defining that term. Rather a broad reading and interpretation was appropriate to address the problems which the legislation clearly sought to remediate. *Ibid.* at p. 338. So too, the New Jersey statutes were designed, in part, to prevent securities fraud by regulating the marketing and sale of securities to the public in such a way as to protect their interest in some reasonable fashion. See, *Cola v. Terzano*, 129 *N.J. Super* 47 (Law Div. 1974); *Stevens v. Liberty Packing Corp.*, 111 *N.J. Eq.* 61 (Ch. 1932). Thus, the phrase "any note" should be read to include promissory notes within the definition of security thereby allowing regulation to help prevent fraud upon the public with respect to transactions involving the same.

Nevertheless, calling a particular instrument a "note" or "promissory note" does not end the inquiry as to whether it also is a "security." It is, rather, the particular characteristics of the instrument which determine whether it should come within the definition. Thus, in *Reves v. Ernst & Young*, 494 *U.S.* 56 (1990), the United States Supreme Court determined that since notes were used in a variety of settings, it would apply a "family resemblance" test to determine whether a note is in fact a security under federal law. Although I have been unable to find a New Jersey decision which adopts the family resemblance test articulated in *Reves*, since New Jersey adopted its definition of security consistent with the definition established by Congress, I believe it is appropriate for me to adopt the family resemblance test as well. (The Nevada Supreme Court took that approach in *Nevada v. Friend*, 40 *P.* 3d 436 (Supreme Court, Nev. 2002)).

The family resemblance analysis provides that the language of the statute establishes a presumption that all notes are securities because they are listed within the definition of a security. However, this presumption can be rebutted by demonstrating

that the note more closely resembles one of a judicially crafted list of categories of instruments that are exempted from the definition of securities. These would include, for example, notes delivered in consumer financing, notes secured by a mortgage, short-term notes occurred by assignment of accounts receivable, *etc.* See, *Exchange Nat. Bank of Chicago v. Touche Ross & Co.,* 544 *F.* 2d 1126 (2d Cir. 1976).

In *Reves* the Supreme Court listed four factors to consider in determining whether an instrument is a note: (1) the motivations of the buyers and sellers; (2) the instrument's plan of distribution; (3) the reasonable expectation of the investors; and (4) the existence of another regulatory scheme or factor that reduces the risk of the instrument. See, *Reves, supra*, 494 *U.S.* at 66.

With respect to the first factor, if the seller's motive for entering into the transaction is to "raise money for the general use of a business enterprise . . . and the buyer is interested primarily in the profit" the instrument likely is a security. *Reves, Ibid.* In the instant case, it appears that the seller's motivation for issuing the notes was to raise money for the general use of a business enterprise since the promotional material for the notes stated that the proceeds were to be used for company operations, corporate acquisitions, retirement of current and long-term corporate debt, *etc.* It appears, as well, that buyers certainly were interested in purchasing the notes because of the expected profits to be received from the high interest rates.

The second factor involves an examination of the way the instrument is to be distributed – a determination as to whether there is a "common trading for speculation or investment." *Reves, supra*, 494 *U.S.* at 66. With respect to this second factor the Supreme Court observed that the offering and selling of notes to a broad segment of the public generally is sufficient to fulfill the "common trading requirement." *Reves, supra*, 494 *U.S.* at 68. In this case, although it is not completely clear whether the factor is fully satisfied since the notes were sold to a relatively small number of investors, this is not dispositive of the second factor analysis. See, *e.g., McNabb v. SEC*, 298 *F* 3d 1126, 1132 (9th Cir. 2002); *Stoiber v. SEC*, 161 *F* 3d 745, 751 (D.C. Cir.

1998). Courts have found that failure to satisfy one of the four factors is not necessarily fatal because the factors are to be considered as a whole. See, *SEC v. Wallenbrock*, 313 *F.* 3d 532 (9th Cir. 2002); *McNabb v. SEC, supra,* 298 *F.* 3d at 1132-33.

The third factor, "reasonable expectation of the investing public," means that the persons investing reasonably believe it to be investment even though an economic analysis of the particular circumstances might suggest otherwise. *Reves, supra*, 494 *U.S.* at 66. In the instant matter, the promotional brochures and literature provided to prospective buyers included the terms "investors" and "investments" and plainly sought to convince persons buying them that they were investing in the company. In short, the issuer clearly viewed the note as an investment and it is more than likely that a prospective buyer would do so as well. See *Reves, supra*, 494 *U.S.* at 69.

The final factor requires an examination of whether there is a regulatory scheme in place that significantly reduces the risk of the instrument, thereby rendering the applications of securities law unnecessary. In this case the notes were not insured by either the government or any governmental agency; rather, they were insured by a private company guarantee set forth on the face of the application form. Thus, a risk of non-payment existed and application of the protection of the securities law clearly was needed in order to deal with the high risks posed by this type of transaction.

Prior to the United States Supreme Court decision in *Reves*, New Jersey had followed the test set forth in *SEC v. W.J. Howe Co.*, 328 *U.S.* 293 (1946) which asks whether the, ". . . scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others," *SEC v. W.J. Howe Co., supra,* 328 *U.S.* at 301. The *Howe* test was expressly adopted by the Law Division in *Matlack v. Bd. of Chosen Freeholders of Co. of Burlington*, 191 *N.J. Super.* 236 (Law Div. 1982). Here, applying the *Howe* test, it would seem that the promissory notes would be considered securities because buyers were investing their funds and notes issued by companies.

However, in light of the decision in *Reves*, there is a question whether New Jersey should adopt *Reves* or continue to follow *Howe*. Arizona has followed this route. See, *McCollum v. Perkinson*, 913 *P.* 2d 1097 (Ariz. App. 1966). On the other hand, Georgia has continued to look to the *Howe* test. See, *Resch v. Georgia*, 579 *S.E.* 2d 817 (Ga. App. 2003).

Regardless of which test is used, it seems clear that the promissory notes sold by the respondents in this case should be considered securities. Indeed, respondents essentially have conceded the same by arguing that liability does not exist because the notes falls within a "commercial paper" exemption. Thus, although it is unlawful to sell unregistered securities, there is an exemption for commercial paper which, ". . . arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which evidence is an obligation to pay cash within 12 months of the date of issuance, exclusive of days of grace, or any renewal of such paper which is likewise limited, or any guarantee of such paper or of any such renewal." *N.J.S.A.* 49:3-50(a)10.

The term "commercial paper" is not defined in the statute. Respondents, therefore, argue for a literal reading. On the other hand, the Bureau argues that the statute should be read as interpreted by the SEC which applies the exemption only to "prime quality" commercial paper sold to "highly sophisticated" investors. Again, I have found no New Jersey case on point with regard to this question.

According to respondents, the exemption has three components: (1) the notes are commercial paper; (2) the notes arose from a current transaction; and (3) the notes evidence an obligation to pay cash within 12 months of their issuance. Thus, respondents maintain these notes clearly fall within the definition of "commercial paper," since they arose from a current transaction, proceeds were to be used for current transactions and they were payable in nine months. Respondents also maintain that the exemption cannot be disregarded under the pretext of pursuing "the spirit of regulatory protective laws" and the SEC interpretation of the exemption is not relevant.

This is a position that one state has taken. See, *New Mexico v. Sheets*, 610 P. 2d 760 (N.M. App. 1980). The Bureau's counter-argument is that since the SEC exemption applies only to "prime quality" commercial paper, it would be absurd to imbue the notes in this case with that quality.

In construing the purpose of legislation a court must consider not only the language of the statute, but also the entire legislative scheme of which it is a part. See *Kimamin v. Henkels & McCoy, Inc.*, 108 *N.J.* 123 (1987); *State v. Wright,* 107 *N.J.* 488 (1987). To determine whether the New Jersey commercial paper exemption is inconsistent with the purposes of the New Jersey Uniform Securities Act it is beneficial to examine the SEC interpretation of the commercial paper exemption since it is substantially similar to New Jersey's own language.

The legislative history of the Securities Act makes clear that § (a)(3) [federal commercial papers exemption] applies only to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper issued to facilitate well recognized types of current operational business requirements and of a type eligible for discounting at Federal Reserve banks. See, SEC Release No. 33-4412, 26 Fed. Reg. 9158 (1961). This view has been adopted both by the 2d and 7th Circuit Courts of Appeal. See, *SEC v. American Bd. of Trade*, 751 *F.* 2d 529 (2nd Cir. 1984) and *Hunsinger v. Rockford Business Credit, Inc.,* 745 *F.* 2d 484 (7th Cir. 1984). No Circuit Court has rejected the SEC's interpretation. See, *In re N.B.W. Commercial Paper Litig. v. Federal Deposit Insurance Corp.,* 813 *F. Supp.* 7 (D.C. 1992). Moreover, several Federal District Courts have held that the commercial paper exemption only applies to prime quality commercial paper. See, *e.g., SEC v. Better Life Club of America*, 995 *F. Supp.* 167 (D.C. 1998); *Ruefenacht v. Holleran,* 737 *F.* 2d 320 (3d Cir. 1984); *UBS Management, Inc. v. Wood Gundy,* 914 *F. Supp.* 66 (SDNY 1996) (quoting from *Sanders v. John Newvin & Co.*, 463 *F.* 2d 1075, 1079 (7th Cir. 1972), cert denied, 409 *U.S.* 1009 (1972). At least two state courts have also confined the exemption to prime quality commercial paper. See, *People v. Dempster*, 242 *N.W.* 2d 381 (Michigan 1976); *Tanner v. State Corp., Comm'n*, 574 *S.E.* 2d 525 (Virginia 2003).

Accordingly, with respect to whether the promissory notes sold or offered to be sold by the individual respondents in this case fall under the exemption, I believe the proper conclusion to be reached is that they do not. In my view, the *Reves* "family resemblance" test set out by the United States Supreme Court in 1990 appropriately replaces the *Howe* test with the four pertinent factors discussed above and seems to me to be a more precise means to pinpoint what is or is not a security.

With regard to whether there is a commercial paper exemption, I believe that there is not. A literal interpretation clearly would frustrate the salutary purposes of the New Jersey Act to prevent fraud by regulating the marketing and sale of securities to the public. The exemption, I believe, must be read to further, not obstruct, those purposes. That appears to be the predicate for the SEC limitation, and I adopt it as well. If commercial paper was not restricted to instruments of "prime quality," then any corporation or any similar entity, regardless of its financial capabilities, arguably could issue promissory notes maturing within 12 months and thereby evade registration and the securities law. Thus, I adopt the SEC interpretation that would apply the exemption only to: (1) "prime quality" commercial paper sold to (2) "highly sophisticated" investors. Since neither element was present in this case, respondents are culpable for their misconduct.

Accordingly, for the reasons set forth herein, partial summary decision in favor of the Bureau is **GRANTED.** Following agency head review I will, if appropriate, schedule hearings with regard to any sanctions.

This order granting partial summary decision is being submitted under *N.J.A.C.* 1:1-12.5(e) for immediate review. This recommended order may be adopted, modified or rejected by **CHIEF OF THE BUREAU OF SECURITIES**, who/which by law is authorized to make the final decision in this matter. If Chief of the Bureau of Securities does not adopt, modify or reject this order within forty-five (45) days and unless such

time limit is otherwise extended, this recommended order shall become a final decision in accordance with *N.J.S.A.* 52:14B-10.

Within thirteen (13) days from the date on which this order was mailed to the parties, any party may file written exceptions with the **CHIEF OF THE BUREAU OF SECURITIES, 153 Halsey Street, 6th Floor, PO Box 47029, Newark, New Jersey 07101**, marked "Attention: Exceptions." A copy of any exceptions must be sent to the judge and to the other parties.

March 15, 2004
DATE

STEPHEN G. WEISS, ALJ

E-mail Receipt of Initial Decision Confirmed by the Bureau of Securities on:

DATE

Mailed to Parties:

DATE

OFFICE OF ADMINISTRATIVE LAW

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