COMMITTEE MEETING

of the

ASSEMBLY BANKING AND INSURANCE COMMITTEE

To conduct a study of the trading of "penny stock" in
the State of New Jersey pursuant to an Assembly Resolution

Held:
February 20, 1985
B.P.U. Hearing Room
1100 Raymond Boulevard
Newark, New Jersey

MEMBERS OF COMMITTEE PRESENT:

Assemblyman Michael F. Adubato, Chairman
Assemblyman Nicholas J. LaRocca
Assemblyman Ralph A. Loveys

ALSO PRESENT:

Spiros J. Caramalis
Office of Legislative Services
Aide, Assembly Banking and Insurance Committee

* * * * * * * * * * *

TABLE OF CONTENTS

TABLE OF CONTENTS (continued)

* * * * * * * * * * *

mjz: 1-37
jb: 38-44
mjz: 45-101

ASSEMBLYMAN MICHAEL F. ADUBATO (Chairman): This is an Assembly Banking and Insurance Committee meeting. We are delighted to be in the first city in the State of New Jersey -- Newark. I ask you all to rise, along with the members of the Committee, to salute the flag. Please join with us. (Committee and audience join in reciting the Pledge of Allegiance) Thank you. By the way, I just realized that big flag is behind us. It's a great flag. I hope General Patton doesn't come out of the wings.

Joining the Committee today is Assemblyman LaRocca, to my left. He is also Chairman of the Assembly Banking and Insurance Subcommittee, which, as you may know, is in the middle of an inquiry about banking situations in our State. Assemblyman Deverin called and, unfortunately, he is not able to be with us today. Assemblyman Loveys is sitting to my right, and Assemblyman Louis Kosco may join us during the course of the meeting. I'm not sure; we haven't heard yet.

The purpose of this meeting is to examine the trading of penny stock in New Jersey and the laws applicable to those stocks, and to make legislative recommendations. This meeting is being held pursuant to an Assembly Resolution sponsored by Assemblyman Stephen Adubato, Jr. and Speaker Alan Karcher. As the resolution states: "It is the public policy of this State to assure that the trading of securities is conducted so as to maintain the highest public confidence." This policy not only gives peace of mind to investors, but also benefits corporations, in that it encourages greater investment in equity securities.

There are a number of questions which need to be answered, and every person who has been invited has been asked to comment on at least these following points:

(1) To briefly summarize New Jersey law and regulations on the issuance of penny stock by start-up penny stock firms, particularly with respect to the requirements for disclosure, and the merit review, or registration, of such stocks.

(2) How adequate are these laws and regulations in protecting the investing public?

(3) How adequate are the regulatory systems of other states in this regard?

(4) What are some of the market creation activities employed by penny stock brokers that you consider -- if you do -- to be detrimental to the investing public?

(5) How adequately do New Jersey laws and regulations deal with such activities?

(6) How are these activities regulated in other jurisdictions?

(7) What sales practices employed by brokers in penny stock offerings do you consider to be detrimental to the investing public?

(8) What investor education program should be adopted regarding penny stock offerings?

Before we hear from our witnesses, I would like to make a few observations concerning the trading of penny stock. Penny stock is the name given to the small new companies which sell shares to the public at prices usually no higher than $5.00. There are small new start-up companies that have proved to be success stories. A few of these companies, such as the Apple Computer Company, have proven very successful. Government regulations should never discourage innovation and productivity, but government should seek to make sure that the hype and the manipulation are not mistaken for innovation and productivity. Government should also have as its objectives to suppress fraud, to ensure the fear allocation of risk between investors and promoters, and to strengthen investor confidence in capital markets. This, in turn, would benefit the securities industry and would promote economic growth.

These are the stated purposes in the areas which we respectfully ask the witnesses to at least comment on. This does not restrict comment; it does not limit the scope of comment. The Committee, as I said, was brought here as a result of the resolution sponsored by Assemblyman Stephen Adubato and cosponsored by the Speaker, Assemblyman Karcher.

Again, I would like the people in this room not to limit themselves to the outline I gave. We are here, and you are not restricted from speaking about any facet of this that you would like to share with us.

We are going to start off our meeting by asking the sponsor of the resolution, Assemblyman Stephen Adubato, Jr., to be our first witness. Assemblyman Adubato?

ASSEMBLYMAN STEPHEN ADUBATO, JR.: Thank you, Assemblyman Adubato. This could get confusing. First of all, I want to thank the Chairman of the Assembly Banking and Insurance Committee, as well as the other members, for allowing me the opportunity to speak.

Those of us who are here have come to listen and to learn, and to form whatever observations we need to over the 30-day period provided by the Assembly Resolution that the Speaker of the House, Alan Karcher, and I introduced. I believe the things that we hear today will be extremely helpful in letting us move toward whatever solutions -- legislative or otherwise -- we need to embark upon to improve our situation here in the State. It is my contention that you will hear from a series of witnesses today from several different perspectives, from both inside New Jersey and from as far away as Colorado, Washington, and Massachusetts, people who believe that what goes on in New Jersey in the penny stock industry is important, not only in this State, but that it will have ramifications throughout the entire country.

In a way, the penny stock issue is a very deceptive issue. As the Chairman mentioned, when we talk about penny stocks we are referring to stocks which sell for between one penny and $5.00. It is not unusual, in fact, for people to invest thousands of dollars in penny stock ventures. As our parents taught us, pennies add up, and penny stocks are no small matter to people who have lost either part or all of their life savings on a particular penny stock venture.

We are here today to take a long look at the business of penny stocks, from their issue by small companies to their purchase by hopeful investors. As the Chairman said, we are not here to protect investors from the natural and reasonable risks of the marketplace. We are here to look at the ways in which investors can be protected from limited and deceptive information about penny stock issues. We are here today to look at small companies and security dealers which may fall between the cracks of proper, legitimate regulation. We are not

here to indict the entire securities industry and the countless honest brokers and dealers who easily represent the majority of the securities profession.

Finally, we are here today to find out what the State government is doing, and if it is doing the best job possible to protect investors from fraud and manipulation by the penny stock industry. Our aim is to find solutions, if necessary, in the form of new legislation or new initiatives by the State government in New Jersey. Thanks to a recent series of articles by The Newark Star-Ledger, we have all become more aware of the possible abuses in the penny stock market. Those articles detailed a system with apparently weak regulations, ineffective enforcement procedures, and manipulation of stock issues by insiders, and consumers all too susceptible to a financial plunge into a vast unknown.

Frankly, since I introduced the resolution with Speaker Karcher, approximately two weeks ago, calling for a 30-day investigation into the penny stock trading industry, I have been overwhelmed by the complexity and magnitude of this issue. Also, I have received numerous offers from people inside the State of New Jersey and, as I said before, people from far away from the State, to assist in our efforts to improve our State's ability to address the penny stock issue. Today we will hear from people who represent many sides of that question -- officials from the public and private regulatory agencies, state regulators from Colorado and Massachusetts, a former employee of a penny stock company, and investors who lost a significant percentage of their life savings due to fraudulent penny stock practices. Hopefully, we will come away with a better understanding of this issue, along with a sense of direction of where we need to go from here.

Thank you, Mr. Chairman.

ASSEMBLYMAN MICHAEL ADUBATO: Assemblyman Adubato -- this is probably going to get confusing during the course of the day, people addressing both of us. For the record, I will just say that I am the older one. I want to thank you for bringing this to our attention.

Assemblyman, I would appreciate it if you would come up and join us at the Committee table.

As is the protocol with our Committee, we will make an attempt to hear from the citizens who are not representing any specific entity except themselves. We will keep with that tradition by calling the first person to testify, Mr. Kurt Kvist. I hope I am pronouncing your name correctly. Will you please come up to the witness table with your wife, Toni? Mr. Kvist is a victim. Please share your experience with us, Mr. Kvist.

KURT KVIST: I would like to read a brief statement which I have prepared, and will then follow it up with questions, I guess. As stated, my name is Kurt Kvist; I am 29 years old; and, I design and sell residential kitchens for a living.

In September, 1983, I purchased 1,500 shares of Ross Exploration for $2,250 from Korbin Securities in East Brunswick. What motivated me to withdraw over $2,000 and invest in something I never invested in before, and knew little about, was a strong belief that this was a good investment.

While at work, I heard a radio advertisement for Ross Exploration. It said that the company went public last May at ten cents a share, and was now at one dollar and three-eighths. It went on to say that the company just struck a large pool of oil in Adair County, Kentucky, and that it was the first strike for the company. It gave an 800 number for their hot line and an office number. I called and heard very positive things about the company's activities. The ad, the hot line, and the calls to the company inspired me to take the next step and inquire at Korbin Securities.

It was the phone call with Lou Rosen at Korbin that convinced me to actually buy the stock. I was assured that the company was one of rapid growth and that I would make 50% on my investment by January -- in about three months. By November 9, 1983, the stock was traded at five-eights to a dollar. Soon after that, I believe at the end of December, the company had a five for one reversed split. So, instead of having 1,500 shares, I now had 300 shares. It was not until after January that I learned my portfolio value was under $300.

During the decline, the company blamed outside forces on the stock's price. First it was the warrant holders, then getting an

NASDAQ listing. All the time the hot line was telling us about strikes, finds, new companies, and new leases. So, I hung onto the stock. I have a statement here from Korbin Securities, dated June 29, which tells me that I have 300 shares of Ross Exploration at 0.005% of a dollar, whatever that is worth. I gave up and chalked it up as a bad experience until I read The Star-Ledger article on Sunday, January 20. Now I am angry at them. I am amazed at how companies can get away with this, and at the lack of regulations the State has to control the marketing strategies that these companies employ. That is about it.

ASSEMBLYMAN MICHAEL ADUBATO: There is probably nothing we are going to hear today from anyone that will have more of an impact than your statement and your experience. I am glad that you took the time to be here today. It is important that you are here so we can understand. I would like to start off by asking Assemblyman Stephen Adubato if he has any questions.

ASSEMBLYMAN STEPHEN ADUBATO: Thank you, Mr. Chairman. Mr. Kvist, you said you became interested in the company -- Ross Exploration -- through a radio advertisement.

MR. KVIST: That's right.

ASSEMBLYMAN STEPHEN ADUBATO: You described very briefly what that advertisement said. Obviously, you were impressed.

MR. KVIST: Yes, I was.

ASSEMBLYMAN STEPHEN ADUBATO: What else about Ross Exploration impressed you? Maybe impress is not the right word. From the point of view of legitimacy, or perceiving that this particular entity was a legitimate entity, what made you think that?

MR. KVIST: I assumed it was legitimate.

ASSEMBLYMAN STEPHEN ADUBATO: Did you have any experience in the stock market?

MR. KVIST: None whatsoever. I am in residential kitchen design. I design and draft; I know nothing about securities or stocks, or anything like that. I heard about it on the radio and it sounded as if this was a company of growth. I had a few bucks and, you know, what do you do? You put it in a money market, or a CD, or something these days. Well, I figured I was young and maybe I could do something with

this. The ad was very good. The information I got from Korbin was very good. I assumed, you know, ridiculously enough, that everything was legitimate and aboveboard, that this was the way things were done, and that it was okay. They give you this hot line number to call in the ad. I had given up calling, but I called it again last night. They are still saying they are striking this, they got another lease of land, and they hit oil there.

ASSEMBLYMAN STEPHEN ADUBATO: What was the reason they gave you when the stock didn't go up, because at the time that you invested--

MR. KVIST: (interrupting) They blamed what they called a "warrant holder." They had warrants out; there was something going on with warrants.

ASSEMBLYMAN STEPHEN ADUBATO: How long did that last?

MR. KVIST: I guess it was into December; it was the end of December.

ASSEMBLYMAN STEPHEN ADUBATO: The recording -- the 1-800 number -- what did they say last night? They had said they expected to strike oil the next week. But, what was the reason they weren't going to strike oil the next week?

MR. KVIST: Snow; they had 18 inches of snow. It was always that they would tell you something good, they would tell you something bad, and then they would tell you something good. It was like a sandwich affect, you know.

ASSEMBLYMAN STEPHEN ADUBATO: How much did you know about Korbin Securities.

MR. KVIST: Nothing.

ASSEMBLYMAN STEPHEN ADUBATO: You didn't know much about them?

MR. KVIST: No.

ASSEMBLYMAN STEPHEN ADUBATO: Were you at all aware that in 1976 Mr. Korbin was convicted by the Federal government for something related to fraudulent manipulation practices in a penny stock company called the Bel Air Financial Corporation?

MR. KVIST: No, not until the article in The Star-Ledger.

ASSEMBLYMAN STEPHEN ADUBATO: Were you aware that Mr. Korbin, the head of Korbin Securities, the securities firm which sold you this stock, was suspended in 1979 from the securities industry by the SEC because of that conviction?

MR. KVIST: No, not at all.

ASSEMBLYMAN STEPHEN ADUBATO: Were you aware that Mr. Korbin, the head of the securities company which sold you the stock, and the man whom Mr. Rosen works for, was censured twice in 1983 by the National Association of Securities Dealers, which is represented here today, for violations of security rules?

MR. KVIST: I wouldn't think that type of person would be allowed to be in business. I didn't know that there were no laws to protect people.

ASSEMBLYMAN STEPHEN ADUBATO: Let me ask you this: Have you ever heard of the Securities and Exchange Commission?

MR. KVIST: Yes.

ASSEMBLYMAN STEPHEN ADUBATO: Okay. Most laymen like ourselves, who are not experts in the securities industry, assume that the SEC clears these things, or at least we are okay if people have to adhere to SEC regulations. The Securities and Exchange Commission permitted Mr. Korbin, in 1981, to open up a new brokerage firm after his conviction in 1976. That is according to the information we received from The Star-Ledger and from other research we have done. In fact, in 1984, three years after the Securities and Exchange Commission allowed Mr. Korbin back into the industry, they began a new investigation into Korbin Securities. At any point during the time that you held this stock-- Do you still own this stock?

MR. KVIST: Oh, yes.

ASSEMBLYMAN STEPHEN ADUBATO: For a point of information, how much was your original investment?

MR. KVIST: It was $2,250.

ASSEMBLYMAN STEPHEN ADUBATO: That was for 1,500 shares at approximately $1.50 per share?

MR. KVIST: Yes, a buck and a half.

ASSEMBLYMAN STEPHEN ADUBATO: How much is that worth right now?

MR. KVIST: It's worth $197.00.

ASSEMBLYMAN STEPHEN ADUBATO: That $197.00 represents 300 shares at .005% of one dollar?

MR. KVIST: I have that in my paperwork here somewhere. I think it's quarterly that they send me this stuff. (Witness looks through his papers.)

ASSEMBLYMAN STEPHEN ADUBATO: Okay. When did you buy the stock, Mr. Kvist?

MR. KVIST: September 16, 1983.

ASSEMBLYMAN STEPHEN ADUBATO: You told me that the stock began to go down very quickly, and you saw your investment disintegrating before your eyes. In terms of sales practices, and in terms of promotion-- You are in sales, if I am not mistaken, and to some extent you are familiar with these practices. Did anything happen in January, 1984, when the stock of Ross Exploration was just about at its lowest? Did anything happen at that point which, in some way, rejuvenated your interest in the stock?

MR. KVIST: Well, yes. They invited us to a cocktail dance they were having. It was a thank you to the stockholders. Again, I think the warrant situation was cleared up, and they were waiting for a NASDAQ listing, which was supposed to go throughout the country. Then, once the rest of the country got a hold of Ross and it was available on a NASDAQ sheet, you know, of course, everyone would be buying and selling it, and things would go up. We received an invitation to a cocktail dance at Lowe's Glen Point East in Teaneck. It was quite elegant. We went, and we went up to see the offices of Ross Exploration, which were quite impressive. We stood there and had cocktails with Clevon Little, Jake LaMotta, Muhammad Ali, and Cyd Charisse.

ASSEMBLYMAN STEPHEN ADUBATO: What were they there for?

MR. KVIST: I believe they were stockholders. I found this article from The Star-Ledger about Ross Pascall pumping up, you know--

ASSEMBLYMAN STEPHEN ADUBATO: (interrupting) Ross Pascall is the chief operating--

MR. KVIST: (interrupting) He is the owner of Ross Exploration.

ASSEMBLYMAN STEPHEN ADUBATO: Right, right.

MR. KVIST: This article is dated April 1, 1984, and it says, regarding Pascall Energy: "Ross had no trouble attracting investors before. Among its 6,000 shareholders are boxing great Muhammad Ali, Ed Kranepool, formerly of the New York Mets, and entertainer Cyd Charisse." These are people that own the stock. They were there to -- whatever. They got Muhammad Ali up there; he is starting a sports company here. I got something on that from Korbin. He said he is going to buy Ross' stock, and Ross said he was going to buy Muhammad Ali's stock. You know, they were up there, and it was like a real "rah rah" type of a situation. They were pumping everyone up.

ASSEMBLYMAN STEPHEN ADUBATO: Were you impressed by that?

MR. KVIST: Well, we were impressed to be standing there having drinks with all of these famous people, thinking that we were a part of something. It was as if we were on the inside; very naively, we thought we were on the inside.

ASSEMBLYMAN MICHAEL ADUBATO: Forgive me for interrupting your presentation. It isn't often that I have been known to be lost for words, but I am. Quite frankly, I think anyone, under those circumstances, would be impressed with those kinds of people.

MR. KVIST: I have a list here. We got home and we tried to-- Here is the invitation. We have Jake LaMotta's signature. This whole thing is full of autographs we got that night.

ASSEMBLYMAN STEPHEN ADUBATO: Mr. Kvist, just so the people here will understand, we are not so much concerned about these celebrities and their business. What we are concerned about are the sales practices here.

MR. KVIST: Yes, right, how they influenced me to hang on, or whatever.

ASSEMBLYMAN STEPHEN ADUBATO: My question is about something else, not celebrities, but Mr. Pascall, who was there and who was primarily the person who was speaking. It was his company. You told me, when we spoke before the meeting, that not only were the celebrities there, but you mentioned other people who were there who made you think this was more legitimate.

MR. KVIST: I overheard a conversation. He said he had every mayor, and Assemblyman, and, you know, all the government types within a 50-mile radius there at the party that night. At least, that was what he was claiming to another person.

ASSEMBLYMAN STEPHEN ADUBATO: This was the president of the company?

MR. KVIST: Yes, he was saying--

ASSEMBLYMAN MICHAEL ADUBATO: (interrupting) Forgive me for interrupting, but would you repeat that? The president of the company said what?

MR. KVIST: He was talking to someone, and he said that there must be every mayor, and councilman, you know, government types within a 50-mile radius there that night -- people from all over.

ASSEMBLYMAN MICHAEL ADUBATO: Just for the heck of it, did he actually use the word "Assemblymen?"

MR. KVIST: I'm not sure.

ASSEMBLYMAN MICHAEL ADUBATO: Did he say "elected officials?"

MR. KVIST: Yes, elected officials, but he did say "mayors" and he did say "councilmen."

ASSEMBLYMAN MICHAEL ADUBATO: I was not there, by the way.

MR. KVIST: No, you weren't there.

ASSEMBLYMAN STEPHEN ADUBATO: Mr. Chairman, for a point of clarification, the person we are speaking about, Ross Pascall, is the Chairman and President of Ross Exploration Company of Korbin Industries. A little information about Mr. Pascall is in order. He was the person who was doing business with Muhammad Ali; they were going to buy each other's shares, etc.

Mr. Pascall was a penny stock dealer until the 1970s, when he was barred by the Federal and State governments for two years. Violations against him were regarding stock manipulations and sales campaigns. He was convicted of promoting stock without a broker's license. In 1984, they began offering stock in Pascall Energy on the radio at fifteen cents a share. He grossed $1.6 million in that ad campaign. An earlier offering of Pascall Energy at ten cents grossed $1.5 million.

The reason I raise this point, Mr. and Mrs. Kvist, is that you are obviously not alone. Let me ask you this, and I will finish my questioning, and I want to thank the Committee's indulgence. Are you at all embarrassed about being here today?

MR. KVIST: Of course. This is a very humbling experience, all right? When you get ripped off by someone, you obviously get angry, and you obviously want to get even, get revenge, or get your money back. The latter is what I really want. Sure, of course, I want my money back, or I want the stock to go up like they claim it is supposed to. You call this hot line and they pump you up with false hopes. If you listen to the hot line, you think they are the "Beverly Hillbillies." Wherever they shoot a gun off, the oil comes up. They can do no wrong, according to their hot line. I didn't think anyone could just go to a radio station, advertise, and say anything they wanted on the air. I did not know there were no controls.

ASSEMBLYMAN STEPHEN ADUBATO: Finally, if you knew beforehand about the things you read in the newspapers after you made your investment, and lost your investment-- If you had that information about the management of Korbin Securities and Ross Exploration, would you have bought the stock?

MR. KVIST: I would not have bought it.

ASSEMBLYMAN STEPHEN ADUBATO: You would not have bought the stock?

MR. KVIST: No, of course not.

ASSEMBLYMAN STEPHEN ADUBATO: Would you have considered buying the stock?

MR. KVIST: No, not even a little bit.

ASSEMBLYMAN STEPHEN ADUBATO: Toni?

MRS. KVIST: Not at all.

ASSEMBLYMAN STEPHEN ADUBATO: Thank you very much, Mr. Chairman.

ASSEMBLYMAN MICHAEL ADUBATO: I had one question I was going to ask you; it was just that, and very properly so. Quite frankly, I don't know, under the present conditions in New Jersey, if that would even be allowed -- that kind of a disclosure, the fact that these

people have already been convicted of fraud, the fact that it is obvious they are not people of integrity. Yet, you know, it is not just government's responsibility. It is the responsibility, primarily, of the people who are in the stock market, the legitimate people who deal with securities, to police their own house. Obviously, they fail miserably at doing that.

Again, I want you to know that I am very appreciative that you are indignant, that you are angry, and that you are here.

MR. KVIST: I guess I just don't understand what happened to the value of the stock in a company which is now expanding, and which now has the Pascall Energy Group.

ASSEMBLYMAN STEPHEN ADUBATO: Is that a subsidiary of Ross Exploration?

MR. KVIST: Yes, it is a subsidiary of Ross. Here, a company is growing and expanding. By what I purchased, I showed initial faith in these folks; I gave them my money. Now the stock is worth some minuscule percentage of a dollar. What happened? What is a reverse split? Why did I go from 1,500 shares to 300 shares?

ASSEMBLYMAN STEPHEN ADUBATO: Didn't you authorize that?

MR. KVIST: They authorized it. It says here (referring to paper in his hand): "Notice is hereby given that the directors of Ross Exploration consent to a one to five reverse split, effective 4:00 p.m. Eastern Standard Time, December 23.

ASSEMBLYMAN MICHAEL ADUBATO: Excuse me for interrupting you. Who consented?

MR. KVIST: It says right here, "The directors of Ross Exploration."

ASSEMBLYMAN MICHAEL ADUBATO: In other words, you had no say in that. It was just done. You did not sell it; you did not trade it. It was your stock, but they did it.

MR. KVIST: Right. They gave it to me this way. This is how I found out.

ASSEMBLYMAN MICHAEL ADUBATO: Assemblyman Loveys?

ASSEMBLYMAN LOVEYS: I have a question. Maybe I should address this to someone else in the audience other than you, sir. Is

this common practice? Can someone tell me if it is common practice in the industry to decrease in a stock split? Usually, when I hear of a stock split, people are elated and happy because they figure they have already made some money. Can anyone answer that question?

ASSEMBLYMAN MICHAEL ADUBATO: Excuse me, Assemblyman Loveys. (addressing audience) No one is going to answer any questions, so don't raise your hands. Just keep your hands down. We have other witnesses here who are experts. Rather than go back and forth, we will wait for the other people who have come here to testify; they will have the answers.

ASSEMBLYMAN LOVEYS: All right, I will hold my question.

ASSEMBLYMAN MICHAEL ADUBATO: If they do not have the answers, we will find the answers. But, we are not going to have an open forum.

MR. KVIST: That is my question, and I question how and why they did it. If they did it for a legitimate reason, well, here it is 1985. They are expanding into a resort in the Bahamas, and into another venture hand-in-hand with another group of people. I have a note which they sent us on that.

They are diversifying and they are going into other areas. They are obviously expanding on capital they are raising through penny stock soliciting, but still the value is nothing. I just don't understand that.

ASSEMBLYMAN MICHAEL ADUBATO: Well, you don't understand it, and that is why we are here today. I don't understand how the State of New Jersey -- and we, as elected officials -- don't know what is going on. The Governor himself said he was not aware of just how serious a matter this was. So, certainly if the Governor of the State of New Jersey is not aware of what is going on, there is no reason why an Assemblyman should know what is going on. I think the best policy is honesty, to say that we did not know it was that serious. This is not an excuse; it is a reality. That is why this meeting is so important, and that is why your testimony is so important, so it will be on the record. You know, without carrying it through, the one thing I want to say -- and I don't want to shoot from the hip -- is that your response

to Assemblyman Adubato should be repeated. That response was, if you had known the track record of these individuals, you would have run away from them very quickly.

MR. KVIST: Yes, I would. Now, I don't put these companies down, but you have Amway, and Mary Kay, you know, with multi-level marketing. They use advertising and the media. They use marketing strategies to manipulate people into thinking the way they want them to think. They use the media as a tool to fulfill their own gain.

ASSEMBLYMAN MICHAEL ADUBATO: Assemblyman LaRocca, do you have a question?

ASSEMBLYMAN LaROCCA: Did you ever receive a prospectus?

MR. KVIST: No. I received a prospectus for Pascall. They wanted to sell me shares of Pascall.

ASSEMBLYMAN LaROCCA: Initially, when you were solicited, did you ever receive a prospectus?

MR. KVIST: No.

ASSEMBLYMAN LaROCCA: Do you know what a prospectus is?

MR. KVIST: I do now. It tells you about a company, what it is worth, and so on.

ASSEMBLYMAN LaROCCA: Are you sure you never received one?

MR. KVIST: I'm positive that I never received one on Ross Exploration.

ASSEMBLYMAN MICHAEL ADUBATO: Thank you both very, very much for coming here. Is David Sheehan here? (affirmative response from audience)

For those people who have come here to testify, we are not going to hear all the testimony. We are going to have another meeting, but we have a full agenda today. You are welcome to stay in the room; you are welcome to listen to the testimony; but, those people who are not on the list are not going to have time to testify today. If you have just submitted your name, I would not count on testifying. The chances are slim to none. I apologize to you, but because of time constraints we have no choice. However, we do intend to have another meeting, and we will be happy to have you testify then.

Mr. Sheehan, please go right ahead.

DAVID SHEEHAN: Thank you. My name is David Sheehan. I am an attorney with the law firm of Crummy, DelDeo, Dolan, Griffinger, and Vecchione, located here in Newark, New Jersey. What we have done over the last seven years is operate as trustee, and counsel to the trustee, in a number of SIPC liquidations. SIPC is the acronym for the Securities Investor Protection Corporation, which is a bill enacted by Congress. It is an industry-supported, not-for-profit corporation that protects customers when a broker/dealer goes bankrupt. We go in and liquidate that company. The purpose of the statute is to provide protection for the customer, for the cash and securities which he has on deposit with the broker/dealer when it is liquidated.

I asked to come here today to speak to this Committee in order to provide you with some information we have encountered with respect to the practices engaged in by some of the firms we have dealt with through the SIPC liquidation exercise. Essentially, these can be broken down into two areas. One is the so-called "front office," that is, the sales operation. Then, in addition -- and this is an interrelated matter -- there are the "back office" operations of the brokerage firm. What the individual who initially testified pointed out is very true across the board in many instances when dealing with some of these houses. What you have is a very unsophisticated investor, someone who -- as was pointed out -- may not even know what a prospectus is until he receives one. He may not know what the nature of the enterprise is that he is investing in. For example, on many occasions we have had customers call us after we have gone in to start liquidating a company. They call, and we have an obligation under the statute to forthwith deliver cash and securities to the customer. Often, two things will happen. One is, the customer will receive from us a warrant and a common stock, because what he purchased was a unit. Often in the industry, what the new issuer will do is sell his stock as a unit. That term refers to a common stock and a warrant sold together.

I have had customers call me up and say, "I bought units," and I say, "Yes." Then they say, "But, I didn't get units, I got common stock and a warrant." What they expected to receive was a piece

of paper that said "unit" on it. They didn't even understand what a unit meant. In fact, when they purchased a unit, what they were getting was common stock and a warrant to be exercised later. Also, on many occasions we have had customers who have received the stock call us up. They have no idea how to contact the issuer or how to subsequently sell the stock, and no idea of the nature of the enterprise itself, because they received no communication from the broker at the time the stock was sold evidencing what the nature of the enterprise was. They received no prospectus. They didn't ask for one, but in many instances they wouldn't know to ask. So, the broker is then selling the stock, and really what the customer is relying on is what the broker tells him over the phone. In many instances, what the broker is engaging in is what those in the securities industry call "prospecting," or cold calls, calling up customers who are not really customers, individuals out of phone books and other listings. They call them up, get them on the phone, and tell them that they have a very good investment for them. The customer gets excited about it and purchases the security, never having received a prospectus or any other information with respect to the company.

Once that unsophisticated investor gets into the company, the subsequent problems that develop are the ones that we see most often. That investor becomes a captive of the company. What happens is, as he purchases the stock -- and, perhaps he is sophisticated enough to know to ask that it be placed in his name, as opposed to his street name -- he will then ask that the stock be delivered out. Many, many customers complain to us that they can never get the stock out. The stock stays there. They can't get it delivered out. The reason is, if the stock gets delivered out, the customer goes, as they say in the trade, flat. He no longer has an active account, so the broker no longer has something to trade with. He doesn't have a position. So, what he tries to do is not let that stock out. We have often had customers come to us and say, "We have been trying for months to get our stock out. We're so glad that you are in now and we can get our stock out."

What will also happen is, the customer will be touted onto another stock. The stock that is already in the customer's portfolio

will start to decline in value. The customer is not too happy with the current history of his investment, and isn't too interested in making another purchase. What happens then is, all of a sudden his next customer statement reflects a sale of his existing stock and the purchase of a new security, an unauthorized trade. The customer then writes to his broker; he writes to the back office people; and, he writes to the NASD and the SEC, which then forward it to the broker for investigation. In the meantime, the months drag on, while the investor sits there with stock he purchased that is no longer in his account, and stock which he didn't authorize purchasing is now in his account.

Another thing that happens often is that the customer will call up, or he will be called and told that he wants to purchase, for example, 30,000 shares of his given security. One must remember that often these issues are to the tune of 400 million shares, so that purchasing 30,000 shares isn't altogether that significant. What he gets back is a statement which tells him that what he really purchased was 20,000, and there is a cash credit balance. There is no absconding with the funds; it reflects accurately that he purchased only 20,000 shares. He wants either the additional 10,000 shares that he thought he purchased, or he wants his cash back. What subsequently happens, in many instances, is another unauthorized trade, where that cash is then used to buy stock that he did not authorize purchasing.

What we then find is that the back office starts to creep into the RR's conversation -- the registered representative, account executive, or whatever the term is for the salesman in that given company. It starts to creep into the conversation, because as these things start to happen, the customer will be told: "You're right; absolutely right. That stock shouldn't be in your account. I don't understand what is going on in that back office. Let me check into it and I will get back to you." The back office is the accounting operation for the securities firm. It keeps track of all the customer trades, the trades with other brokerage houses, and the purchases and sales of securities. What then occurs is, the back office becomes the culprit. The back office is inefficient; the books and records are not being kept properly. "As soon as we can straighten them out, your account will be straightened out."

The difficulty is that in many instances the back office is in a state of disarray, and the books and records are not being kept very well at all. Indeed, in the instances where we have been brought in by SIPC -- I have dealt with SIPC for a number of years, and I find this to be so in other cases they have been involved in -- the state of the books and records has been so bad that you cannot necessarily rely on them to satisfy customer claims. When we went into Southeast Securities of Florida, which was located in Hoboken, the bank reconciliations in that case had not been done for four months. There was no idea of what cash was on hand, or what was available to pay out to customers for cash credit balances, until we went in and started to do the bank reconciliations after our appointment by the Federal District Court.

That is not an uncommon occurrence when a brokerage house reaches that stage of the liquidation process where they are on the eve of going into bankruptcy. Those are two aspects of the brokerage firm, that is, the firm that engages in these kinds of activities and, as Assemblyman Adubato pointed out, we are not talking about a large percentage here; essentially, we are talking about the underbelly of the industry that engages in selling over-the-counter securities. We are not talking about major listed houses. These types of practices are not uncommon, and are found as a continual strain throughout all of them. The victim ultimately, of course, is the unsophisticated customer who becomes involved. The whole jargon of the securities industry is unknown to him -- longs and shorts, margin accounts, due bills. A whole host of information is unavailable to him because he is unsophisticated. But, he is being given high pressure sales tactics up front to get him into that industry. Once he is a part of it, he finds out it is very difficult to disengage. Essentially, that, in a very general fashion, is what we have encountered in dealing with the liquidations we have dealt with to date.

I would be glad to answer any questions from the Committee.

ASSEMBLYMAN MICHAEL ADUBATO: Thank you for coming today, Mr. Sheehan. Assemblyman Adubato?

ASSEMBLYMAN STEPHEN ADUBATO: Thank you, Mr. Chairman. Just very briefly, Mr. Sheehan, you said your firm specializes in bankruptcies and liquidations.

MR. SHEEHAN: Among other things, yes.

ASSEMBLYMAN STEPHEN ADUBATO: In the case of Southeast Securities, a New Jersey-based firm doing business in Florida, what could have been done, in your opinion? Once you went in there and you saw the books, and you saw the way Southeast was being managed, what, in your opinion, could government have done, if anything, to have prevented that liquidation, and prevented the company from going into receivership? Or, do you see it, in your experience and expertise as an attorney in this field, as the natural course of business that this company just couldn't make it with their product? By the way, what was their product?

MR. SHEEHAN: Their product was essentially new issues. What they were engaged in was primarily delivering new issues to the marketplace. They also sold other over-the-counter securities, but that was essentially their main product.

ASSEMBLYMAN STEPHEN ADUBATO: Could government have done anything to avoid that situation where customers lost significant amounts of money?

MR. SHEEHAN: That is a very difficult question to answer. Let me break it down, if I may, into several parts. One, we live in a free enterprise system, and the customer should be allowed to purchase whatever security he wants. I think that at best what we can achieve is to provide him with the tools necessary to make an intelligent choice. For example, your first witness did not get a prospectus before he was able to buy the stock. There should be a requirement that that kind of information be made available to the customer before he purchases it. There should be further access to information with regard to the principals of the company itself, the company which is actually selling the securities, so the customers would have some insight into who they were dealing with.

ASSEMBLYMAN STEPHEN ADUBATO: That's fair game.

MR. SHEEHAN: Yes. For example, I think if you call up a major house -- without naming any names, we all know who they are; they advertise -- you know you are dealing basically with a legitimate corporation which has been in business for many, many years. But, when you deal with an over-the-counter house, you are not necessarily sure who they are. Perhaps if there were some information available to the public, or required to be provided, that would-- Again, the first witness indicated he would not have dealt with that company if he had known its background. That kind of information would arm the investor with the kind of intelligence he needs to make an insightful decision.

ASSEMBLYMAN STEPHEN ADUBATO: Thank you, Mr. Sheehan. Thank you, Mr. Chairman.

ASSEMBLYMAN MICHAEL ADUBATO: It is interesting to note the lack of information that is shared. You know, when I look at the New Jersey statute and regulations for a person who is doing some very menial task in a casino, the kinds of forms he has to fill out, and the kind of information he has to share before he can be employed in a casino, a person's whole history has to be public information. It has to be disclosed. And, here we are allowing people to invest their life savings, maybe, with persons who do not have to disclose any information about anything.

MR. SHEEHAN: Well, there is a registration requirement. There are other witnesses here--

ASSEMBLYMAN MICHAEL ADUBATO: (interrupting) Well, we will get into the registration requirement, but I don't think that is protecting anyone. I mean, it is a requirement, and that's nice, but the important thing is, what does it do?

MR. SHEEHAN: Yes, that's true. In the case of Southeast, in several instances -- and, the Bureau of Securities was on top of this -- they had salesmen who weren't even registered as selling. They didn't even bother to register.

ASSEMBLYMAN MICHAEL ADUBATO: Is it a fair statement to say that the captive situation is something where once they've got you, they don't let go?

MR. SHEEHAN: They don't want to.

ASSEMBLYMAN MICHAEL ADUBATO: Let's say that the mentality, in my opinion, based on what you and other people have told me, is that of a person who is a victim of a finance company because he can't get credit at a commercial bank. His only hope is the finance company, so he goes to the finance company and makes his payments, or whatever, and when it gets down to his last payment, they say: "Don't pay it. Leave an open account." Then they just rekindle him. That may be stretching the point, but I think the philosophy is the same.

MR. SHEEHAN: I agree.

ASSEMBLYMAN MICHAEL ADUBATO: When these outfits tout, do they trade within their own entity as much as possible?

MR. SHEEHAN: That is correct; that is often the case. What you will find is that when a brokerage house collapses, as Southeast did, the market generally falls apart with respect to the issues it was supporting.

ASSEMBLYMAN MICHAEL ADUBATO: Total?

MR. SHEEHAN: Well, it generally goes very flat, and it is very difficult to resurrect it until such time -- interestingly enough -- as the RRs, the registered reps, move out and go on to other companies, call up the customers whom they have left behind at the liquidated brokerage house, and say, "I am now located at a new company" -- or whatever it might be -- "have my account transferred over to me; I will take care of it." Then they might be able to rejuvenate that stock. But, without that kind of input, what happens is, the market activity supporting the price of the stock, whatever it might be at that point, just disappears.

ASSEMBLYMAN MICHAEL ADUBATO: Is it a fair analogy, Mr. Sheehan, to say that if a person were dealing, or buying stock, and he had a broker, that broker, when he trades, makes a commission whether a person buys a stock or whether he sells a stock through that broker?

MR. SHEEHAN: Absolutely.

ASSEMBLYMAN MICHAEL ADUBATO: Is that a normal situation for independent brokers, people who are legitimate, that they make a commission on both ends for a service?

MR. SHEEHAN: Absolutely.

ASSEMBLYMAN MICHAEL ADUBATO: In these situations, do the people who are more or less captives of these securities dealers, or these types of entities, make a commission if they sell the stock that this person bought with their house? Do they get a commission on that?

MR. SHEEHAN: Oh, sure; absolutely. That is one reason for generating sales and keeping them captive.

ASSEMBLYMAN MICHAEL ADUBATO: Well, here is my point; let me rephrase it. If a person buys a penny stock -- okay? -- and he makes a commission, and the broker makes a commission, if that is an in-house account and they trade that stock, they sell that stock, and they buy another stock that is controlled by that same entity, in that mire, I do not think there would be a problem with anyone. I think everyone would still be happy.

MR. SHEEHAN: That's true.

ASSEMBLYMAN MICHAEL ADUBATO: But, if that person took that penny stock and wanted to sell it and get out, I think there might be a problem.

MR. SHEEHAN: We found that to be a consistent complaint.

ASSEMBLYMAN MICHAEL ADUBATO: That is what I wanted to put on the table.

MR. SHEEHAN: Okay.

ASSEMBLYMAN MICHAEL ADUBATO: People are intimidated, and I mean intimidated. I am not just talking about high pressure sales; I'm talking about intimidation. I'm talking about the fact that people who want to cash in that stock have a hard time doing it.

MR. SHEEHAN: Yes, sir, that is absolutely true.

ASSEMBLYMAN MICHAEL ADUBATO: And, it is all legal, supposedly.

MR. SHEEHAN: Well, the difficulty is that we are not talking about--

ASSEMBLYMAN MICHAEL ADUBATO: (interrupting) I said "supposedly."

MR. SHEEHAN: Supposedly, okay.

ASSEMBLYMAN MICHAEL ADUBATO: I say that in jest, because it is happening. I said, "Supposedly it has to be legal." It happens

everyday; it happens every minute. So, I am sure it is supposedly legal; otherwise, the people in government would do something about it. That is my point.

MR. SHEEHAN: Exactly.

ASSEMBLYMAN MICHAEL ADUBATO: Or, at least those credible people in the industry would clean up their own house, instead of waiting for the government to rush in. Then they start crying wolf: "Leave us alone. You know, it's a bureaucracy. You're over-regulating us." I think it is important to put on the record that when people don't see anything happening to these individuals, when they see that they get away with what they are doing, they supposedly think it is legal too: "I guess it is all right, because no one is doing anything."

MR. SHEEHAN: That could very well be the case.

ASSEMBLYMAN MICHAEL ADUBATO: Assemblyman LaRocca, do you have any questions?

ASSEMBLYMAN LaROCCA: Aren't there State laws on the books regarding registration and isn't there some kind of control over all issues and securities?

MR. SHEEHAN: Well, there are, but as I understand it, the registration requirements -- of course, there are exemptions to those -- follow basically the Federal securities laws, which are predicated upon disclosure. The interesting thing in this regard is that if you read the prospectus, if you actually get one, it will adhere to that disclosure requirment. You will find that it will say right on the very front of it, in bold print, that if you can't afford to lose all of your money, don't buy this stock.

ASSEMBLYMAN LaROCCA: In your opinion, what is wrong? We appear to have -- not appear -- we do have rules and regulations about all kinds of disclosures. We also have this on a State level, and still all of these things happen. You are experienced as an attorney. What would your opinion be as to what the problem is? Why do these things happen?

MR. SHEEHAN: Quite frankly, I think it is a dissemination problem to a large extent, in this sense: While the prospectus is

required, and it is indeed filed and examined for complete disclosure, the question is really whether or not the investor in these types of securities actually receives it and gets the benefit of that information. That is a very difficult thing; I do not suggest it is easy to regulate and assure yourself that that is happening. I would say that while we have all of those regulations, and we force the issue that we are to disclose all of the documentation concerning the background of the individuals and the finances of the company, in many instances, the investor never sees it.

ASSEMBLYMAN LaROCCA: You're saying the problem is not with the law, not with the regulations, but possibly with the Bureau that administers it. Maybe they don't have enough money; maybe they don't have enough attorneys or investigative staff; or, possibly it could be the very nature of the American public, that there is a direct relationship between gambling in Atlantic City and gambling in Wall Street. Everyone wants to make a dollar.

I am trying to figure out the basis of all these problems. Apparently we have enough laws. I know that I have a complete staff in my office, and after 48 years of practicing law, they follow the book. I hired attorneys from the SEC, both State and Federal, to make sure that there is disclosure, and it is there. You have all these high pressure things.

Another comment I can make, just as an aside on that, is that in handling estates over 48 years of practice, I haven't seen one estate, whether the total gross was $10,000 or $10 million, that didn't have dog stocks in it. Every one of them. When I go to file the inheritance tax return, I have to put down "no value." I have to get a certificate from a broker to substantiate that with the tax people, so I do not report it as an asset. And, it comes back, "No record," or "They were liquidated," and so forth. So, maybe the problem is with the people themselves. You can put up a lot of signs saying, "Don't gamble here," but people will still gamble on the big American dream.

MR. SHEEHAN: I agree with virtually everything you just said. I think there is probably a great deal of regulation. There is a lot of law. There is difficulty with the public itself; you can't

protect the public in certain instances. But, I think what I perceive to be the problem, as I said, is more the dissemination of information. I think the best example was your first witness this morning, who said that if he had had that information, he would not have invested. I think there is a lulling effect upon the investor when he thinks the Securities and Exchange Commission is involved, and the State Bureau of Securities is involved, that he is protected. He knows it is a well-regulated area; so, therefore, if he purchases, he has to be all right. That isn't necessarily true, because the fundamental basis for those laws is disclosure so that one can make an intelligent decision.

The only thing I can offer to the Committee, perhaps, is that if we can, through further staffing on the State or Federal level-- I find that to be a problem. It is very difficult with the proliferation of these offices to keep track of all of them, to know who is moving from where to where, and what new issues are coming out. If we had further support with the existing laws through those agencies, I think you might find that the salutary effect which that legislation was intended to have, would indeed then have that impact.

ASSEMBLYMAN MICHAEL ADUBATO: You know, it is interesting that the Governor, in his statement, said that he was not aware of this problem just based on what he has heard. If I interpret his statement correctly, he said that he feels legislation should be introduced in New Jersey. So, evidently the Governor doesn't think that our laws are strong enough. He said he would -- I didn't understand this part -- draft a bill. I know he used to be an Assemblyman, but he is not anymore. So, I'm sure he was misquoted. He will not introduce any bill, unless he wants to serve in both positions at the same time. I'm sure it was a misquote. But, the Governor himself, who is the Chief Executive Officer of this State, already acknowledges that our laws are lacking. I don't even think that is an issue. I think the issue is, what are we going to do about it? It's not that we already have enough laws; we don't. It is obvious to the Governor, and it is obvious to me that we need more legislation with teeth in it, as well as people to enforce it. There I would agree totally. As Assemblyman

LaRocca said, you can have all the laws in the land, but if you don't have people to enforce them, the laws do not mean anything.

So, in that respect I would concur totally. Also, based on the statements of people in public office who are almost in a state of shock, they had to admit, as I am admitting, as the Chairman of the Assembly Banking and Insurance Committee, as a person who has had the privilege of serving in government in an elected office for 12 years, that they were not aware. That is not a cop-out, you know. As the Governor said, he was not aware that this was such an extensive problem. That is not a cop-out, and once we acknowledge that, that is why we are here. Assemblyman Loveys?

ASSEMBLYMAN LOVEYS: Mr. Sheehan, how many investigators are employed by the State of New Jersey?

ASSEMBLYMAN MICHAEL ADUBATO: Excuse me for doing that to you, Assemblyman Loveys. The person who is in charge of that Division is coming up next, the Director of Consumer Affairs. Maybe we ought to leave that for him.

ASSEMBLYMAN LOVEYS: That is two questions I have backed up.

ASSEMBLYMAN MICHAEL ADUBATO: I'm sorry.

ASSEMBLYMAN LOVEYS: I have another question; let's see if we can make it three for three.

ASSEMBLYMAN MICHAEL ADUBATO: I'm sorry, but he doesn't know anyway.

ASSEMBLYMAN LOVEYS: In your vast experience working with bankruptcies in these areas during the past seven years, could you guess what percentage of those selling stocks in this area we are talking about?

MR. SHEEHAN: The percentage of--

ASSEMBLYMAN LOVEYS: The percentage of those who are creating some of the major problems in this industry.

MR. SHEEHAN: I would be guessing; I am not really sure, but it is a small percentage. However, I really don't know.

ASSEMBLYMAN LOVEYS: Could you just take a guess?

MR. SHEEHAN: My guess would be 5%.

ASSEMBLYMAN LOVEYS: Five percent.

ASSEMBLYMAN MICHAEL ADUBATO: That's a good guess.

MR. SHEEHAN: But that is all it is.

ASSEMBLYMAN LOVEYS: Right. I have one other question for you, Mr. Sheehan, and I say this partly in jest. Did you ever buy an Edsel?

MR. SHEEHAN: Did I ever buy an Edsel? No.

ASSEMBLYMAN LOVEYS: Okay.

ASSEMBLYMAN MICHAEL ADUBATO: You know, I'm not cutting you off intentionally, even though you are a Minority member. (laughter)

ASSEMBLYMAN LOVEYS: I am well aware of that.

ASSEMBLYMAN MICHAEL ADUBATO: Assemblyman LaRocca, do you have any questions?

ASSEMBLYMAN LaROCCA: No, thank you.

ASSEMBLYMAN MICHAEL ADUBATO: Okay. Again, Mr. Sheehan, I appreciate your taking the time from your very busy schedule to come here to share your experience, because it certainly is of great value to this Committee. I want to compliment you as a citizen of New Jersey who is obviously interested in the people of New Jersey. Your mere presence shows that, and I appreciate it very much.

MR. SHEEHAN: Thank you.

ASSEMBLYMAN MICHAEL ADUBATO: We would like to have both James Barry, Director of the New Jersey Division of Consumer Affairs, and James Smith, Chief of the New Jersey Bureau of Securities, join us at the witness table. Mr. Barry, as a former colleague who has had the same privilege I have of serving in the Assembly prior to your present appointment, I know you realize our dilemma. Thank you for coming here today.

JAMES J. BARRY, JR.: Thank you, Mr. Chairman. For the record, my name is James Barry. I am the Director of the Division of Consumer Affairs. I appreciate this opportunity to testify today on the subject of the penny stock market.

New Jersey has two securities laws -- The Uniform Securities Law of 1967 and The Real Estate Syndication Offerings Law. The Uniform Securities Law is modeled after the Uniform Securities Act, one of the model acts adopted by the National Conference of Commissioners on Uniform State Laws.

New Jersey's Uniform Act differs from the Uniform Securities Act in that New Jersey's law does not provide for the registration of securities which are also registered with the Securities and Exchange Commission. This means that there is no filing or review of any such offerings, including penny stock offerings.

I believe there is room for change in the statute. The Legislature could require registration designed to assist in the protection of investors. Disclosure registration with some statutory merit requirements might be preferable to disclosure alone. If this form of regulation were required, we could repeal the Real Estate Syndication Offerings Law to avoid duplication. The Real Estate Syndication Offerings Law now requires disclosure registration for offerings by issuers engaged in some aspect of the real estate business and would only duplicate securities regulation under the Uniform Securities Law.

It is my understanding that most other state statutes have provisions for the registration of securities. Some are disclosure states and others merit review states. I cannot comment on the adequacy of specific state regulation; however, I'm sure that other speakers here today will be able to assist the Committee on that point.

The creation of companies, penny stock or otherwise, with no bona fide business or purpose cannot help but be detrimental to the investing public. The money obtained by such issuers is drained from the legitimate capital-raising process. At the present time, such companies can sell their securities in New Jersey if the securities are registered with the SEC. Most other states register such offerings and many have the authority to reject them after a merit review.

Ideally, markets are created by a bona fide public demand. Sales practices employed by broker/dealers that create markets by confusing, misleading, or intimidating investors create problems. These practices include hyping a stock, refusing to take sell orders, and making false promises. New Jersey's law is not very different from the laws of other states in this regard.

Education is extremely important and is one factor that we stress at the Division of Consumer Affairs. An informed investor is

the best defense against the sort of problems that this Committee is looking into.

The Division attempts to educate the public in all areas over which it has jurisdiction. We have a toll free telephone access information system consisting of 159 tapes on a variety of subjects, including two tapes on securities.

In addition, we distribute investor alert press releases and an informative brochure entitled, "How to Protect Your Savings From Con Artist Hypnosis." This material has been produced as a result of a joint effort by the Council of Better Business Bureaus and the North American Securities Administrators Association, of which we are a member. The releases deal with various problems in the securities and securities-related industries, including commodity investments, tax shelters, oil and gas lottery investments, and penny stock.

One of the problems that the Division faces is that investors who have lost money in securities are more often than not embarrassed by the fact that they have been taken. They often refuse to file a complaint or cooperate, especially if the amount invested is small. In addition, many salesmen are so good at duping people that their victims don't know that they have been taken.

I am pleased that the Legislature and the media have devoted time and attention to this important area of consumer fraud. Securities fraud can cost consumers thousands of dollars and sometimes their life savings.

In the past two years, this form of consumer abuse has grown, in part because of the improved economic conditions nationally. The fact that more people have money to invest in a bull market has not escaped the con artists who can make a furtune on fraud and deceit. During the same period, the stock market boom has triggered a 100% increase in applications for broker/dealers and agents.

There might always be a buyer for the phony elixir, the miracle cure, and the worthless stock, but with consumer education, the toughest laws, and effective enforcement, the number of injured consumers can be reduced significantly.

I thank you for your interest and stand ready to assist you in any way as you consider constructive changes in the law that will, hopefully, improve protection for New Jersey consumers.

ASSEMBLYMAN MICHAEL ADUBATO: Mr. Barry, I, for one, am not taken back by your testimony. I more or less had the opportunity, because I served with you, to know how interested you are and how dedicated you are to the people of New Jersey. Your opening salvo doesn't surprise me at all. What you said is very clear. Assemblyman Adubato, do you have any questions?

ASSEMBLYMAN STEPHEN ADUBATO: Mr. Barry and Mr. Smith, while I was not in the Legislature when you were there, I am pleased that you joined us today, but I am particularly pleased that Mr. Smith is here. In many ways, Mr. Smith -- and, you know it better than any one of us -- you are charged, as Chief of the Bureau of Securities, with the responsibility of regulating or enforcing the laws that those of us in State government put on the books. It is clear that New Jersey's reputation-- Let me ask you this: In terms of making it perfectly clear as to what New Jersey's reputation is in the penny stock industry -- and, I will move to another question after you answer -- do you have any feelings, Mr. Smith, about--

ASSEMBLYMAN MICHAEL ADUBATO: (interrupting) Excuse me, Assemblyman.

ASSEMBLYMAN STEPHEN ADUBATO: Sure.

ASSEMBLYMAN MICHAEL ADUBATO: Even though you are a Majority member, we have a fair, even hand here. I apologize to both the Assemblyman and Mr. Smith. I think we ought to hear Mr. Smith's testimony first, and then we can ask them both questions. Okay? So, I stand corrected. Mr. Smith, would you like to read your statement?

JAMES McLELLAND SMITH: Thank you, Mr. Chairman. My name is James McLelland Smith. I am the Chief of the New Jersey Bureau of Securities, which is the agency that administers New Jersey's securities laws.

At this time, I would like to thank you for affording me this opportunity to speak before this Committee. In all likelihood, we would not be here if it were not for the excellent series of penny

stock articles written by Robert Cohen. My remarks today do not necessarily refer to the specific persons named in those articles, but to the topics covered. These articles put the spotlight on a growing problem with a relatively small, but persistent segment of the securities industry. I am referring to an amoral group of loosely-connected con artists which has infiltrated the so-called penny stock market. Like all other con artists, this group's main goal is to fleece the public. They do this by selling worthless or overpriced paper in exchange for empty promises. Their victims represent all walks of life and include the sophisticated, as well as the novice. With the compassion of a shark, these predators methodically strip investors of their savings. It doesn't matter to them that the money they take was to be used for a child's college education or for a long-needed vacation. It doesn't even matter that they are taking money representing a widow's sole source of retirement income. Most victims are so embarrassed at having been duped that they refuse to file a complaint. Many don't even know that they have been taken.

The tools of the con artist are the telephone, persistence, half truths, outright lies, and a glib tongue. The bait they use is the hope of a sure profit. The catalysts are greed, lack of knowledge, and a naive belief on the part of the investor that government regulation of securities protects them completely.

The problem with the penny stock market has two parts: the companies issuing the securities, generally referred to as the issuers, and the persons selling and making a market in these securities, the broker/dealers and the agents. Many of these issuers of penny stock are owned or controlled by people who have been thrown out of the securities or commodities business; others have been sanctioned by regulatory authorities or are closely related by business or family to those sanctioned. They make themselves officers, directors, and majority shareholders of corporations with legitimate-sounding names. As insiders, they purchase a majority of the shares for a small amount of money, and offer to sell the minority of the shares to the public at a price per share many times what the insider is paying. The stated purposes of these companies are as varied as the insider's

imagination. The real purpose, however, is simply to take money from the public without giving anything in return.

The issuer and broker/dealer are usually brought together by a consultant, who may also be the person creating the issuer. The consultant is one of those faceless, behind-the-scenes movers in this subculture industry who is valued for his contacts. His charge to the issuer may be a yearly fee of $25,000 to $60,000, usually for nonexistent consultant services. More often than not he will get a percentage of the insider's stock. This may sound like a lot, but he is worth it because he can provide the issuer with a broker/dealer that can bring the issuance company to the public.

The main factor in bringing the penny stock issue to the public is the sales force of the broker/dealer. Very often, they are no more than boiler shops. Their sales forces very often consist of heat merchants or graduates of defunct penny stock dealers, or both. Sometimes the sales persons are novices having arrests for minor cocaine or marijuana charges, who are given their first jobs in the securities business. Some are registered and some are not, but most are easily manipulated. The salespeople are usually motivated at sales meetings where they are told that they are to concentrate on selling a particular stock. The experienced salesperson knows the routine. First, he sets up the investor with a low-key call of introduction, telling him that he has nothing now, but when he does, the investor must be prepared to move, and move fast. A week or two later, the investor is called again and told that now is the time to invest in the chance of a lifetime, that they have been holding aside a small allotment just for him. Prospectuses containing disclosure of all risks, even if requested, are rarely sent prior to final confirmation, if then. Wooden tickets, the sending out of a confirmation when no sales were authorized, are often used. Investors lucky enough to receive a prospectus, to read it, and to question the salesperson, will usually be convinced or intimidated into accepting the sale. Although the main purpose of the prospectus is disclosure, it is often of little protection to the investor in the circumstances I have just described, and the con artists are fully aware of this.

Later, in the so-called aftermarket, similar and additional problems occur. Customers are continually lied to. Salespersons are rarely allowed to buy securities from customers, and are compensated, very often, only when such securities are sold. The activities which I have just described are not the activities of the legitimate entrepreneurs or broker/dealers who represent the clear majority of the securities industry. But, the harm that these activities cause from New Jersey and to New Jersey residents cannot be taken lightly. They not only tarnish the industry's reputation, but they tarnish the reputation of our State.

There are Federal and state securities laws in place which are designed to cope with these and similar problems. There are state and Federal agencies whose job it is to administer these laws. It might be beneficial at this time to take a brief look at them. Securities regulation is shared by the states and the Federal government. The Securities and Exchange Commission is a Federal agency charged with administering the Federal securities laws. It was originally conceived in the early 1930s to supplement existing state securities regulations. Each state also has its own securities law. Collectively, these laws are know as "Blue Sky Laws." This term is believed to be derived from a 1911 court decision involving a state securities law, in which the court noted that the securities involved in that case had no more substance than so many feet of blue sky. By state standards, the SEC is a huge agency; by Federal standards, it is one of the smallest. Notwithstanding the fact that the SEC has been one of the better run Federal agencies, it cannot do, and does not claim to have the ability to do, the whole job of regulating the securities industry or of protecting the investor. It is understaffed and under pressure to operate within budget restraints, just as all other Federal agencies must. It has no choice but to analyze the Federal interests before entering a case and to leave the locally-oriented fraud and abuse to state agencies, such as the Bureau of Securities.

The SEC fully expects the states to shoulder a heavy load and to increase state budgets and personnel to take up the slack. Faced

with this situation, each state must respond to protect its investors. No one will do it for us. Many states not only review offerings for disclosure purposes, but have the ability to reject offerings found to be unfair, unjust, inequitable, or which tend to work a fraud on investors. This is called "merit review."

Let us look at the protection afforded New Jersey residents. New Jersey not only does not have merit review, it has no review whatsoever for offerings, including penny stock offerings filed with the SEC. The securities laws in New Jersey make it a so-called "free State." Once securities have been filed with the SEC, New Jersey's law permits these securities to be sold without filing, without review, and without clearance of any kind.

It is my job as Chief of the Bureau to administer these laws. They are laws which were designed to protect investors from abuses involving securities. In addition to coping with the penny stock market problems, the Bureau is required to register broker/dealers, agents, and investment advisers doing business in or from the State of New Jersey. This is done by reviewing applications for registration in order to determine whether or not such a registration is warranted. At the present time, we have nearly 44,000 agents, 1,200 broker/dealers, and 300 investment advisers registered. This represents an approximate 100% increase in registrants since 1982. Each year we answer thousands of inquiries and process numerous exemption requests. Each week hundreds of new agent applications must be processed. According to my review of current statistics, the volume of registrations in New Jersey ranks the State about fifth in the nation. Applications for registration as broker/dealers and agents continue to pour in each week. As the volume increases, the review time naturally decreases. More and more problem people are attempting to become registered. Some accurately state their backgrounds, and some do not. Many boiler shop and bucket shop employees, and many who have been trained in companies operating commodity-related scams, are now filtering back into the securities industry. We cannot catch or properly review all of them. With that amount of activity and with New Jersey's proximity to New York and Pennsylvania, the problems that should, but cannot be investigated, grow accordingly.

For the record, it should be noted that these problems are not limited to the penny stock market. States' securities agencies, such as the Bureau of Securities, are on the cutting edge of fraud. Our investigations, which are initiated by Bureau personnel, references, and complaint letters, concern all classes of registrants, as well as those flaunting the registration requirements. Some complaints are justified, others are not, but all deserve investigation. In addition to the standard investigations, the Bureau also investigates what are known as "exotic" securities, an area that the SEC is leaving almost completely to the states. For example, we investigate pyramid schemes and boiler shop selling schemes involving the oil and gas lottery, bogus oil leases, and deferred delivery contracts in coal, precious metals, and strategic metals. We have been successful in shutting down several of these entities. These and numerous other scams are looked into by no other State agency. The actions we have taken, often in cooperation with postal inspectors, have saved residents of New Jersey and other states many millions of dollars. However, many times that amount is being lost because we are unable to effectively investigate and prosecute offenders. Very often, one major investigation brings the office to a near halt.

To register agents, conduct investigations, answer inquiries, and do all of the things I have mentioned, New Jersey has a staff of 10 people, plus myself. Give or take one or two, the number of personnel has not changed for approximately 20 years. Notwithstanding the dramatic increase in registrants and market activity, there are five clerical personnel, two examiners, and three investigators. There are no accountants, and except for myself, no attorneys.

What can be done to alleviate this problem? First, we need authority to review securities offerings prior to the time they are sold in New Jersey. It is much easier and cost efficient to prevent offerings that may tend to work a fraud, than to try to make investors hold long after the offering is completed and the money dispersed. That segment of the industry -- and I have difficulty alluding to them as part of the legitimate industry -- which we are discussing here today cares little about subsequent investigations or sanctions by the

SEC or New Jersey. The cease and desist orders and the injunctions are merely an annoyance and, at worst, the cost of doing business. Once they have the money, they have won, and the investors and the legitimate segment of the securities industry needing capital have lost.

We might also consider increasing money penalties, extending investors' recision rights, and giving the Bureau specific authority to require deportment on behalf of investors. In addition, we should take a close look at recent amendments to New York's law, which were designed to outlaw illegal pyramid schemes and boiler shops of any kind.

Second, if our legal responsibilities are increased, additional staff and legal personnel will also be required. The Bureau staff should include attorneys and accountants, as do most other state securities offices. Legal representation should also be increased and permanently assigned to securities matters. This would assure the familiarity and expertise required to prosecute securities matters -- both civil and criminal -- quickly. Not only are Bureau investigations complicated, paper intensive, and time-consuming, but we are often matched against some of the smartest and craftiest attorneys in any field, who are fully capable of using old and new delaying tactics in a war of attrition which delays Bureau action until the investors have been fleeced.

In order to obtain sufficient staff and legal representation, it may be necessary to amend the securities law to dedicate Bureau revenues for investor protection. There is certainly a moral, as well as a practical argument for dedication. As was noted in the penny stock article, the Bureau currently operates on less than 25% of the revenues it produces to protect investors. To pay for increases, additional revenues of $1 million to possibly $3 million would be available in the form of fees, if the statute was amended to require registration of securities.

The need for reform is there, and the revenues can be obtained. All that is needed to do the job is for industry, the investing public, and the regulators to cooperate by lending their

special expertise to the reform process. It is to our mutual advantage to eliminate, to the extent possible, all organizations, individuals, and offerings that work as a fraud on investors, and which thereby tarnish the reputation of New Jersey. When deciding whether or not, or how to enact changes in the securities law, I only ask that you keep in mind the one person who will have no lobby, but whom the law was designed to protect. I am talking about the investor.

If you have any questions, I will be happy to answer them.

ASSEMBLYMAN MICHAEL ADUBATO: Mr. Smith, let me express our gratitude for your being here today and for sharing such profound information. The Chair would like to go on record as saying that The Star-Ledger and Robert Cohen, whom I have never met, by the way -- I don't even know if he is in the room-- Robert Cohen deserves the gratitude of all of the people in the State. You know, I almost hestitate, because I know when you compliment some reporters, they don't know how to take it. But, I think this is very well-deserved and earned. He has done a service in bringing this to light for all the elected officials of this State, including the Governor. The Governor wasn't aware -- none of us were -- of the problems that are going on in this area. I, as Chairman of this Committee, publicly thank Mr. Cohen.

Assemblyman Adubato, do you have any questions?

ASSEMBLYMAN STEPHEN ADUBATO: Thank you, Mr. Chairman. I want to thank the Chairman for cutting me off before. Mr. Smith, I would have gone off on a line of questioning based on the assumption that you were in an awkward situation. You are on the hot seat, and you are the person we rely upon to enforce the laws that those of us in State government put in place.

Your testimony, as the Chairman of the Committee stated, has answered every question I thought we might have to drag out of you. You have put it on the table; you have been more than frank; and, you have provided us -- at least me personally as the sponsor of the resolution which called for this review of the penny stock industry in New Jersey -- with very clear recommendations. You have defined the problem. I just want to repeat, you said there were 44,000 people eligible to do business in this State.

MR. SMITH: Actually registered, yes.

ASSEMBLYMAN STEPHEN ADUBATO: They can do business in this State, can't they?

MR. SMITH: That is right.

ASSEMBLYMAN MICHAEL ADUBATO: They are the legal ones.

MR. SMITH: That is right.

ASSEMBLYMAN STEPHEN ADUBATO: Again, the number of investigators the Bureau of Securities has is three.

MR. SMITH: Again, you are correct.

ASSEMBLYMAN STEPHEN ADUBATO: We are going to hear a little bit later on from the person who is in an analogous situation to you in the State of Colorado -- the state that is called the penny stock capital of the country. I'm sure they are not proud of that, as we are not proud of our problem. We are also going to hear from the person who heads the securities' office in the State of Massachusetts. We are going to find out how many people they have. I happen to know it is a lot more than we have -- many times more than we have. I also know that in Massachusetts, they have a lot less people eligible to do business in that state.

I guess my question is-- It comes more back to us. What is the average salary of an investigator?

MR. SMITH: Approximately $19,000 or $20,000.

ASSEMBLYMAN STEPHEN ADUBATO: I serve on the Joint Appropriations Committee, and we are going to begin deliberations shortly. There is an argument between the Executive Branch of government and the Legislative Branch of government as to how much our surplus is. On the low end, it is somewhere around $500,000, and on the high end, it is close to $1 billion.

It seems to me that for us to double the size of your enforcement efforts in terms of investigators, it would mean adding approximately $57,000 to $60,000 to the State budget. Just assume -- forget about changing the way in which you get money -- we were to do that, and we were to take $60,000 on the high end of three $20,000 salaries. What would it mean to your operation in terms of stopping on the front end -- meaning, as you said, that people see in this business that if they get caught doing something wrong, they have to pay a fine,

and that is part of business. If we can stop them from doing business -- if they need to be stopped based on whatever criteria we determine is needed to do that -- and if you had three more people, and it cost us $60,000, which is our problem, what would three more investigators mean to you, regardless of how we got them?

MR. SMITH: Obviously, it would mean at least doubling the amount of action we have taken. I don't want to throw any cold water on that suggestion of three investigators, but it is kind of a complicated problem in that legal assistance is also necessary. The investigators also need supervision, which requires a higher salary -- someone to direct them. Although I am, I guess, the bureaucracy in the Bureau, I am like the SEC when they go through various steps. I can move quickly.

ASSEMBLYMAN MICHAEL ADUBATO: Mr. Smith, allow me to interrupt you and say that I don't think the Assemblyman was saying that would do the job. The thing he was trying to point out, very vividly, is that just by $60,000, you could double your investigative force. He is not saying we don't need accountants, we don't need lawyers, and we don't need expertise to compete in this situation. I didn't take that as a recommendation. I took that as an example of the pittance you are getting now--

MR. SMITH: (interrupting) Yes, I understand that.

ASSEMBLYMAN MICHAEL ADUBATO: (continuing) --not as a solution, so don't interpret it as a solution. That is not the way I interpreted it.

MR. BARRY: Mr. Chairman, I just want to add that we are talking about increasing staff and improving the situation. I don't think that alone can be the answer. If we increase the investigative staff, we are going to be able to investigate problems like the people who testified earlier today experienced. They are already ripped off; they are already out of money. What we probably should be doing, along with that, is trying to prevent this problem by reviewing the initial offerings that are happening everyday. We don't want to talk solely about, if we throw some people into the office, we'll correct the problem. We really have to look at the statute. I know that is what you intend to talk about.

ASSEMBLYMAN MICHAEL ADUBATO: The important thing is, if I can just put a circle around it without pulling it apart-- The circle of the presentation was your opening two sentences. They have stuck here. They spoke about disclosure and merit review, so no matter how many staff people you have, if you don't have the teeth-- You know, I don't want you to think we lost that anywhere; we didn't. None of us here lost that; I know that. Believe me, those comments are not being eliminated by the inquiry that is going on now. I just want you to understand that.

MR. SMITH: If I may be permitted, just on some of the points that were made earlier, I would like to make a couple of comments. On the reverse split, I don't think the question was ever answered. If you have a reverse split--

ASSEMBLYMAN MICHAEL ADUBATO: (interrupting) Would you tell us what a reverse split is?

MR. SMITH: If you had 100 shares of a stock, those 100 shares would become 10. Normally the price of the share would go-- For example, if it were a penny for 100 shares, it would then go to 10 cents. Now, the practical effect of something like that is to keep the stock "high." So, if the price of the stock dropped significantly -- you had a reverse split -- you would bring it back up. It looks as if your stock is doing either much better or as well. I'm not saying that was the purpose of it, but I just wanted to mention that.

ASSEMBLYMAN MICHAEL ADUBATO: But, that is the effect, whether or not it is the purpose.

MR. SMITH: Yes. Ross Exploration was mentioned earlier. We were aware of that, and so far as Pascall Energy is concerned, which was a subsidiary of Ross and which was doing the same, the Bureau initiated a cease and desist order against those practices. We also took action against Southeast Securities.

ASSEMBLYMAN STEPHEN ADUBATO: Through you, Mr. Chairman, when did you pose a cease and desist order against Ross Exploration?

MR. SMITH: No, it was on Pascall Energy.

ASSEMBLYMAN STEPHEN ADUBATO: Okay, on Pascall Energy, which is, again, a subsidiary of Ross Exploration.

MR. SMITH: That is right.

ASSEMBLYMAN STEPHEN ADUBATO: And which, again, has the same parties involved.

MR. SMITH: That is right.

ASSEMBLYMAN STEPHEN ADUBATO: Okay. This doesn't do much for Mr. and Mrs. Kvist because they bought in on the first end, which is virtually worthless. Then a subsidiary entity opens up, and now markets in the same way that got Mr. and Mrs. Kvist to buy in on the radio and New Jersey's airwaves.

MR. SMITH: That was on December 3, 1984.

ASSEMBLYMAN STEPHEN ADUBATO: Right, okay. I just want to reiterate to Mr. Barry and Mr. Smith that the reason why I didn't go into questions about the statutes was because during the last few weeks, in looking at it from my end, I've come to certain assumptions, and I was hoping that today would confirm those, deny those, or provide more information for me. I could not agree more with virtually everything that was said by the two of you, particularly by Mr. Smith, because with all due respect to you, former Assemblyman, you were on the hot seat. You were the one who was written about in The Star-Ledger. You were the one who was asked the questions about how these people could be functioning in the State, and how people like Mr. and Mrs. Kvist could get ripped off the way they did.

What I am trying to say is, your testimony has done a great deal to confirm the notions that I've come up with since doing my research in the last few weeks.

I only asked about the issue of staffing to try to point out the absurdity of the situation -- the absolute utter absurdity of how we could talk in any way about this being borderline or questionable, or about maybe it being a legitimate investment, and maybe you just lost your money. I don't think that is what we are talking about. I think the State is admitting very openly and candidly that we can't deal with this until we change the laws, until we change enforcement patterns, until we change disclosure and registration, and, in fact, potentially merit review by stopping people from going out there and offering, if they should not be out there. Everyone should have the privilege of doing business in this country based on who they are and what they are offering.

I couldn't thank you more. Thank you, Mr. Chairman.

ASSEMBLYMAN MICHAEL ADUBATO: Assemblyman Loveys?

ASSEMBLYMAN LOVEYS: Mr. Smith, how many years have you been Chief of the Bureau?

MR. SMITH: Approximately 11 years.

ASSEMBLYMAN LOVEYS: Have you ever verbally spoken to or written to anyone in Administration or anyone in the Legislature asking for some type of reform of this whole process?

MR. SMITH: Yes, over the 11 years, from time to time.

ASSEMBLYMAN LOVEYS: From time to time?

MR. SMITH: Yes.

ASSEMBLYMAN LOVEYS: Do you have any idea how many times you made such a request?

MR. SMITH: Seven or eight times; I don't remember.

ASSEMBLYMAN LOVEYS: To no avail? Did you ever get a response from anyone in the Legislature?

MR. SMITH: No, not that I can recall.

ASSEMBLYMAN LOVEYS: You didn't feel fit to carry through on asking for some type of reform?

MR. SMITH: Maybe I should back up a little bit and explain to you what I think my position is. I'm here today by invitation. I'm not here to tell you what to do; I'm here to give you whatever knowledge I can. I look at my position as that of an administrator; my job is to administer the law. If there is a problem, I mention the problem, but I don't go directly to you, Assemblyman, or to you, Assemblyman Adubato, and say, "Listen, this is my problem." I don't consider that to be my job. If I am asked, I'll tell you the truth and what I believe without reservation.

ASSEMBLYMAN LOVEYS: Fine, I'll accept that. At some time in the near future, if I come to you and ask you what some of your recommendations might be, would you be most happy to give them to us?

MR. SMITH: I would.

ASSEMBLYMAN LOVEYS: I have no other questions. Thank you.

ASSEMBLYMAN MICHAEL ADUBATO: I think you have outlined your position very vividly, and we have it on the record. I'm certain we

will have other questions and other inquiries. I would like to rephrase a statement that was made about who is on the hot seat.

ASSEMBLYMAN STEPHEN ADUBATO: We are.

ASSEMBLYMAN MICHAEL ADUBATO: Mr. Smith, you are not on the hot seat; the elected officials of this State are on the hot seat to produce. The fact that we were unaware-- Quite frankly, I wish you had written me. I don't think you ever did, but that is not the issue. The issue is, we are here today as a result of the catalyst of a newspaperman, in my opinion, and as a result of Assemblyman Adubato picking it up, with Assemblyman Karcher, not just to have words said and then forgotten about. This Committee has a track record, I think most people would agree, and when we hold an inquiry, we produce a result. It isn't something that is put on a shelf and is then forgotten about, as often happens.

I am very honored that this was addressed by the Assembly unanimously and that this Committee will do the inquiry. We share total responsibility for what is happening here, just as we must share total responsibility for changing it, all of us. So, you are not on the hot seat; certainly, the Director is not on the hot seat. We're on the hot seat, and that is why we are here. You know, the seat isn't hot, by the way. It is very relaxing. I want to tell you how proud I am of your openness. You are not surprising me, by the way; Director Barry is not surprising me, although he did surprise me with his first two sentences. That is really the basis of why I think we are here, to put the disclosure situation on the table, the merit review on the table, and maybe the staffing, the people who should be there.

We will be directly in touch with both of you, and we will be asking for your expertise. Legislation will be drafted and we will be talking to you about that legislation, with the cooperation of Assemblyman Adubato, who is the sponsor of this resolution. The easiest thing for Assemblyman Adubato to have done would have been to just throw in a bill, and that would have been okay. However, I think it is a lot more responsible for us to do it the way we are doing it. Rather than just putting in a bill, we will attempt to get the information, and we will do it where we can put the cards on the table, so to speak.

Again, I want to thank you both for coming. Assemblyman LaRocca, I apologize. Did you have any questions for either gentleman?

ASSEMBLYMAN LaROCCA: I am just appalled and upset as to how this problem came to everyone's attention. We had to rely on the media, the press, to bring it to our attention. There is something wrong with our system when no one knows the problem. I would say it is common knowledge that New Jersey is a free state and that we do not have merit review, but the leadership has been lacking to bring this to the attention of the proper people. As Assemblyman Stephen Adubato has said, the Appropriations Committee is there; it is there every year. No one has ever complained, and that is one of the places where they could have gone to complain, or to the leadership, the Executive Branch possibly. They could have said, "Look, there is a problem. We can't handle it; come to our aid." I am not aware that any of this has been brought to the attention of the leadership in the Legislature, nor specifically to the Appropriations Committee. So, from that point of view, I am thankful for your review of the whole situation. However, I am still of the opinion that something is wrong somewhere. Thank you.

ASSEMBLYMAN MICHAEL ADUBATO: That is why we are here. Thank you, gentlemen.

I would like to change the pace a little bit and bring up Mr. Cocci, who is the President of the National Association of Securities Dealers. (Two gentlemen approach the witness table.) Which of you gentlemen is Mr. Cocci?

FRANK J. WILSON: Mr. Cocci is back in the audience.

ASSEMBLYMAN MICHAEL ADUBATO: Okay, would you please identify yourselves?

MR. WILSON: I am Frank Wilson; I am Executive Vice President and General Counsel of the NASD.

ASSEMBLYMAN MICHAEL ADUBATO: What is your name, sir?

MR. WILSON: My name is Frank Wilson. With me at the table is Mr. John Pinto, who is Senior Vice President, Compliance, NASD. I also have with me Mr. Ray Cocci, who we don't have a seat for up here. He is our Vice President in charge of Congressional and State Relations.

ASSEMBLYMAN MICHAEL ADUBATO: So, the title I gave him was in error?

MR. WILSON: Slightly.

ASSEMBLYMAN MICHAEL ADUBATO: You have a nice way of correcting me; I like that. Please go ahead.

MR. WILSON: He would like to be President, but we have another guy down there who likes the job too.

ASSEMBLYMAN MICHAEL ADUBATO: Please go right ahead, sir.

MR. WILSON: Initially, I would like to express our appreciation for being given the opportunity to come here today to say a few words to the Committee. We have a long statement which we will submit for the record, but I have tried to shorten that statement somewhat. I will not be reading it all; I will read a portion of it, so if I get a little lengthy or boring, please stop me.

The NASD's purpose, pursuant to an act of Congress, is to provide for self-regulation of the over-the-counter securities markets. We employ over 1,100 people to achieve that purpose. At this time, the NASD has 5,700 broker/dealers. That is actually an increase of about 55% over the last couple of years. Those 5,700 broker/dealer members employ in excess of 330,000 securities-registered personnel. Those 5,700 members also have in excess of 14,000 branch offices, which is up from 11,000 just about a year ago, or some 27%. I throw those numbers out to you just to demonstrate the vastness of this market we are charged with regulating and the difficulty we have increasing our staff in a manner consistent with the increases in the size of the market itself.

We carry out the examination authority of our members by the exercise of disciplinary and regulatory responsibilities through our Washington office and 14 district offices around the country.

In addition, the Association maintains and operates the NASDAQ automated quotation system. This system, which revolutionized the over-the-counter securities market in 1971, provides over-the-counter securities quotations of securities listed on a NASDAQ system for securities professionals and investors. The share volume on NASDAQ is second only to the New York Stock Exchange. Presently, there

are approximately 4,700 securities listed on NASDAQ, 1,100 of which are part of the rapidly developing NASDAQ national market system, which was authorized by an act of Congress in 1975.

As we understand it, the purpose of these meetings is to allow the Legislature to gather information relating to the penny stock market in the State of New Jersey. At the outset, it is important to understand, in our view at least, that there is no inherent evil in bringing to the capital marketplace a low-priced public offering of securities. Such offerings are frequently the only means by which the ideas and entrepreneurial aspirations of development stage companies may be fulfilled. In your invitation to testify, it was stated that the meeting seeks to obtain information relating to the adequacy of New Jersey law to deal with the penny stock market, marketmaker and sales practices in the penny stock marketplace, and public education with respect to penny stocks. The NASD, historically, has not taken a position with respect to the type of regulation provided by state Legislatures. Therefore, we hesitate to suggest to you how you should or should not shape your laws. We will focus primarily on our regulatory activities with respect to the over-the-counter marketplace and, in particular, the more speculative lower-priced end of that marketplace.

As an aside, however, I would like to suggest that the key to effective securities regulation is aggressive enforcement of the laws which are on the books. What the law says matters not if enforcement potential is not provided. Thus, in your deliberations, we think you should at least evaluate whether you, as a Legislature, have provided the resources necessary to enable your professional staff to aggressively and effectively enforce the law. We do not have any opinion, of course, as to whether that has been done; however, it would appear because of the size of the staff -- as was brought out in questioning a little while ago -- that there may be a problem there.

Any examination of potential abuses in the penny stock market must almost inescapably also look to the related concept of a "hot issue" market. We define a hot issue in our so-called free-riding interpretation as "Securities of a public offering which trade at a

premium in the secondary market whenever such secondary market begins." In general, hot issues involve the initial public offering of an issuer. The reason that the penny stock and the hot issue concepts are so closely interrelated is the fact that public interest in purchasing low-priced securities will not long survive unless potential for dramatic gains is evidenced in the marketplace. Hot issue markets have become a cyclical phenomenon involving low-priced and, at times, higher-priced stocks.

The most recent penny stock hot issue market and one which was typical of most such markets occurred in Denver in 1980-1981. In that market, of the 134 initial public offerings of securities which traded at a premium in the secondary market, 86, or 64%, of the issues had offering prices of $5.00 or under per share, and 52 of those 86 sold for $1.00 and under. In addition, 67 of the 134 hot offerings had 25 or fewer broker/dealers participating in the distribution, and over 20 of those involved 10 or less broker/dealers in the distribution.

The 1980-1981 Denver hot issue market occurred in a generally negative market environment, where the potential existed for utilization of improper sales practices because substantial selling efforts were required to create initial interest in new issues among the public. However, once the existence of a hot issue market is established in the investing community, customers actively solicit broker/dealers demanding a share of the next offering. In addition, a relatively limited number of broker/dealer firms involved in the distribution of low-priced speculative issues increased the possibility that one or more of the participants in the market would be in a sufficiently dominant position to exert control over the marketplace in order to artificially establish or maintain prices which might be unrelated to the actual value of the securities.

I am going to list a few of the kinds of market abuses we have seen in this kind of a hot issue market:

Best efforts underwritings with heavy retention by the managing underwriter, to the extent that it will sell either all or a substantial majority of the shares to its own customers;

Domination and control of the market utilized to manipulate the price of the shares in the aftermarket;

Tie-in sales where a customer is required to purchase a "cold" new issue in order to get a piece of the hot issue;

Tie-in sales requiring customers to buy shares of other issues in the aftermarket at premium prices if they are to receive a "hot" issue allotment. If you get one, you can have some of the other. If you don't get one, you can't have the other;

Broker/dealer commission schedules which give extra compensation for sales to customers of favored stocks, while providing no compensation for liquidations of those securities.

ASSEMBLYMAN MICHAEL ADUBATO: (interrupting) Well, sir, that does go on.

MR. WILSON: Yes, it does go on.

ASSEMBLYMAN MICHAEL ADUBATO: Were you in the room when I asked that question?

MR. WILSON: Yes, I was. (Mr. Wilson continues with list.)

Failure to deliver prospectuses;

Tactics designed to avoid the delivery of certificates to customers, thereby allowing the broker/dealer to maintain the customer's position. Other broker/dealers are reluctant to accept a customer's sell order without presentation of the certificate, especailly in securities of this type. If you have GM, something else might result;

Use of nominee accounts, sales to favored customers, and controlled accounts;

Companies going public having little or no operating experience. There has been a lot of discussion about this today;

Salesmen making forecasts and price projections without a reasonable basis in fact, and we heard some discussion of that today as well.

In addition, a willing public that views the market for low-priced speculative issues more as gambling than as investing is an important factor to be taken into account in these hot issue markets. The customers themselves also create regulatory problems. Many times, customers have little, if any, inclination to come forward with complaints of improper conduct by brokers, since they want to continue

to participate in the market, and whistle-blowing would preclude that participation. Rather than do that, customers complain that they could not obtain shares in an offering or that their orders were filled for less than the desired amount.

Also, customers either don't read, or pay little heed to prospectuses, regardless of whether the issue is low-priced or high-priced.

ASSEMBLYMAN MICHAEL ADUBATO: That is assuming that they receive a prospectus.

MR. WILSON: Yes, assuming that they get a prospectus and, as I said earlier with respect to this kind of a market, you do see cases where the prospectuses are not delivered. Other customers follow the practice of opening accounts with a large number of brokers so they can participate in as many hot issues as possible. So, there is a little bit of a greed factor involved.

ASSEMBLYMAN MICHAEL ADUBATO: I think greed is innate. I don't think that anyone denies that.

MR. WILSON: Also, hot issues develop a momentum of their own, so much so that improper sales practices and activities by professionals which may have been utilized, and maybe necessarily utilized, to engender initial interest in the issues, may be less necessary as the market progresses and the speculative fervor of the investing public increases. Such intense interest was seen in the 1981 Denver market, where customers and potential customers of broker/dealer firms were vying for shares of almost any issue which was offered. The particular public danger, of course, in the low-price speculative market is that at some point in the cycle, the cycle comes to a close, the ferver is diminished, and the prices for the security which have reached artificially high levels fall back to the level more nearly reflecting their actual worth. Obviously, at this point, those holding the securities have suffered substantial losses.

One problem which can affect the market involving low-priced securities, especially when public interest is on the rise, is that of free-riding and withholding, an area in which the NASD has the primary enforcement responsibility. Free-riding and withholding result in a

failure by broker/dealers participating in a public offering of securities to make a bona fide public offering by retaining securities for their own accounts or for those in which they have a beneficial interest, or selling those securities to select individuals, such as perhaps favored customers, for the purpose of securing future business by allowing those individuals to partake in the short-term profits available in the aftermarket.

Free-riding and withholding practices may, in some instances, form a part of a scheme of manipulative activity with respect to a particular issue. Any form of that activity violates the Association's rules.

ASSEMBLYMAN MICHAEL ADUBATO: What happens when someone violates the rules?

MR. WILSON: One of our rules is that we--

ASSEMBLYMAN MICHAEL ADUBATO: (interrupting) Excuse me for interrupting, if you don't mind.

MR. WILSON: That's fine; I don't mind at all. If we discern a violation of our rules, the matter is initially put to a district Business Conduct Committee. We have 13 district Business Conduct Committees around the country, one for each of our districts. If it appears that a violation has occurred, a complaint is filed. The respondent is entitled to a hearing and full due process, and thereafter the committee issues a decision. Then, if the respondent is aggrieved, he has the right to appeal to the Association's Board of Governors, the SEC, and then to the United States Court of Appeals. Many times it takes two or three years to get this finished.

ASSEMBLYMAN STEPHEN ADUBATO: Mr. Wilson, on this issue of what it is that NASD does to someone who violates rules, I am going to go back to the first two witnesses we had today, Mr. and Mrs. Kvist. They were given a business card by Mr. Louis Rosen, the person who sold them the stock in Ross Exploration, and on the top of the business card it said, "Members NASD and SIPC."

MR. WILSON: Yes, SIPC.

ASSEMBLYMAN STEPHEN ADUBATO: Now, from the records we have been able to obtain, Mr. Korbin of Korbin Securities, the firm which

sold this stock, was censured twice in 1983 by the NASD for violations of industry rules. What type of activity, if any, does NASD undertake to inform the public, to circulate within the industry, to do whatever, to tell a little bit about some of the people doing business who call themselves members of the National Association of Securities Dealers? I guess what I am saying is, could NASD have helped Mr. and Mrs. Kvist to know more about the people who sold them the stock, and their past convictions?

MR. WILSON: Well, every disciplinary action taken by the NASD is a matter of public record at the Securities and Exchange Commission. We are required to file these actions with the Securities and Exchange Commission. In cases where a disciplinary action results in a suspension of an individual or a firm, or a bar, which is a technical term which essentially means putting them out of business -- either a member or a securities person -- we issue a press release on the subject. These press releases are almost always picked up by at least The Wall Street Journal, and generally always by the newspapers in the locale where the individual is located.

ASSEMBLYMAN STEPHEN ADUBATO: I have a follow-up question. Does NASD allow people to become members who have been convicted of Federal charges related to fraudulent manipulation of penny stock?

MR. WILSON: No. A person who has been--

ASSEMBLYMAN STEPHEN ADUBATO: (interrupting) Let me interrupt again. Mr. Korbin was convicted in 1976 on Federal charges for fraudulent manipulation of penny stock in conjunction with a company called Bel Air Financial Corporation. Mr. Korbin, and his Senior Vice President, Louis Rosen, have a business card that they hand out to people, people like Kurt and Toni Kvist. On the top it says, "NASD" -- and I happen to know that Mr. Kvist did not know what that meant until today -- and "SIPC," which I know is some form of--

MR. WILSON: (interrupting) That is the Securities Investor Protection Corporation.

ASSEMBLYMAN STEPHEN ADUBATO: Is it something like FDIC in the banking business?

MR. WILSON: Yes, it is the same as FDIC, only it relates to the securities industry.

ASSEMBLYMAN STEPHEN ADUBATO: In your opinion, is putting something like this on a business card intended to give the impression or to, in fact, document that the person giving out this business card is a legitimate member doing business -- a member of an association of securities dealers who are legitimate?

MR. WILSON: I cannot comment on what the intent was behind him putting that on the card.

ASSEMBLYMAN STEPHEN ADUBATO: Is he a member of the NASD?

MR. WILSON: I believe he is a member.

ASSEMBLYMAN STEPHEN ADUBATO: You are the head of compliance, aren't you?

MR. WILSON: Yes.

ASSEMBLYMAN STEPHEN ADUBATO: Mr. Pinto, do you know--

MR. WILSON: (interrupting) I would like to get back to the original part of your question relating to the conviction for manipulation. I don't know whether that was a conviction or a finding of violation in an administrative proceeding. Was that a criminal conviction?

ASSEMBLYMAN STEPHEN ADUBATO: Yes, a criminal conviction. You said no one could become a member of the National Association.

MR. WILSON: Let me develop that. In the Securities Exchange Act of 1934, there is a provision relating to statutory bars. Statutory bars include a variety of things, nearly all of which involve findings against an individual of violations of the securities laws. A person who has been subjected to a statutory bar is not permitted to become a member of the NASD when he is subject to that statutory bar. There are provisions in the act for ways in which that individual can be relieved of the ongoing effect of that statutory bar. In other words, perhaps a hearing is held, or whatever, whereby it is concluded that in a sense he has served his sentence and, therefore, is permitted to come back into the business.

Beyond that, however, a firm cannot become a member of the NASD unless it is first registered as a broker/dealer with the SEC. Once having been registered with the SEC as a broker/dealer, we do not have the authority to keep the firm out, except for violations of law.

ASSEMBLYMAN STEPHEN ADUBATO: Mr. Wilson, you said before that the National Association of Securities Dealers does not take a position on the question of what states should do in terms of regulation and statutes.

MR. WILSON: Right.

ASSEMBLYMAN STEPHEN ADUBATO: You said you think it is important that states like New Jersey enforce the existing laws on the books. You are in a position to say that. In light of the testimony received from the Chief of the New Jersey Bureau of Securities, and the person who heads up our Division of Consumer Affairs to protect the consumers of our State, would you want to change your opinion in any way, given the fact that the people who are responsible on a day-to-day basis have pretty much called the existing laws in New Jersey less than woefully inadequate. Forget about enforcement right now. Would you like to clarify your statement in any way?

MR. WILSON: I was going to offer some observations later that would put a little meat on that statement. I think perhaps it might be appropriate--

ASSEMBLYMAN STEPHEN ADUBATO: (interrupting) Mr. Chairman, may I ask him to do that now?

ASSEMBLYMAN MICHAEL ADUBATO: I think he is almost finished with his statement. Is that right, Mr. Wilson?

MR. WILSON: Yes.

ASSEMBLYMAN MICHAEL ADUBATO: He is just about finished, so we will let him continue with his statement.

MR. WILSON: We can skip the rest of the statement, because I was simply going to get into some of the procedures and methodology used by the Association in discharging our responsibility, as well as some of the numbers of disciplinary actions we have taken in the past year, which I thought might be helpful to the Committee.

However, on the question just asked, the discussions I have heard today relate almost entirely to sales practices. In our view, you have adequate laws to-- Please believe me, I am not an expert on New Jersey law, even though I grew up here; I live in Washington now. I am not an expert on New Jersey securities law by any means. However,

in reviewing your law, it appears that you have as much authority to prosecute fraud as any state and, as a matter of fact, there are provisions in your State law which would give authority to the Securities Board and, I believe, the Attorney General, to go to court in any case where it is seen that a firm, or an individual, has violated the law or is about to violate the law, or has violated the public interest or is about to violate the public interest, to seek injunction from that conduct. That is your existing law, and I--

ASSEMBLYMAN MICHAEL ADUBATO: (interrupting) Mr. Wilson, forgive me for interrupting you. Having had the opportunity to serve on this Committee for 12 years, I'm sure you are sincere in what you are saying. It's unfortunate that, you know, as I said, I have sat on this Committee for 12 years, and as you are speaking I hear insurance company officials saying that the Commissioner of Insurance has the power to change this, and you in government have the power to change that. We are only going by the laws that are there.

What I am trying to say is, we in government do not necessarily want to pass laws or interfere with the private sector. In fact, some of us would rather not. But, when your foot is put to the fire-- In my opinion, Assemblyman Adubato was on target when he talked about the fact that the SEC is doing what it is doing, and about the way it functions. It is our responsibility; it is not the SEC's responsibility. I think most of us here today agree that New Jersey is a haven for penny stock; that is our opinion. We intend to do something about it. We intend to do something about it because, quite frankly, the people who are in this industry have not done enough to keep out the sharks. I am not saying that everyone in the industry is a shark, and I am not saying that people should not have a right to take a risk or a right to gamble, if they want. As long as they know they are gambling, that's fine. As long as they know what they are getting involved with, that's fine. So, I would differ with your statement. It is not just sales practices alone. That is not a fair statement. I would disagree with you, respectfully. It goes beyond sales practices. It is innate in people in that segment who, by design, are there to mislead. They are doing it, I submit, with intent.

MR. WILSON: I think there are a couple of areas where changes in the law could be helpful. I was going to mention them.

ASSEMBLYMAN MICHAEL ADUBATO: Oh, okay. Go ahead, Steve.

ASSEMBLYMAN STEPHEN ADUBATO: Before you do that, Mr. Wilson, the only follow-up I have is the question of existing laws in New Jersey and your feeling that you couldn't really comment on them, but that you could comment on enforcement. Correct me if I am wrong, but from your vast experience in dealing with securities dealers, there are no laws on the books in the State of New Jersey that in any way would have barred or stopped any of the practices that were undertaken in the case we heard about here from Mr. and Mrs. Kurt Kvist involving Korbin Securities and Ross Exploration.

MR. WILSON: No, I disagree with that.

ASSEMBLYMAN STEPHEN ADUBATO: Okay, but as far as I know, there were no laws violated. How do you disagree with that? What was violated?

MR. WILSON: If I heard Mr. Kvist's testimony correctly, there were misrepresentations made to him, exaggerated statements relative to the stock, promises as to increases in value, and things of that nature. They are all manipulative practices.

ASSEMBLYMAN STEPHEN ADUBATO: Are you saying that this person who was a member of your Association-- Do they pay dues?

MR. WILSON: If they are a member they do.

ASSEMBLYMAN STEPHEN ADUBATO: Okay. Hopefully, they had enough money in their stock to pay dues. Now, they're paying dues to the National Association of Securities Dealers. You have acknowledged that. If what you heard is correct, then those two people who came before us today to talk about their situation have a legitimate beef. You're saying that the laws were violated.

MR. WILSON: From what I heard, they were violated.

ASSEMBLYMAN STEPHEN ADUBATO: Mr. Chairman, I know our objective is to come up with legislation in the end to address the situation. For all intents and purposes, I feel that Kurt and Toni Kvist have gotten beat. Are you saying you would join with them to try to help them address that particular situation as it has to do with a

particular dealer? They were sold stock of Ross Exploration. Based on your opinion, the opinion of the National Association of Securities Dealers, were they victims of manipulation in terms of sales practices?

MR. WILSON: I said that what I heard here today were statements that, in my view, represented actions which violated the law. Now, as to helping him-- Of course, I never met the gentleman, or even heard of him before today. But, we do have a system of accepting customer complaints. Each of our offices is equipped to handle complaints. In Washington, we maintain a centralized computer base customer complaint file aggregating those complaints around the country. If you see a concentration by broker/dealer, by branch office, or whatever, generally you know that where there's smoke, there's fire.

An individual, a member of the public, has a right to file a complaint with us against a member or against a representative of a member. That individual also has a right to file an arbitration proceeding with our Arbitration Department located in New York, against an individual or against a member. There are avenues that an individual member of the public can pursue through the Association. Obviously, I could not predict in any way how any particular case would come out of either the disciplinary process or the arbitration proceeding.

ASSEMBLYMAN STEPHEN ADUBATO: Through you, Mr. Chairman, you would provide the same comments or testimony that you just gave us based on the assumption that that was a true story and that those practices were illegal. The sales manipulation practices of Ross Exploration, assuming that what was said was correct, were illegal.

MR. WILSON: Yes. As an attorney, however, I think you would have to put a lot more meat on a bare statement before you could find someone in violation of the law.

ASSEMBLYMAN STEPHEN ADUBATO: I asked you the question, "Were the practices that were undertaken by Ross Exploration to sell those stocks" -- and I went to the existing New Jersey laws as to whether they were effective or not. You said that regardless of what the law is, those practices did not make sense, and you would not condone them with the NASD.

MR. WILSON: No, I would not condone them.

JOHN PINTO: Those practices, had we gotten a customer complaint, as Frank just described-- Had we gotten a complaint alleging what was alleged earlier today, there would have been an investigation conducted by whichever of our district offices received that complaint, which would have included on-site inspection.

ASSEMBLYMAN MICHAEL ADUBATO: Mr. Pinto, help us to understand. How would a person go about that?

ASSEMBLYMAN STEPHEN ADUBATO: How would they even know who you are?

ASSEMBLYMAN MICHAEL ADUBATO: How do they know you're there? How does a person know? How does Mr. Citizen, the person we are talking about, the unsophisticated buyer, know? I am not saying you are not there. I am not saying you wouldn't be attentive. What I'm asking is, how does he get to you?

MR. WILSON: That is a good question. It is a good question because, obviously, if you don't know the vehicle for the remedy, you cannot pursue the remedy.

ASSEMBLYMAN MICHAEL ADUBATO: Even if there is a remedy, and I'm not saying there isn't -- even if it is a great remedy--

MR. WILSON: (interrupting) We get thousands of customer complaints a year; I think John may have some numbers for last year. So, some people do get to us. There is publicity about the Association. We participate in seminars; we put on things; we conduct meetings, and those kinds of things. It is unfortunate that certain of these--

ASSEMBLYMAN MICHAEL ADUBATO: (interrupting) Yes, but you see, the overwhelming majority of the people who are legitimate, the people you are dealing with, don't have that hassle. We're talking about the people who cause the hassle.

MR. WILSON: I agree with you.

MR. PINTO: A lot of times we have seen where customers have a problem, they might not know there is an NASD office located right in the city, but they do know something about an SEC somewhere. They will contact the SEC, and the SEC, in the norm on sales practices or related

kinds of customer complaints, will refer those over to one of our district offices, or investigate them themselves. But, at the least, either the customer will be directed over to the NASD, or the complaint will be directed. Then we will just process it and investigate it.

ASSEMBLYMAN MICHAEL ADUBATO: Do you know what I wanted to ask both of you? How does the SIPC -- is that what it is?

MR. PINTO: It's SIPC, Securities Investors Protection Corporation.

ASSEMBLYMAN MICHAEL ADUBATO: How does that relate to FDIC insurance?

MR. WILSON: It's similar.

ASSEMBLYMAN MICHAEL ADUBATO: Similar in what respect? It's protection for what?

MR. WILSON: It is similar in this way: It is protection in the case of the demise of a broker/dealer. Assume that a broker/dealer went bankrupt, just as a bank would go bankrupt. If a bank goes bankrupt, FDIC insures a customer's account up to, I believe, $100,000.

ASSEMBLYMAN MICHAEL ADUBATO: A hundred thousand, yes.

MR. WILSON: Now, SIPC does the same thing in the case of a broker/dealer who has gone bankrupt, insuring cash deposits up to $100,000 and securities up to $500,000.

ASSEMBLYMAN MICHAEL ADUBATO: All right, but what does that mean? If I buy a security--

MR. WILSON: (interrupting) It doesn't protect you there. It protects only--

ASSEMBLYMAN MICHAEL ADUBATO: (interrupting) Wait a minute. Before the place goes bankrupt, they have already run away with the cash.

MR. WILSON: That's right.

ASSEMBLYMAN MICHAEL ADUBATO: I mean, they have done their thing. I'm trying to figure out -- excuse me -- what the hell you are protecting.

MR. WILSON: I have not advanced SIPC as a protection for a customer in this particular situation.

ASSEMBLYMAN MICHAEL ADUBATO: No, no. I'm saying, the equation was made and presented, not by you--

MR. WILSON: (interrupting) Not by me.

ASSEMBLYMAN MICHAEL ADUBATO: No, but in talking, in conversation. I'm not, you know--

MR. WILSON: Okay.

ASSEMBLYMAN MICHAEL ADUBATO: It was equated with FDIC insurance, and I don't think that is a good equation.

MR. PINTO: I think it was only equated from the perspective that if a bank went out of business, the depositors could look to the FSLIC for their moneys; if a broker/dealer goes out of business, likewise, they would look to SIPC for their moneys. That is about as far as the equation would go.

MR. WILSON: As to the kind of losses we are talking about today caused by manipulations, misrepresentations, whatever, forget SIPC. It does not come into play unless that broker goes bankrupt.

ASSEMBLYMAN MICHAEL ADUBATO: Okay.

MR. WILSON: I was going to suggest-- As I said earlier, I think strong enforcement is a necessary ingredient to effective and efficient administration of securities laws. In the area of new legislation, notwithstanding my earlier statement that we hesitate to comment on how states construct their state laws, I was going to suggest that perhaps some kind of additional enforcement authority, in addition to more severe penalties, could very well be an area the Committee might want to explore. I believe the SEC has started an initiative on this point as well, and the State might want to consider it, that is, a prohibition on individuals who have been subjected to statutory bars under the securities act from participating in the management of public firms. I think in some of the discussion I heard here today, in almost every case, participants in those distributions were people who were even then subject to securities bars. So, it might be appropriate that legislation prohibit that from occurring. I think you would get at a lot of the deals you talked about today.

ASSEMBLYMAN LOVEYS: Mr. Wilson, maybe this is not pertinent, but you compared penny stock to the hot issue market, and I believe you made the statement that more often than not one firm becomes dominant in that hot issue market. Can you elaborate on that particular point?

MR. WILSON: I will let Mr. Pinto elaborate on it.

MR. PINTO: Frank also mentioned something about best efforts underwritings with a heavy retention by the broker/dealer who is doing the actual underwriting. Just as an example, if a broker/dealer can distribute an entire offering solely to his customers, and doesn't involve other broker/dealers around the country, as you get with national syndications, where you may have several hundred firms around the country distributing shares from one coast to the other-- If you can concentrate a distribution of a low-priced penny stock just to the customers of a specific broker/dealer, and then couple that with the fact that perhaps you do not deliver out the certificates, as we heard earlier, which is a problem, you have the securities in-house, you have the customers in-house, and it really creates an immobility on the part of those customers to go anywhere else to sell the stock. Other broker/dealers are not going to want to take that sale knowing they can't get the stock because there are rules which require them to do certain things after a certain amount of time when they can't get delivery of securities.

So, customers are pretty much locked in to doing business with the broker/dealer from whom they bought the shares. If that broker/dealer happens to be a marketmaker in the stock, and pretty much has control over the whole outstanding float, you get to a point where he dominates and controls that market. He dominates it because all of the activity is flowing through that broker/dealer since he has all the customer base. You really have a market that totally hinges upon that one broker/dealer. Then when you have a situation as was described earlier, where that broker/dealer goes out of business, that is where you have the types of situations where the stock trading at four, all of a sudden now has no market because, in effect, there was only one market, and that was the broker/dealer who went out of business.

ASSEMBLYMAN LOVEYS: This is primarily because of the non-release of the stock. This is one of the major factors.

MR. PINTO: One of the difficulties if you delivered stock out, theoretically anyway, is that the customer could go anywhere on the street and sell that stock. Whether everyone would want to accept stock of one cent, two cents, a half a cent, or whatever the price, is

another question. But, yes, that customer could go anywhere to sell that stock.

ASSEMBLYMAN MICHAEL ADUBATO: In keeping with Assemblyman Loveys' comment, a broker/dealer is a salesman, a NASD salesman, and they have account reps?

MR. PINTO: Yes.

ASSEMBLYMAN MICHAEL ADUBATO: They're licensed?

MR. PINTO: Yes.

ASSEMBLYMAN MICHAEL ADUBATO: In the NASD they take a course, and the whole bit. Now, when you have a situation where you have a controlled environment, to where you have your own NASD licensed people selling an in-house product that you have created, is that what you are talking about? If you create an entity for distribution in New Jersey -- for instance, I'm told that there are situations where in New Jersey right now, there is no filing necessary for anything. All they need is the SEC. They don't have to file anything, absolutely nothing. They don't even have to have an entity. They can have an idea on a piece of paper, which is fine, and say, "Okay, now we are going to raise capital to promote something we might do. This is what we are going to do. We haven't done it yet; we don't have it yet; but, this is what we are going to do." And, it's sold and controlled by that house, which may have officers, you know, wherever. But it is not available to the salesmen unless they are contolled by that entity. Is that a fair statement? In other words, just because you have a license doesn't mean you can sell that product. Isn't that what is being said under certain conditions?

MR. WILSON: It is not necessarily controlled by that entity, if by the entity you mean the broker/dealer. Rather, the broker/dealer would have to be participating in that distribution, if it was a new offering, for his salesmen to sell it. Or, if it was an aftermarket transaction -- a secondary market transaction -- his broker/dealer employer would have to authorize that transaction. In other words, if I understand your question correctly, he can't go out on the street and, on his own, do anything he wants without the broker/dealer member's imprimatur authority stamp of approval.

ASSEMBLYMAN MICHAEL ADUBATO: The thing I am confused about is the underwriting. What is the responsibility there?

MR. PINTO: Of the broker/dealer or the individual salesman?

ASSEMBLYMAN MICHAEL ADUBATO: I'm talking about the underwriting itself.

MR. WILSON: In the underwriting, the broker/dealer would have to be a participant in the distribution in order for the registered rep to sell those securities. He would have to be a participant in the selling group, or the underwriter, of course.

ASSEMBLYMAN MICHAEL ADUBATO: Assemblyman Loveys, do you have any other questions?

ASSEMBLYMAN LOVEYS: No, thank you.

ASSEMBLYMAN MICHAEL ADUBATO: Assemblyman LaRocca?

ASSEMBLYMAN LaROCCA: No questions.

ASSEMBLYMAN MICHAEL ADUBATO: Thank you both very much for coming here today. We appreciate it.

We would appreciate it if Mr. Michael Unger and Mr. Royce Griffin would join us collectively. Mr. Unger is the Director of the Massachusetts Securities Division, and Mr. Griffin is the Commissioner of Securities of the State of Colorado. The Chair would like to thank both of you gentlemen, not only for coming here, but for your patience. We are more than delighted that you have taken the time out from your very, very busy schedules to come to New Jersey to help us with your information.

MICHAEL UNGER: Thank you, Mr. Chairman. We are delighted to be here. The subject which your Committee is looking at is one dear to our hearts, and our interest extends beyond the boundaries of our individual states. Mr. Griffin and I are authorized to speak on our own behalf certainly, but also on behalf of our Association, the North American Securities Administrators Association, Inc. Our Board met over the weekend, discussed the matter of our appearance today, and authorized us to speak on their behalf as well.

NASAA is an association of 65 state and provincial securities administrators from the United States, Canada, and Mexico, charged with the responsibility for administering and enforcing securities laws. I

would also add, parenthetically, that I grew up right across the river in Washington Heights. My family is still there, and substantial numbers of my family are citizens of your great State. So, I do have some interest as to what New Jersey does.

I would like to commend the Committee for conducting this investigation. I would like to commend you, Mr. Chairman, the Speaker of the Assembly, Assemblyman Karcher, and Assemblyman Stephen Adubato for your interest and effectiveness in putting this matter before your Committee and the public. We believe this is very important.

New Jersey, as you no doubt have heard, is one of the seven so-called "free states." That term generally means those which impose no registration standard beyond full disclosure requirements of the Federal securities laws. The question we must ask ourselves -- one which I think has been asked at this meeting -- is, does full disclosure adequately protect investors from unscrupulous promoters and brokers? It is my opinion that it does not.

Full disclosure is enough investor protection only if one believes that prospective investors read and understand offering documents prior to investing. My experience is that most often this is not the case. People, not prospectuses, sell securities. There is an old term that floats around Wall Street and other capital markets of the country, and it is essentially that: "Securities are sold and not bought." Prospectuses are seldom read because they are lengthy, written by lawyers, and filled with boiler plate disclosure and complicated financial statements. On the other hand, many persons who sell securities, particularly penny stocks, are optimistic, highly motivated, commissioned salesmen who illustrate their product as highly desirable, in great demand, and scarce. I would add with respect to commenting on prospectuses, that over the years, because of the evolution primarily of Federal securities laws, these documents have become rather archaic and esoteric documents which oftentimes are difficult to read. In my opinion, in many ways they have become nothing more than insurance policies for the issuer of the securities, the firm selling the securities, the underwriting syndicates, the lawyers who are compelled to give legal opinions before the securities

are sold, and the accountants who are compelled to provide financial statements. I call them insurance policies simply because if there is enough disclosed and there is a litigant, an investor who subsequently wants to litigate because money was lost or he felt something was wrong, the defense raised by counsel will be, "Here, turn to page 47; we told you this was going to happen."

Well, that may very well be true. They did tell him, but you find that one single sentence out of a 100-page prospectus filled with charts, graphs, and accounting presentations. I think most investors are really not in a position-- Even if they are sophisticated business people, it does not mean they are sophisticated securities people. The purpose of the prospectus, while laudable initially, has gone down the road of boiler plate and is not the kind of document it was originally meant to be, which was to disclose risks to investors.

Weak laws and inadequate enforcement resources attract the less scrupulous promoters who realize, correctly, that they can make money even if the companies whose stock they sell are ultimately unprofitable or simply scams. A 1983 survey by Venture magazine revealed that in 1982, almost half of the companies going public with stock priced under $1.00 "had participants with histories of securities injunctions, violations, fraud, or associations with reputed crime figures." Many of these promoters make their money by selling the initial offering to uninformed investors and by trading the stock while its price rises. They rely on hard sell, cold calls to these investors, or they tie sales of worthless stock to opportunities to buy more popular ones, and you have heard similar testimony from Mr. Wilson. This is often based on what is known as the "greater fool" theory, which is simply that, no matter how unrealistically high the prices that I may have paid for the stock, surely somewhere, somehow, a greater fool can be found who will buy the stock at an even higher price. The securities are often sold on that basis. At some point someone is a loser. Again, it is my opinion that the loser, more often than not, is the average investor who is not privy to rapid market developments, inside information, or similar such types of information. However, before that happens, millions of dollars may

have been made by the brokers who marketed the security, as well as the promoters of that security, the officers who may pay themselves fat salaries, bonuses, automobiles, condominiums, and all of the other kinds of things that are generally associated with a corporate purpose, but probably are not appropriate for a company going public for the first time, one which has not really developed any sound business.

It is impossible for the states to rely, nor should we, on the Securities and Exchange Commission to protect our citizens from securities fraud in low-priced stock offerings. These offerings involve a limited number of investors, small amounts of money, and are not often the type of abuses that are identified as national enforcement priorities by the SEC or the Department of Justice. Mr. Smith, in his comments, said pretty much the same thing. Budget cuts and staff reductions at the Commission have increased the likelihood that fraudulent offerings will not be caught because resources are strained. These enforcement voids at the Federal level are exploited by promoters, brokers, and others to the substantial detriment of the state and its citizens.

The state securities division must bear the regulatory burden of providing basic investor protection to the citizens of the given state. An inordinate amount of securities and other investment fraud in a state results in a loss of confidence in lawful securities markets. Every dollar of such capital that is invested in worthless, fraudulent offerings makes it that much more difficult for the legitimate entrepreneur to raise needed funds. There is simply a finite amount of capital available and, if it goes down the drain, it is not going to be there for people with legitimate business purposes.

As I mentioned earlier, New Jersey is one of the seven so-called "free states." It ranks in the top five in terms of registered brokers and general securities activity. I think it is important that you look at me with a certain perspective, because I come from a state that is often compared to New Jersey. In fact, when our Legislature does bills, our states are compared. We have about six million people; we are both Northeastern states; we are both old industrial states which have moved into the high technology era; we

have urban populations throughout our states; and, we are generally compared. You have probably seen that in other legislation that has come before your legislative body.

Let me tell you what is happening and what has happened in Massachusetts. We have a staff of 18 people. Ten of those people are attorneys; one person handles our broker/dealer/agent registration; and, the rest are clerical people. All of our professionals are lawyers. We do not have accountants. I regret that, but the salary the state pays has generally made it very difficult for us to hire accountants. So, we opted to hire attorneys because, as you have heard Mr. Smith say, the people generally on the other side of the regulatory table when we are working are attorneys, and generally among the highest paid attorneys. Having that kind of professional help is critically important to protecting investors in your State. We would encourage you to look at that issue very carefully.

The roles played by the staff people break down as follows: We have a general counsel, who is also my Assistant Director; we have an attorney who serves as the Chief of Corporate Finances, whose responsibility is to review offerings that are filed with us and supervise the staff who so do; and, we have a Chief of Enforcement. The staff attorneys under these people divide their time between corporate finance and enforcement activity. We have cease and desist authority which enables us, very quickly, to stop unlawful activity without the delay of lengthy court proceedings. Hence, if we hear of a situation that has come about which is illegal and which violates our statute, we do not have to go to our Attorney General and wait until a complaint is prepared and adequate evidence gathered for court proceeding. We need only make certain that there is sufficient evidence that would be sustainable in an administrative proceeding before we issue an order. We can react much more quickly than the Federal authorities and the self-regulatory authorities, or even our own State Attorney General.

Now, that may not seem to be a lot, but when you combine that ability to react swiftly to instances of fraud with an effective media presentation-- You gained the confidence of your local media when you

asked about education when matters came up. I believe the media is the must element in investor protection. We could issue orders left and right all day long and, if the public did not know that, they would not be aware of the kinds of scams that are occurring, nor would they know that we are there. That is critical. However, if you don't have anything to tell the media because you don't have staff to put cases together, there is nothing to tell anyone.

We have generally come to be known as a "merit regulation" state in Massachusetts, although we do not have within our statute the magic words "fair, just, and equitable," which give me the authority to review offerings. There has been a great deal of dispute as to the length our office has extended our authority, but, nevertheless, we provide sufficient amounts of front-end protection. We have 24-1/2 thousand agents registered in our state, and we have between 5,000 and 6,000 securities offerings filed with us each year. One-third of those offerings tend to be mutual funds which are generally not enforcement problems, and they do not get a lot of attention. The rest do.

The question might be raised, or may be suggested to you later, that if you have merit review, if you interpose the authority of government for that of the marketplace of the investor, you are interfering with capital formation. That is a rhetorical argument. It is what has been said many times in many places. Frankly, I do not believe in that argument, and I will tell you why. Number one, in Massachusetts, though we have been the subject of criticism for our style of regulation as being too tough, I firmly believe that the front-end protection we have provided to our citizens has had an enormous deterrent effect. We do not get the penny stock offerings filed with us which have caused penny stock problems. On occasion, they are filed, but probably by mistake because people have been unaware of our regulatory system. But, generally, they are not filed in Massachusetts. I would like to believe that that has an important deterrent effect. That will not prevent a person from going out and participating in the penny stock market if he wants to on an unsolicited basis. He can call someone and say, "I want to buy penny stocks." But, an initial public offering of a company that would

qualify as a penny stock offering generally does not get filed. It took a while for us to get around to that position through our regulatory efforts, but generally that does not occur.

The next question might arise, "What about a guy in Massachusetts who is honest, has a legitimate business idea, and wants to raise a little bit of money with a low-priced stock?" Well, we are flexible, and I'll tell you why we are flexible. A firm in Massachusetts, or even within the New England area, which is geographically small, can be watched. We can say, "Okay, in this instance we will let you start your company because you are from Boston," but we are able to walk in on a moment's notice and pull out those books and records because we have the authority to do that, and we can see what the company has done with the money it raised. I can't do that if someone from my colleague's State of Colorado wants to sell a penny stock in Massachusetts. I couldn't afford people very much protection, but I can for local people. What I am suggesting is, you need not fear the argument that you will be hitting on the small guy by setting up a strong statutory scheme for the added protection of your investors because there are ways to do that so that the people in your State who you are concerned about, and the jobs in your State which you are concerned about, can be adjusted. You can build in a system whereby your Securities Bureau can protect the public from out-of-state offerings that perhaps ought not to be sold, without unjustly penalizing the local fellow. I submit to you that doing so is very important, simply because there has been a deregulatory philosophy which has gripped the Federal government and has weakened the ability of the SEC to provide adequate investor protection. Much of the burden for policing the securities markets has fallen to the states, and appropriately so.

As I have just indicated, we are closer to investors and are more familiar with the local markets. We can weed out fraudulent offerings before they are sold, and before investors have lost their money. Similarly, if they are local people, we are able to watch them. We are generally less burdened with bureaucratic red tape, and state regulators do have the ability to respond more quickly to

complaints of misleading sales practices and threats of market manipulation.

Utah has recently undergone a very similar introspective exercise such as New Jersey is doing now. There was a task force put together by the Governor and they came up with specific recommendations. Some of those are: prohibiting blind pool offerings because they have a tendency to work a fraud upon the public, and I think Mr. Griffin will probably address that in his testimony; providing the securities division there with cease and desist authority, and I discussed that; permitting the securities division to retain a greater percentage of the fees it derives from its regulatory system so that can be put to staff use; and, hiring additional staff.

The trend in those states whose securities markets have historically been riddled with fraud, is to clean up the markets and to provide basic investor protection. In another "free state," Colorado, Governor Richard Lamm noted in his State of the State Message that a good business climate and tough securities laws go hand-in-hand. He suggested that a weak state securities law is an invitation for the unscrupulous businessman to locate in the state.

The question before your Committee -- and your entire Legislature -- is, how much longer can New Jersey afford weak securities laws and inadequate enforcement resources? I would only add -- and this will be the conclusion of my testimony -- that my staff has been given specific instructions when reviewing broker/dealer applications, that is, before we let a broker/dealer or any of its sales personnel sell in our state, to go over applications from four states with a fine-tooth comb. They are all free states; they are all states where there have been enforcement problems in the past. They are Colorado, Utah, applications that come from the southern part of Florida, and New Jersey. That is not by accident; that comes by experience. We are not picking on New Jersey for any particular reason. It is simply that we know there are firms in New Jersey that have had problems in the past. When a new firm springs up, oftentimes the principal of that firm will be someone who left a previous firm, or someone who was a principal in a previous firm that went SIPC, that was

liquidated, and is getting back into the business again. My staff has been instructed to review those applications very carefully. The clerical person in charge has authority to clear applications, but not for these states. They must then go to my Chief of Enforcement.

This may harm some of your legitimate broker/dealers, if only because it takes longer for that application to be processed and, therefore, they will be cut out of the Massachusetts market for that extra period of time. But, that is what we feel is necessary to protect our investors from some of the unscrupulous firms and practices in certain parts of the country. Thank you.

ASSEMBLYMAN MICHAEL ADUBATO: Mr. Unger, again, thank you for coming. I would agree with you that New Jersey and Massachusetts are similar in many ways as far as demographics go, and so forth. In fact, one of the states I used through the years when making comparisons in insurance was always Massachusetts. I understand that Massachusetts recently changed its system and has adopted our new joint underwriting association method with auto insurance. I am very glad to hear that. Maybe we will adopt some of the things you are doing now with securities. Assemblyman Adubato?

ASSEMBLYMAN STEPHEN ADUBATO: Maybe Mr. Griffin has a statement.

ASSEMBLYMAN MICHAEL ADUBATO: Okay, we will wait for Mr. Griffin's statement. I apologize.

ROYCE GRIFFIN: Thank you, Mr. Chairman. Because Mr. Smith did such a good job and the NASD has presented an unusually frank description of what goes on in the penny stock market, it is really not going to be necessary for me to read my statement as written. That will save more time for questions, I hope.

I am the Securities Commissioner in Colorado. I have been there for four years. Prior to that time, I was the Assistant Securities Commissioner in the State of Arkansas. Arkansas has a strong merit jurisdiction. Colorado is even freer than New Jersey, inasmuch as we do not have a regulatory handle on the broker/dealer end of the business, as you have under your current law. I think I can speak to both ends of the problem. I have seen regulation and I have

seen no regulation, and believe me, regulation is preferable if you don't want to have a market that routinely defrauds large numbers of your citizens.

I brought a number of offering documents with me, underwritten by New Jersey brokers. I think these are fairly instructive and I hope, at the appropriate time, to offer them as exhibits to my testimony.

The first of these is fairly well-known, the Lezak Group, Incorporated. On the front page of the document it says: "This offering is of securities of a start-up company with no operating history and no plan of operation. The company will not engage in any business, any business whatsoever, until after the completion of the offering." Yet, on the back page it says: "The company is currently leasing office space from its president" -- that is to accomplish no business -- "and major shareholder on a month-to-month basis at approximately $6,000 per month." The offering document goes on to say: "This is a blind pool offering, and that means that the funds to be raised are not at all allocated except for the payment of salaries and consulting fees, and the expenses of this offering. The company does not know what business it will engage in. It has no plan of operation."

ASSEMBLYMAN MICHAEL ADUBATO: Excuse me, is this a real thing you are talking about here?

MR. GRIFFIN: Yes. It is offered by M. H. Meyerson and Company, Inc. out of Jersey City, New Jersey.

ASSEMBLYMAN MICHAEL ADUBATO: Wait a minute. Are you saying this exists now?

MR. GRIFFIN: I think the company is bankrupt now, but these securities were sold in 17 days.

ASSEMBLYMAN MICHAEL ADUBATO: But, this existed in New Jersey?

ASSEMBLYMAN STEPHEN ADUBATO: Excuse me, Mr. Chairman. I don't know if that is correct. I think they are still doing business.

MR. GRIFFIN: Are they?

ASSEMBLYMAN STEPHEN ADUBATO: Our information is that they are still doing business in Jersey City.

MR. GRIFFIN: One of Mr. Lezak's companies went bankrupt; I am not sure which one. They sold $3 million worth of this stock in 17 days.

ASSEMBLYMAN MICHAEL ADUBATO: In 17 days they sold $3 million worth of stock?

MR. GRIFFIN: That is correct.

ASSEMBLYMAN MICHAEL ADUBATO: With no business, except to pay for salaries, consultant fees, and office space for someone, and maybe a yacht somewhere?

MR. GRIFFIN: That is correct. In that regard, Mr. Lezak is presently being compensated at the rate of $125.00 per hour; that is to do no business, as well. It is understood that he will be compensated at the rate of $120,000 per year once the company goes into existence, and he will not be obligated to devote full-time employment to the company.

ASSEMBLYMAN MICHAEL ADUBATO: Excuse me. What was the name of that outfit again?

MR. GRIFFIN: That is the Lezak Group, Incorporated.

ASSEMBLYMAN MICHAEL ADUBATO: Lezak?

MR. GRIFFIN: Yes, sir.

ASSEMBLYMAN MICHAEL ADUBATO: How do you spell that?

MR. GRIFFIN: L-e-z-a-k.

ASSEMBLYMAN MICHAEL ADUBATO: In Jersey City now?

MR. GRIFFIN: Out of M. H. Meyerson and Company, Jersey City, New Jersey.

ASSEMBLYMAN MICHAEL ADUBATO: Okay, go ahead.

MR. GRIFFIN: Another offering, Coal Technology Corporation--

ASSEMBLYMAN MICHAEL ADUBATO: (interrupting) Would you please spell that for us?

MR. GRIFFIN: C-o-a-l Technology Corporation, offered by the now defunct Southeast Securities of Florida, Incorporated, headquartered in Hoboken, New Jersey.

ASSEMBLYMAN STEPHEN ADUBATO: (interrupting) Excuse me, Mr. Griffin. Through you, Mr. Chairman, that was the company where Mr. Sheehan, our second witness, was the lawyer appointed by the courts when Southeast Securities went into receivership.

MR. GRIFFIN: That is correct. Coal Technology Corporation came into the offering insolvent, approximately $200,000 in debt. They raised $762,061 after offering expenses. Of that, $325,000, approximately half, went to pay loans to the current insiders in the company. So, 50% of this new offering, as soon as you put your money down, went back into the pockets of the guys promoting the offering.

Another offering -- Northern Arizona Gold and Silver Milling and Mining Company -- listed the following risk factors: There was no feasibility study on whether or not they could, in fact, mine gold and silver in the mine. They raised inadequate proceeds to construct the mill they were planning to put forward from this offering. The company officers were allowed to receive substantial benefits from the public offering, and I can confirm that. There was a lack of any operating mine associated with the company. They had no alternative business plan; they had substantial conflicts of interest; there was a lack of a mill site; there was dependence on the precious metal prices in the metals market; it was untried management who had never been in the mining business before; there was no market for the company's common stock; and, the offering price was arbitrarily determined, which indicates basically that they threw a coin up in the air and it landed on fifty cents a share. The underwriter was Seaboard Planning Corporation, 215 Main Street, Chatham, New Jersey.

ASSEMBLYMAN MICHAEL ADUBATO: What was the name of that outfit?

MR. GRIFFIN: Seaboard Planning Corporation.

ASSEMBLYMAN MICHAEL ADUBATO: In Chatham?

MR. GRIFFIN: Yes, in Chatham. I'm sorry I don't have the original of this one, because this is the only full-color prospectus I have ever seen. It is called "JoAnn's Chilli Bordello." (laughter)

ASSEMBLYMAN MICHAEL ADUBATO: Say that again, please.

MR. GRIFFIN: JoAnn's Chilli Bordello, Incorporated.

ASSEMBLYMAN MICHAEL ADUBATO: Bordello? I thought that was what you said. Go ahead.

MR. GRIFFIN: This picture is much more exciting in color, I assure you.

ASSEMBLYMAN MICHAEL ADUBATO: We ought to investigate that.

ASSEMBLYMAN STEPHEN ADUBATO: May we have a copy of those pictures while you are talking?

MR. GRIFFIN: Yes.

ASSEMBLYMAN MICHAEL ADUBATO: This is for real now; this is not a--

MR. GRIFFIN: (interrupting) All of these are real security offerings.

ASSEMBLYMAN MICHAEL ADUBATO: This is for real, okay. I know we are laughing because we have to keep our sense of humor, as serious as this is.

MR. GRIFFIN: The imperatives described by other speakers are present in that prospectus as they are in the last two, which I will not detail for you.

ASSEMBLYMAN MICHAEL ADUBATO: Wait a minute. What happened with that?

MR. GRIFFIN: The securities were sold.

ASSEMBLYMAN MICHAEL ADUBATO: We want to give this the same amount of time we gave the others.

MR. GRIFFIN: The securities were sold.

ASSEMBLYMAN MICHAEL ADUBATO: I don't believe this; I don't believe this. They were sold. Go ahead.

MR. GRIFFIN: As to what has happened to the company, I don't know. I think it was about a 1983 offering.

ASSEMBLYMAN MICHAEL ADUBATO: No, 1984; June, 1984. That is incredible. Thank you.

MR. GRIFFIN: A secondary problem that New Jersey is going to face is not simply the fact that it doesn't register securities if they are Federally registered. It is my understanding from reading your act that you also don't register securities if they are Federally exempt. There is a large category of companies coming out of Colorado and Utah -- and I expect New Jersey will be next -- known as "Rule 504 Shell Companies." They are relying on a Federal exemption, and then they are registering it in a state on an intrastate basis. They cannot prevent the offering sale. Well, what happens is, essentially they take companies public with no net proceeds, net proceeds of $900.00. Then

they merge with a private company and, all of a sudden, you have totally evaded state and Federal securities laws on both levels. This is a problem which has been raised--

ASSEMBLYMAN STEPHEN ADUBATO: (interrupting) Excuse me.

MR. GRIFFIN: Yes, sir.

ASSEMBLYMAN STEPHEN ADUBATO: Mr. Griffin, through you, Mr. Chairman, please explain why a company would be Federally exempt. Why Federally exempt in the first place?

MR. GRIFFIN: The Federal Securities and Exchange Commission has passed a regulation which is intended to raise capital for small companies, to make small business financing simpler. As a part of that, for offerings under $500,000, they look primarily to state regulation. Your law, obviously, is not intended to dovetail with that, inasmuch as you exempt the same stock that they exempt.

ASSEMBLYMAN STEPHEN ADUBATO: We make certain assumptions in New Jersey about the SEC laws in place protecting the public and allowing for a free flow of capital formation. However, on the reverse end, the SEC has a certain stipulation that says certain entities can go through the process and not have an exemption. Their assumption is that they are being regulated on a state level.

MR. GRIFFIN: That is correct.

ASSEMBLYMAN STEPHEN ADUBATO: Okay.

MR. GRIFFIN: So, these offerings basically fall through the cracks.

ASSEMBLYMAN STEPHEN ADUBATO: I know the people from NASD are still here listening to that. Okay.

MR. GRIFFIN: You might ask, why would anyone buy an investment of this sort? The penny stock market does not run on logic; it runs on hype and manipulation. The atmosphere during a hot issue market is comparable to the feeding frenzy among ocean fish. Because the price of the stock is so low, a few cents movement upward can mean as much as 100% appreciation to the investor. During the hot issue market in 1980 and 1981, people clamored to buy new issues because they believed that new issues always go up. No purchaser intended to remain the owner of a particular stock for more than a few weeks or months,

and no one bought with investment intent. The Director of the Denver Regional Office of the SEC described this phenomenon as an application of the "greater fool" theory. This theory states that no matter how stupid I am to buy this worthless stock, I firmly believe there is someone out there more stupid than I who will pay more for it than I did. The essential point here is that the people who fall victim to the penny stock market in this game of musical chairs, the person who is left without a chair, is typically not a sophisticated investor. He or she is not an attorney, not an accountant, not an insider in the company, but an ordinary citizen, like Mr. Kvist, who was here this morning, a bus driver, a secretary, a laborer. These are the people who can invest $200.00 or $500.00 to buy a round lot of this stock, and who are so embarrassed when the stock collapses that they don't complain to you. They may complain to us on isolated occasions, but that is why you don't hear about it. It is the perfect scam. If you can steal $200.00 from everyone in America and no one complains, you are the richest man on earth. It is an ideal sort of scam that these people operate.

It has also been stated by the Regional Administrator of the NASD in the district I am a part of, that it is very difficult to retain your ethics as a penny stock broker if you are clearing $40,000 a month. The amounts of money made by the penny stockbrokers during hot issue periods are astronomical. The commission structure is different than in other parts of the stock market. There is high pressure on the salesmen to sell the new issue, but not to resell it in the market after it is sold in the first place. The whole direction is to get the stock out, though the certificates often will not be delivered because that would facilitate resale. In documents filed in Federal court relating to the bankruptcy of OTC Net, the largest penny stockbroker, I guess, in the history of the country, a former coach for one of the school districts in the Denver area increased his net worth by over $7 million in a two-year period, and this was essentially on commission sales of the stocks.

Customer solicitation practices of penny stockbrokerages during hot market periods have been described by participants as those

of boiler rows. Typically, an agent arrives at work and is given a column of the phone book to cold call in an attempt to sell securities that the broker/dealer is pushing that week.

Finally, there is abundant evidence that there is a clear correlation between merit regulation and clean securities markets. Six states are commonly known in the industry as free states. These are: Colorado, Utah, Nevada, Florida, New York, and New Jersey. It is not a coincidence that all six of these states have very lenient review requirements, or no review requirements at all, as you have in New Jersey, and they are renowned as havens for one form or another of securities-related fraud. The best and most effective means of doing away with the abuses you heard about today is to eliminate the product, that is, the penny stock, around which these abuses center. This stock cannot be sold in a state like Massachusetts; it cannot be sold in about 36 of the states because they have substitive standards the stocks must meet before it is legal to sell the stocks in that state.

ASSEMBLYMAN MICHAEL ADUBATO: Are you saying there are approximately 36 states out of the 50 states right now where you would really have a problem trying to sell penny stock?

MR. GRIFFIN: Absolutely; a problem, if not an impossibility of selling those stocks.

ASSEMBLYMAN MICHAEL ADUBATO: Thirty-six out of the 50 states?

MR. GRIFFIN: Thirty-six states responded to the questionnaire put out by our National Association that they exercise merit review in one form or another. Now, there are different forms that that takes.

ASSEMBLYMAN STEPHEN ADUBATO: Obviously, New Jersey is not in that category.

MR. GRIFFIN: Obviously not. New Jersey is in the far end of the other direction.

ASSEMBLYMAN MICHAEL ADUBATO: We are on the other end of the spectrum, okay. Please go ahead.

MR. GRIFFIN: Statutory provisions authorizing your State securities administrator to prevent the initial offer or sale of any

stock offerings, including SEC-registered offerings, which are unfair, unjust, or inequitable to New Jersey investors, or which tend to work a fraud upon them, would go a long way toward eliminating these problems. Merit review works and, to my knowledge, it is the only practical method for preventing securities fraud before the money changes hands. Thank you.

ASSEMBLYMAN MICHAEL ADUBATO: I would ask those two cameramen over there to please pan the audience. I would like to make sure I get a picture of the audience here today for our library.

I want to thank you again, Mr. Griffin. I don't know what to say to you about your coming all the way from Colorado, and Mr. Unger coming from Massachusetts. I appreciate Mr. Unger coming, but you coming from Colorado is-- I just don't know what to say, except to tell you that if you ever need anyone from New Jersey out there, I will be happy to try to help you get whomever you need.

MR. GRIFFIN: I may be on the phone next week.

ASSEMBLYMAN MICHAEL ADUBATO: Well, I have been known to keep my word. Assemblyman Adubato?

ASSEMBLYMAN STEPHEN ADUBATO: Mr. Chairman, again, in the same vein as when Mr. Smith and Mr. Barry testified-- You know, if this meeting has done anything so far, it has allowed us to at least -- in a very clear fashion, and in a very frank fashion -- talk about the issue that we came here to talk about today. The only thing I can raise on the issue of merit review as a question is what seems to me to be a typical response from an industry representative -- and I know we are going to be hearing from industry representatives later -- and that would be that we don't want to stop capital formation in any way. I guess I am as concerned about that as anyone else. That is one of the things that comes to my mind in the issue of merit review. Mr. Unger did talk about that in some sense, but I want to ask, in Massachusetts, or in Colorado -- and, I know your laws are different -- have you in any way experienced any clear indication that merit review in your state has restricted capital formation? What indications have you had that it has or it hasn't?

MR. UNGER: The answer to that is no. I think the economic situation of Massachusetts, as strong as it is, points to that fact. There are many companies that have gone public in Massachusetts -- The Pollo Computer, Automatics -- very strong companies that came public in our state. They may have had a few problems here or there that did not strictly meet our standards and guidelines, but we were able to look at those. We are not inflexible. State regulators are human beings; we are not robots. As far as inhibiting capital formation for legitimate entrepreneurs, for companies with legitimate ideas, and a legitimate basis for existence, more often than not they are able to go forward. I believe the argument about merit review restricting capital formation is really rhetorical, and I think you are going to hear that argument not so much from the business people who try to bring companies public, but you are going to hear it from the bar. And, whatever your legislative proposals are, if they have some type of merit review, you are going to be lobbied hard. I want you to understand that. We have been through this in various states, and you will probably be lobbied hardest by the bar association, whether it is your State Bar Association or the American Bar Association, which does not have a great feeling of warmth for merit review, and I will tell you why.

It is because their jobs are made a little more difficult because of merit review. They have to keep a check list of the various states and the various state statutes and requirements, and they have to make phone calls. Their job is to see, on behalf of the underwriting syndicate more often than not, that the issue is clear in given states. That is not easy. I am not going to say that we make their job easier, but I don't think we are here to make their job easier. You have to confront a very, very basic public policy question. You will be lobbied, and you will be told about the expense of additional regulations to issuers and how the money is taken away from the purpose of the offering to build a factory, and it is going to legal fees, and paper, and all of that. There is probably some truth in that. There is a cost to it; there is certainly a cost to good regulation. As legislators, as any legislator does on any bill, you have to weigh where you feel the public benefit should be. We very

strongly believe that the capital markets are better served, albeit there is some cost, with strong up-front regulation that ultimately is to the benefit of the industry that is being regulated.

And, yes, it might cost a little bit more, but I think that is a sound investment and a sound legislative policy.

ASSEMBLYMAN MICHAEL ADUBATO: Did you say that Massachusetts has the strongest merit review in the states?

MR. UNGER: We are among the four or five states that are probably the strongest. We don't have the strongest statutory language, but we have read our authority under the statute to give us the kind of review that we feel is necessary to protect our citizens. I think that is why we only need 18 people. If we did not have that, we would probably need 40 or 50 people because we would have to be cleaning up after the fact. There is a cost benefit to front-end regulation.

ASSEMBLYMAN STEPHEN ADUBATO: Mr. Chairman, I withdraw my question to Mr. Griffin because I forgot how bad their situation is. I don't know if you can talk about merit review in your own state, because obviously it doesn't exist.

MR. GRIFFIN: I have attended small business conferences, and as to small business relocations, where they are going to move, whether or not a state has merit review is insignificant. What they really look at is the educational environment in the state, the tax laws in the state, and the availability of bank access. The question of whether or not they have to have meritorious stock is not a concern to them, because most of the legitimate businesses are going to try to structure their deals so that they are meritorious in the first place.

In the second place, many of these companies are not raising capital for any business purpose. When you read the prospectuses that I am going to provide you with, you will see that in a blind pool the money is going to be used to pay back loans to insiders. It is going to be used in salaries and consulting fees. We are not talking, in 95% of the cases, about building a factory to produce computers. We are talking about front-end ripoffs.

ASSEMBLYMAN STEPHEN ADUBATO: I have no further questions, Mr. Chairman.

ASSEMBLYMAN MICHAEL ADUBATO: Assemblymen, questions? (negative response) Again, thank you very much. For the record, I think the legitimacy of your last statement is the real bottom line, Mr. Griffin, and that is that the people who are accountable come into a state because it is to their advantage that they can make a profit legitimately, and absolutely everything about profit is good. Without that, nothing happens. It is not a question of profit; it is a question of someone taking the yacht before they produce the profit. I don't mind if they buy the yacht, but first produce the profit.

Thank you both for coming. The next witness will be Mr. William Fitzpatrick. We have Mr. Fitzpatrick listed as the Vice President of the Securities Industry Association. Is that right? (affirmative response) We haven't been right on anyone's title today, Mr. Fitzpatrick.

WILLIAM J. FITZPATRICK: I am Senior Vice President and General Counsel of the Securities Industry Association.

ASSEMBLYMAN MICHAEL ADUBATO: Thank you, Mr. Fitzpatrick.

MR. FITZPATRICK: The Association is a trade association. It is not like the NASD; it is not a self-regulatory organization. We have no regulatory powers, nor do we have rules and regulations outlining the conduct of our members. We are solely a trade association. We represent our members. Our members are approximately 530 broker/dealers, and those broker/dealers represent most of the major investment banking firms and broker/dealers in the country who do approximately 90% to 95% of all securities transactions in this country.

I will try to be as brief as possible, and will comment first on the merit regulation aspect of it. Secondly, I will address the penny stock portion of it. They are two distinct separate questions, although in listening to the testimony today I think there was a great fudging of the two.

I am sure that this panel, as well as many people in the audience, are well familiar with the statistics which indicate that most of the new job creations in this country come from small new businesses, and that actually the creation of jobs, if it were left to

the established corporations in the United States, would be a fairly static number. But, new jobs come from new businesses, new industries. I am sure that New Jersey has profited from this, as well as all of the other states.

Not surprisingly, one of the biggest problems for small companies is the matter of raising capital. A company which chooses to go public is undertaking a very expensive proposition. There will be bills to pay from printers, accountants, and lawyers. Filing fees are another expense. A SEC study determined that for certain types of offerings for small business, the expense related to going public absorbed approximately 18% of the total proceeds of the offering. In recognition of the very considerable costs that regulation can impose upon the process of capital formation, particularly for small businesses, Congress has attempted to help. For instance, the enactment of the Small Business Investment Incentive Act of 1980 led to the recent adoption by the SEC of what is known as Regulation D. That regulation is designed to assist small businesses to raise capital by relieving them of many of the regulatory burdens placed upon public offerings.

When Congress established the SEC and the national system for regulation of securities, it failed to address the interaction between the Federal and state governments, and the state statutes governing securities activities. As the marketplace has developed in the last 50 years since the creation of the SEC, the need for uniform standards of regulation governing the offering of securities has become increasingly obvious. A system of nationally consistent regulation can be brought about by only two means: One is by preemption, total preemption by the Federal government over state regulation. But the second alternative, and the much more desirable alternative, is for states to become uniform and coordinated with the Federal system. The Federal laws, as we have heard many times before, are disclosure laws protecting investors by requiring complete disclosure of all material facts about a company and its offices. Approximately half of the states are disclosure states, and New Jersey is one of them.

All 50 states have their individual statutes and, although they are modeled on what is called the Uniform Securities Act--

ASSEMBLYMAN MICHAEL ADUBATO: (interrupting) Let me interrupt you. You said you were Senior Vice President or Executive Vice President?

MR. FITZPATRICK: Senior Vice President.

ASSEMBLYMAN MICHAEL ADUBATO: I want to get your title correct, Senior Vice President. As a Senior Vice President, did you just make the statement that New Jersey has disclosure laws?

MR. FITZPATRICK: That is correct.

ASSEMBLYMAN MICHAEL ADUBATO: In what way do we have disclosure laws?

MR. FITZPATRICK: You follow the Federal system.

ASSEMBLYMAN MICHAEL ADUBATO: Well, let me ask this in a different way. Who doesn't follow the Federal system? What state does not follow the Federal system?

MR. FITZPATRICK: They all have a degree of disclosure involved, but only half of them have what is known as merit regulation.

ASSEMBLYMAN MICHAEL ADUBATO: No, let me say it again. The disclosure laws you are talking about are not laws that have been put on the books by the states.

MR. FITZPATRICK: Some of them are, yes.

ASSEMBLYMAN MICHAEL ADUBATO: Not New Jersey.

MR. FITZPATRICK: Yes, you have a disclosure law.

ASSEMBLYMAN MICHAEL ADUBATO: But, that is a--

MR. FITZPATRICK: (interrupting) Either you register with the State of New Jersey or you register under the 1933 Act.

ASSEMBLYMAN MICHAEL ADUBATO: Let me ask you a question. I want to make sure I heard you properly. You're saying that if someone wants to go out into the marketplace to raise capital, there is a disclosure they have to make to the State of New Jersey.

MR. FITZPATRICK: There is an exemption for those who have filed under the Securities Act of 1933, which is a disclosure statute. So, the Federal--

ASSEMBLYMAN MICHAEL ADUBATO: (interrupting) But, they don't have to make a disclosure.

MR. FITZPATRICK: They do, Federally, and it becomes public record, yes. That is the system under which securities are sold in this country.

ASSEMBLYMAN MICHAEL ADUBATO: Okay. I'm confused, because I have been told by other people that in New Jersey there exists, widely I'm told-- I am told that people are out there selling stock, and the State of New Jersey doesn't even know who they are.

MR. FITZPATRICK: Well, I can't testify for the State of New Jersey.

ASSEMBLYMAN MICHAEL ADUBATO: They don't even know who they are. There is no record of anything anywhere. Where are they disclosing? Maybe you can help me. Where are they disclosing? Tell me. What department in New Jersey are they disclosing to?

MR. FITZPATRICK: Well, the Securities Commission.

ASSEMBLYMAN MICHAEL ADUBATO: They are disclosing to Mr. Smith? Mr. Smith, would you please join us now?

MR. FITZPATRICK: May I--

ASSEMBLYMAN MICHAEL ADUBATO: Excuse me, sir.

MR. FITZPATRICK: No, excuse me.

ASSEMBLYMAN MICHAEL ADUBATO: No, excuse me; I will run the meeting.

MR. FITZPATRICK: I am just asking for courtesy.

ASSEMBLYMAN MICHAEL ADUBATO: It is a courtesy.

MR. FITZPATRICK: Everyone has testified here at full length, and then questions have come forth.

ASSEMBLYMAN STEPHEN ADUBATO: Excuse me, Mr. Fitzpatrick, we have cut people off in the middle of their testimony.

ASSEMBLYMAN MICHAEL ADUBATO: Excuse me, Assemblyman. Mr. Fitzpatrick, I don't know if you were here during the course of the meeting.

MR. FITZPATRICK: I have been here since ten o'clock as requested.

ASSEMBLYMAN MICHAEL ADUBATO: I'm very happy you were here, and we appreciate it. The point is that throughout the day we have interrupted people's presentations, to be perfectly fair.

MR. FITZPATRICK: But, it wasn't done in stereo with guest speakers. You can ask me any question you want. Mr. Smith has had ample time to give his presentation. If you want to ask him a further question, fine.

ASSEMBLYMAN MICHAEL ADUBATO: Excuse me, Mr. Fitzpatrick. Mr. Smith, where and how do these people disclose what they are doing to you?

MR. SMITH: They don't.

ASSEMBLYMAN MICHAEL ADUBATO: Thank you, Mr. Smith. That is all I wanted to ask.

MR. FITZPATRICK: Wait a minute. May I ask Mr. Smith a question?

ASSEMBLYMAN MICHAEL ADUBATO: No, you may not. Please continue.

MR. FITZPATRICK: In many states, statutes give the commissioner the authority to refuse to approve an offering of securities if he finds the terms of the offering are not "fair, just, and equitable." This is called "merit review," and is totally different from disclosure, which is the Federal system. You have to understand that merit review has nothing to do with fraud. All we are dealing with are the standards of fair, just, and equitable. It has nothing to do with fraud.

All 50 states, including New Jersey, have statutory provisions permitting the state administrator to refuse to approve an offering which would constitute a fraud upon the purchaser. Only about half of the states have merit review. Under the broad discretion granted by merit review statutes, the state administrators review an offering and are involved in deciding whether they are personally satisfied with the amount and nature of the underwriting commissions, the amount of stock issued to insiders and promoters in return for their efforts in organizing the company, the issuances of options and warrants to key officers, the offering price to the public, shareholder voting rights, and interest and dividend coverage. While any one of these individual categories could be the source of an abuse, taken as a whole the net effect is that the state securities commissioner is

involved in each securities issue, not as a regulator, but as a corporate financier. He actually structures the deal as if he had an interest in the economic outcome. Of course, this adds substantially to the time and cost involved in clearing an issue.

Under the merit review standard, an issue can admittedly be free of fraud, but unacceptable in the subjective judgment of the securities commissioner. Therefore, it would not be approved for sale to the public. Exercising their merit review authority, securities commissioners have refused to approve initial public offerings of such stocks as Apple Computer, U.S. Telephone, and others you have all heard about. The subsequent performance of these companies has revealed how dubious was the initial refusal and how costly it was to potential investors.

More importantly, broker/dealers are united in their belief that the chilling effect on the raising of capital in those states that are known as "tough merit review jurisdictions" is significant. Without question, merit review adds cost to the issuance of securities, and the fact that the standard varies from state to state means an issuer must run the gauntlet of state commissioners, each applying his own personal views of what is "fair, just, and equitable." Always remember that all of this has nothing to do with fraud. All states, again including New Jersey, can keep a fraudulent issue from being sold within the state. The securities industry believes coordination of state securities registration requirements with those of the Federal securities laws is essential. The rapid development of national markets for securities cannot proceed in the face of merit review. Individual commissioners reviewing offerings act in good faith, but without fully understanding the increasing nationalization and internationalization of our marketplace, and without the staff, training, funding, and other resources that do the type of in-depth corporate financial analyses that merit review requires.

Redirection of business away from states with obsolete regulatory systems such as merit review is a reality. These factors were considered by the Legislatures of Illinois, Iowa, and Michigan when, over the objection of their state securities commissioners, they

recently modified their statutes and eliminated almost all merit review in favor of a disclosure standard similar to that of the SEC. One need only review the testimony given recently in Illinois on this issue, particularly the testimony of the Honorable Jim Edgar, the Secretary of State of Illinois, who supported and sponsored the elimination of merit review in his state as a result of personally witnessing merit review drive away new business from Illinois. Texas is about to introduce legislation which would largely eliminate merit review. The States of Ohio, Indiana, Kentucky, and Arizona either have or are considering abolishing merit review. In fact, just as an aside on Arizona, that State has recently been sued for $50 million, together with the securities commissioner. The theory is that this was done by an investor because the State of Arizona did not exercise good judgment in its merit review, and allowed a security to be sold which later went bankrupt.

In short, to suggest that New Jersey become a merit State is to suggest that it alone buck an increasing national trend toward eliminating merit review. In the last year, three states have eliminated merit review; no state has recently proposed becoming a merit review state.

The series of articles published recently in your local newspaper did highlight several illustrations where investors lost money by investing in so-called penny stocks. While there is nothing inherently wrong with low-priced stocks, these sorts of securities are recognized by the broker/dealer community as very speculative investments which are not suitable for everyone. Many SIA members have had long-established policies of discouraging selling penny stocks to members of the general public. For instance, salesmen in many broker/dealers receive no commission on the purchase or sale of a stock which sells for less than $3.00. In addition, in many firms brokers have to receive special permission from their superiors before entering an order for such securities, and almost none of SIA's members will underwrite low-priced securities.

It should also be remembered, as Mr. Smith pointed out, that more than 1,100 broker/dealers -- I think he said the number is now

1,400 -- are licensed in New Jersey, but only about 50 of those are actively engaged in the sale of penny stocks. New Jersey must be very careful not to discourage an entire industry from operating in the State because of the occasional abuse by a small segment of that industry. If the problem is fraud, we agree that the Chief of the State Securities Bureau should be given adequate staff to actively enforce the law. However, it must be realized that if New Jersey opts for merit review, it will require a much larger and a much more sophisticated securities staff, with the resultant budgetary demands, and without necessarily increasing the Bureau's ability to combat fraud itself.

If the laws of New Jersey -- and, obviously, it is up to you good gentlemen to decide -- are to be changed, care should be taken to assure uniformity with the other states so as not to single out New Jersey and isolate it from the mainstream of the financial industry. With other states eliminating merit review, to become part of that mainstream, New Jersey should heed the lesson of its large industrial sister states, such as Illinois and Michigan, and do nothing to make this State appear reactionary. The State of New Jersey, with its hopes of playing a major role in high technology, cannot afford such a giant step backward. Thank you.

I have just a few brief comments on one thing you said, Mr. Chairman, about casino employees. You made a point that casino employees in the State of New Jersey have to undergo considerable inspection and investigation before they can play blackjack, or whatever, down at Atlantic City. I must also point out that people in the securities industry must undergo as equally a scrutinizing investigation, and that no one can become a registered representative -- which is the term of art for a salesperson -- register with the NASD, the New York Stock Exchange, or any of the self-regulatory organizations, without first undergoing a complete background check of his entire business, professional, and schooling careers. He must be fingerprinted, and those fingerprints are checked with the FBI. There is a considerable amount of scrutiny given to anyone before he or she can sell securities.

I think that is about it. Again, I thank you. I am sorry for my intemperate outburst before, but you must consider the fact that I am Irish, and those things happen. Thank you.

ASSEMBLYMAN MICHAEL ADUBATO: Mr. Fitzpatrick, in your opinion, is it a fair commentary to say the perception is that we overlap in lumping everyone in the securities business in one pot? Is that what you are saying?

MR. FITZPATRICK: No. I think there was an attempt, certainly by Mr. Smith, to state that we are talking about a very small minority, an extremely small minority. I think it is your job, and the job of the Legislature, to make certain that because of a problem, and no one denies that there is a problem, and believe me, no one wants to see the bad guys thrown out of this business any more than SIA or our members, because they really constitute an unfair--

ASSEMBLYMAN MICHAEL ADUBATO: (interrupting) With that in mind, Mr. Fitzpatrick--

MR. FITZPATRICK: (interrupting) You have to be certain not to throw the baby out with the bath water. I think that is what we are saying.

ASSEMBLYMAN MICHAEL ADUBATO: Well, you know, I won't use the word resent, but I do resent your attitude. You are trying to insinuate, or infer, or accuse us of trying to throw the baby out with the bath water. I mean, that is a tactic I am used to dealing with when I deal with insurance company types. See, it just doesn't work as a strategy.

We are not throwing anyone out. You know, this is free enterprise at its best. What we are trying to do is deal with the targeted area that was presented in the newspaper, which motivated the resolution and this meeting. Now, if you think your people were identified in those stories, that is your problem.

MR. FITZPATRICK: They weren't.

ASSEMBLYMAN MICHAEL ADUBATO: That is not what we're saying. If you are saying that, we will listen to you if the people you represent are a part of that ilk. See, we never said that. What we are dealing with is within that framework.

Let me ask you something. Penny stock, historically, and I am throwing this out to the Committee and to you, is really a stock which has what, maybe a $5.00 normal maximum?

MR. FITZPATRICK: I think that might be very high. There are many stocks selling on the American Stock Exchange, and certainly on NASDAQ, which sell for less than $5.00. It is pretty tough to get a grip on it.

ASSEMBLYMAN STEPHEN ADUBATO: I think to clarify the Chairman's point, what he is saying is between a penny and $5.00.

ASSEMBLYMAN MICHAEL ADUBATO: That is what I am saying.

ASSEMBLYMAN STEPHEN ADUBATO: It is a working definition.

MR. FITZPATRICK: It's tough. Five dollars would be awfully high.

ASSEMBLYMAN MICHAEL ADUBATO: It's high, but that is not the issue. They are the parameters.

MR. FITZPATRICK: It would have been vey high, especially in the market of last year, because PanAm was selling at three.

ASSEMBLYMAN MICHAEL ADUBATO: That is the classical definition, according to what I have been told, of a high and a low, although today we heard from someone who has stock that is worth less than a penny.

ASSEMBLYMAN STEPHEN ADUBATO: A lot less.

ASSEMBLYMAN MICHAEL ADUBATO: It was .005 or something, whatever it was. So, it could be even less than a penny. The issue is that in those kinds of operations, setting up what we call disclosure, and what we call merit review-- In those instances, why would you be upset about that?

MR. FITZPATRICK: Well, if what the first witness described took place, and I have to assume that it did, I mean, he told his story as a truthful person, most certainly there are plenty of laws on the books right now to--

ASSEMBLYMAN MICHAEL ADUBATO: (interrupting) Let me rephrase the question. I am not asking you to condone somethig. What I am saying is, we are talking about a merit review situation, and we are talking about a situation which deals with disclosure; we are not

talking about going to Lehman Brothers. We are not talking about going to Merrill Lynch, where they may have some broker/dealers. Do they have broker/dealers in those houses?

MR. FITZPATRICK: Yes, they do.

ASSEMBLYMAN MICHAEL ADUBATO: Oh. So, we are not talking about going to Lehman. Okay? Let's get that out of the way. Let's get that myth that I think you are trying to present out of the way. That is not what we are targeting on. That is not what we are talking about. We are talking about JoAnn's Chilli Bordello. That is what we are talking about. Now, if you have a problem with that and you want to defend it, that is okay. That is your privilege. That is the kind of arena that we are talking about. You may be oversensitive.

MR. FITZPATRICK: No, I don't think we are talking about that.

ASSEMBLYMAN MICHAEL ADUBATO: Okay.

MR. FITZPATRICK: Actually, when you pass a merit statute, you are affecting all. Lehman, although Lehman is no longer in existence--

ASSEMBLYMAN MICHAEL ADUBATO: (interrupting) How do you know what our statutes are going to be?

MR. FITZPATRICK: I have no idea.

ASSEMBLYMAN MICHAEL ADUBATO: How do you know what our laws are going to be? How do you know what we are going to implement?

MR. FITZPATRICK: I know what merit is though. I know what the merit statutes are. They are in existence and they are in place. Mr. Unger has testified to them, and Mr. Griffin.

ASSEMBLYMAN MICHAEL ADUBATO: The whole point is that there are degrees of everything. I always equate it and come back to the states you are talking about. You mentioned Illinois; you mentioned Ohio. I am very familiar with those states as they apply to insurance regulations and systems. Okay? I don't want to get into that, except to say that the more things change in those systems, the more they stay the same. It is like a circle. Those systems operated one way in Illinois, and now they are coming back another way. Now, you have legislation in there calling for compulsory liability insurance. The

companies are going off the wall. And, you know, they were telling us to follow Illinois -- State Farm and Allstate -- saying, "Hey, we don't have any compulsory insurance in Illinois. That is what you people ought to do." Now their Legislature is pushing for compulsory insurance. We should know what is happening, but that doesn't mean it is the right thing to do, just because someone else is doing it.

Assemblyman Adubato, do you have a question?

ASSEMBLYMAN STEPHEN ADUBATO: Yes, just a follow-up question. Mr. Fitzpatrick, in your statement you said -- and I will quote you if I may -- "Merit review has nothing to do with fraud."

MR. FITZPATRICK: That is correct.

ASSEMBLYMAN STEPHEN ADUBATO: Okay, let me ask you this. Under disclosure review, with a promoter who has a prior conviction -- as we stated earlier -- which put someone out of business for a while for securities violations, can you take a company public as long as the conviction is disclosed?

MR. FITZPATRICK: That is correct.

ASSEMBLYMAN STEPHEN ADUBATO: Shouldn't the State be able to say no to someone -- if Mr. Smith had that power because we chose and the Governor chose to give it to him in his office through a merit review system -- who has prior convictions relating to SEC violations, for example, stock manipulation? Shouldn't we have the right to say, "No, we don't want you to do business in New Jersey"? What problem would you have with that?

MR. FITZPATRICK: Let me liken it to any precensorship by government. Police power is not best exercised in the field of literature by policemen sitting down and reading books, and saying, "Yes, Agatha Christie can be sold, but Mickey Spillane cannot be sold." Police power is best exercised -- and remember, we are talking about the police power of the State here -- by enforcing laws against fraud and throwing the rascals into jail. That is where the State of New Jersey, and all states, should be putting their money.

ASSEMBLYMAN STEPHEN ADUBATO: How can New Jersey, as a State, stop an offering where we perceive there is fraud involved, if the company is not even required to file or otherwise notify the State that

the offering is even taking place? There is a misconception here. You are making it sound as if they disclose in this State, and they do not disclose anything in this State. Mr. Smith did not know when JoAnn's Chilli Bordello was going public. So, I would argue, from a law enforcement point of view, that the best way to protect our citizens is by prevention. On the face of things, and based on the information we have seen here, I would say that we do not want JoAnn's Chilli Bordello to do business in our State, and Mr. Smith doesn't even know they are doing business in the State until it is too late, and until we have people coming before us telling us that they lost a significant percentage of their life's savings. I would argue that that is no way for government to conduct itself as a way to protect people and allow them to have a fair and legitimate opportunity to make an investment and earn a profit.

I have no more questions.

ASSEMBLYMAN LOVEYS: I just want to make a statement, not ask a question. I think I heard correctly, and I feel there can be different types of merit review. I think I heard Mr. Unger say that in Massachusetts, as Director, he does not have the ability to allow or disallow certain securities to be sold in that state, as the last say. I think that is what I heard you say, Mr. Unger.

MR. UNGER: I have the ability to tell someone to sell their securities somewhere else. I said that we also have the ability to be flexible, particularly for local or regional firms where we are able to more carefully keep an eye on their activities. I would feel more comfortable about a firm in Massachusetts going public at $1.00 a share. I would be far more inclined to let them go because they were local concerns, primarily because once they have taken the public's money, I wouldn't have to spend taxpayers' money to get on an airplane to check their books and records. I could just send my people out to check their books and records.

ASSEMBLYMAN MICHAEL ADUBATO: But, the whole key I got from your presentation was that when you analyze the states that you go to first to find out about whether firms have been there or not, and where they came from, whether it is New Jersey, southern Florida, Colorado,

or whatever-- What I'm saying is, if an entity is developed, say, in one of our sister states-- We're all sister states, I guess, but we consider our sister states to be Pennsylvania, Massachusetts, and New York. They are more or less our sister states, if you will. In those situations, we compare not only with Massachusetts, we compare with New York a little bit, and we compare with Pennsylvania a little bit. Now, quite frankly, I don't know what the system is in Pennsylvania, and it hasn't been brought up here. But, from a standpoint of information, it would be strange if someone were to develop a situation, say, in Pennsylvania, the Pennsylvania system would not allow them to sell those securities in Pennsylvania, and they would sell them in New Jersey, or vice versa, if it was in New York. If it were a case where the people in New York did not want them functioning in their state, they would come over here and function and sell in New Jersey, for something that is going to take place in New York. I mean, that would be common sense, I would think. I don't think that that has anything to do with the restriction of trade. I don't think that has anything to do with suppressing the free market. That is just being thoughtful, and saying, "Wait a minute. If they are talking about putting a project in New York State, or in Pennsylvania, and those states will not allow them to sell those securities, or those stocks in those states, how the hell can we allow them to sell them here?" That is a starting point, do you see? We are familiar with situations like that, which I am not going to get into at this time because, quite frankly, we don't have the time. I intended to get into them, and maybe we will at our next meeting. That meeting will probably take place after we have drafted a bill, along with Assemblyman Adubato and the other people here. That is going to happen very soon.

Assemblyman LaRocca, do you have anything to say?

ASSEMBLYMAN LaROCCA: No, thank you.

ASSEMBLYMAN MICHAEL ADUBATO: Mr. Fitzpatrick, I want to thank you for coming. You know the excuse you used for your temperament, the fact that you are Irish? Well, that is the excuse I use, since I am Italian. I know what you are talking about, the Irish temperament, because I have the good fortune of having lived with a

very good lady, who also has an Irish temperament, for 25 years. So, I do understand it. (laughter)

MR. FITZPATRICK: Okay, good. Just tell me where you found her.

ASSEMBLYMAN MICHAEL ADUBATO: I do understand it.

MR. FITZPATRICK: Thank you.

ASSEMBLYMAN STEPHEN ADUBATO: Excuse me, Mr. Chairman. Just as a point of clarification, the Chairman is speaking about his wife, and no one else. (laughter) That is my aunt, so I just want to make that clear.

ASSEMBLYMAN MICHAEL ADUBATO: I meant my wife; I'm not living with anyone else.

ASSEMBLYMAN STEPHEN ADUBATO: I just wanted to get that on the record.

ASSEMBLYMAN MICHAEL ADUBATO: Our next witness will be Mr. Joseph Krassy. Mr. Krassy, I have no idea where you are from.

JOSEPH KRASSY: I am Joseph Krassy, an attorney, and I practice in New York. I have my own firm, Krassy and Heller.

ASSEMBLYMAN MICHAEL ADUBATO: Okay, thank you.

MR. KRASSY: I specialize in state securities laws. I developed that specialty over some 12 years, first with Cleary Gottlieb, then with Wilkie Farr, and then last year I started my own firm. I understand we are running a little short on time, so I will keep my remarks brief. As it turns out, Mr. Fitzpatrick has stolen a lot of my thunder.

What I was hoping to do was focus on the limitations of the merit reviews I have experienced over many years. The broker/dealers I represented were the Lehman Brothers, the Solomon Brothers, and the Shearsons, and consistently the impact of merit review has been to delay public offerings and generate significant additional expense in the process of clearing certain difficult states. When you are dealing with a $50 million offering, or a $20 million offering, the additional $50,000 or $60,000 of expense may be a drop in the bucket, but nonetheless, it comes out of the issuer's pocket.

Some of the characteristics that Mr. Griffin attributed to penny stock are characteristics that are typical of initial public offerings, whether we are talking about Midway Airlines or Apple Computer. You have the dilution that is typical of an initial public offering, where the investor puts his money in -- say it is $15.00 a share -- and by the time it is completed, it is worth $2.00 a share. That is even before a secondary market gets started. You have typically cheap stock, that is, the insiders have reserved 70% or 80% of the equity ownership in the company for themselves, and the public investors, who contribute 80% of the capital, get 20% of the ownership of the company.

We have all heard stories about the gentlemen who brought Apple Computer public, and they are all millionaires several times over. I don't think we would characterize their profit as ill-gotten gains, but these are still characteristics that have been maligned in the case of the penny stock market.

I guess what I am saying is that some of the solutions which have been so easily recommended by people here are not easy solutions, or perhaps not even appropriate solutions, unless you have some pretty clear idea of what it is you are trying to prevent. If you are talking about limiting people who have been convicted of fraudulent activities in the past, that is a pretty fair guideline. I wouldn't have any reservations about putting that into the statute or into the regulations adopted by the Chief of the Bureau of Securities. That would be easy to administer, and would be easy to identify by the underwriters who are selling the securities, the issuers who propose to go public, and the attorneys who represent everyone.

The problem with merit review, in a broad sense, has generally been its subjectivity. That is, you cannot distinguish, in any effective way, whether a company which has made loans to its officers is ipso facto engaging in fraudulent activities or ripping off public investors. For example, you can't determine on the basis of subsequent performance whether the initial public offering was a fraudulent public offering. Any number of companies have gone public and have simply done poorly. They can't make money; the management is

lousy; but, you cannot accuse them of fraud. Some of them were penny stock when they went public; some of them are penny stock as they are being traded now on the stock exchanges.

The issue I wanted to touch on more extensively was, again, the one that Mr. Fitzpatrick addressed, and that is the track record of states which have historically been characterized as "merit review" states. Some are better than others, largely, as someone pointed out, based on the sophistication of the staffs which are called on to administer these laws. So, the staffs which have good accounting and lawyer talents built in tend to do better, not simply because they can identify economic problems, but because they are intelligent enough to make discriminating distinctions. That is a critical element. Discriminating distinctions have to be there if you are talking about merit review, and most merit review states, I'm afraid, do not do that. They focus on dilution at 70%, and they say,"That is excessive; we can't allow you to go public in our state." One of my favorites happened to be Midway Airlines, which I lost several states on because of cheap stock and, frankly, they had a negative net worth. The company was worth less if it went into bankruptcy than it was worth on completion of the public offering. I lost several states because of that negative net worth, but, obviously, you can appreciate that a company which buys airplanes is going to have a lot of debt outstanding before it ever goes public.

The issues we have identified, I submit, cut across the grain, across the entire spectrum of the securities market. As to the trend among merit review states, we have already heard that Illinois and Iowa have substantially reduced their merit review. Texas has just reported a statute out of its house committee that I understand they are expecting to vote on this week, which would likewise remove or eliminate merit review from the commission. Some states, like Washington, have adopted rules that distinguish between the $5.00 stock that is underwritten by several NASD member firms. They say, "Okay, we won't even worry about that. Maybe that is their legitimate threshold that everyone is prepared to recognize, and anything below that we will subject to additional levels of scrutiny." Again, the question is, how

is that scrutiny going to be applied? Is it going to be applied woodenly? Is it going to make economic sense? Frankly, the question of economic sense is not one that even well-meaning public servants are always in a position to determine.

Non-merit review states, likewise, have gone the opposite road in reducing the regulatory impact of state regulation. Hawaii is one state that hasn't been mentioned, but Hawaii has a provision similar to that of New Jersey, in which any security that is registered with the SEC need not be registered at the state level.

ASSEMBLYMAN MICHAEL ADUBATO: Would you please repeat your last statement?

MR. KRASSY: About Hawaii?

ASSEMBLYMAN MICHAEL ADUBATO: Yes, about Hawaii being like New Jersey. I think that is what you said.

MR. KRASSY: That's right, except that Hawaii's is a new entrant. New Jersey has had that provision since, I guess, 1967.

ASSEMBLYMAN MICHAEL ADUBATO: Oh, yes, I realize that, but just for clarification, did you say that if you file with the SEC, you don't have to file with New Jersey?

MR. KRASSY: In 1984, Hawaii enacted a provision. There is no filing requirement in Hawaii, and the security may be offered and sold subject to SEC effectiveness only.

ASSEMBLYMAN MICHAEL ADUBATO: As it is in New Jersey?

MR. KRASSY: Correct. The one difference, of course, is that in a mechanical way, the Hawaiian provision is an exemption from securities registration, whereas the New Jersey one seems to be an exclusion from all of the regulatory provisions.

I left some of my recommendations with Assemblyman Adubato yesterday. I would draw your attention to the goal of these meetings. If your goal is additional access to documents so that the Chief of the Bureau of Securities has a mechanism for determining when an offering is being sold, and takes steps in anticipation of fraudulent activities to prevent that sale, then one can take the Colorado approach, the Georgia approach, or the Florida approach, which provide for an exemption mechanism subject to a filing. There is a fee associated

with that, so you would address the economic issue of paying or subsidizing the Bureau.

ASSEMBLYMAN MICHAEL ADUBATO: I don't want to cut you off, but we were supposed to be out of here by two o'clock, and we have 30 seconds to go. I just want everyone here to know that all documentation and all statements that were presented to the Committee will be officially a part of this Committee session, so whether they were stated fully on the record or not, our staff will review them thoroughly.

I want to thank you for coming, Mr. Krassy. The only question I have is, again, for clarification. You know, we all agree that the overwhelming majority of the people in the industry are more than reputable, and as honest as anyone in any industry. I do not think that is our concern. That is not what we are about today. But, you made a statement and, whether it is allowed today, or it is not allowed today, I think you said you would not want to have people in the securities business who have already been convicted of fraud in the securities business. Is that a fair statement?

MR. KRASSY: I have no reservations about that kind of a restriction.

ASSEMBLYMAN MICHAEL ADUBATO: So, in other words, you do not think it would be unfair if New Jersey had a law that said you could not sell securities in this State if you had been convicted of fraud?

MR. KRASSY: I wouldn't characterize that as fair or unfair, but rather as a legitimate standard you would objectively be able to enforce.

ASSEMBLYMAN MICHAEL ADUBATO: Okay. I would say it was fair. Assemblyman Adubato, any questions?

ASSEMBLYMAN STEPHEN ADUBATO: No questions.

ASSEMBLYMAN MICHAEL ADUBATO: Assemblyman LaRocca, any questions?

ASSEMBLYMAN LaROCCA: No questions.

ASSEMBLYMAN MICHAEL ADUBATO: Assemblyman Loveys, any questions?

ASSEMBLYMAN LOVEYS: No questions.

ASSEMBLYMAN MICHAEL ADUBATO: I want to thank everyone for coming. If anyone has additional information you did not have an opportunity to present today, whether or not you knew about the meeting or did not ask to be heard today, we would appreciate it if you would mail any information to the State Capital in Trenton, in care of the Assembly Banking and Insurance Committee, attention Mr. Spiros J. Caramalis. If you are interested, let us know about it, and we will be happy to share that information with you. Thank you. This meeting is now adjourned.

(MEETING CONCLUDED)

APPENDIX

TESTIMONY OF FRANK J. WILSON,
EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL OF
NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
BEFORE
THE ASSEMBLY BANKING AND INSURANCE COMMITTEE OF
THE STATE OF NEW JERSEY

February 20, 1985

My name is Frank J. Wilson and I am Executive Vice President and General Counsel of the National Association of Securities Dealers, Inc. (the NASD). With me today are John E. Pinto, Senior Vice President, Compliance, and Raymond Cocchi, Vice President Congressional and State Liaison. The NASD is registered with the Securities and Exchange Commission as a national securities association pursuant to the provisions of the Maloney Act which was a 1938 Amendment to the Securities Exchange Act of 1934 and is the only Association so registered. The NASD's purpose is to provide for self-regulation of the over-the-counter securities market and employs over 1,000 people to achieve its purposes. At this time, the NASD has over 5,700 broker/dealer members employing over 330,000 salespersons and carries out its examination, disciplinary and other regulatory responsibilities through its Washington headquarters and 14 District Offices located in major cities throughout the country.

In addition, the Association operates two wholly owned subsidiary corporations, NASDAQ, Inc. and NASD Market Services, Inc. NASDAQ, Inc. maintains and operates the NASDAQ automated quotation system. This system, which is more fully described later, is a state of the art computerized system by which NASD

members exchange quotations for securities traded over-the-counter. NASD Market Services, Inc. enables NASD members to enhance their capabilities in the areas of transaction execution, trade reporting and clearance of transactions through the use of facilities offered by the Corporation.

As we understand it, the purpose of these hearings is to allow the legislature to gather information relating to the "penny stock" market in the state of New Jersey. At the outset, it is important to understand that there is no inherent evil in bringing to the capital marketplace a low priced public offering of securities. Such offerings are frequently the only means by which the ideas and entrepeneurial aspirations of development stage companies may be fulfilled. In your invitation to testify, it was indicated that the hearing seeks to obtain information relating to adequacy to New Jersey law to deal with the "penny stock" market; market maker and sales practices in the penny stock marketplace and public education with respect to "penny stocks" We do not believe that it is appropriate for the NASD to take a position with respect to the type of regulation provided by the state legislatures and the NASD will, therefore, focus this morning primarily upon its regulatory activities with respect to the over-the-counter marketplace and, in particular, the more speculative lower priced end of that marketplace.

Any examination of potential abuses in the "penny stock" market must almost inescapably also look to the related concept of a "hot issue" market. The Association defines a "hot

issue" in its Interpretation With Respect to "Free Riding and Withholding" as "securities of a public offering which trade at a premium in the secondary market whenever such secondary market begins." In general, "hot issues" involve the initial public offering (IPO) of an issuer. The reason that the "penny stock" and "hot issue" concept are so closely interrelated is the fact that public interest in purchasing low priced securities will not long survive unless potential for dramatic gains is evidenced in the marketplace. "Hot issue" markets have become a cyclical phenomenon involving low priced and at times higher priced stocks. Such a market existed shortly after the end of World War II, was repeated during the period of 1959 through 1961 and again in the late 1960s and early 1970s. The problem has been addressed by the Securities and Exchange Commission both in the Special Study of Securities Markets delivered to Congress in 1963 (the "Special Study") and in the Commission's Hot Issue Study in 1971.

The most recent "penny stock" "hot issue" market and one which was typical of most such markets occurred in Denver in 1980-1981. In that market, of the 134 initial public offerings of securities which traded at a premium in the secondary market, all of which were closely scrutinized by routine NASD surveillance and regulatory programs, 86 or 64% were issues with a public offering price of under $5.00 per share and, 52 of those 86 sold for $1.00 or under when initially offered to the public. In addition, 67 of the 134 hot offerings had 25 or fewer broker/dealers participating in the distribution and over 20 of these involved 10 participants or less.

The 1980-1981 Denver hot issue market occurred in a generally negative market environment where the potential existed for utilization of improper sales practices because substantial selling efforts were required to create initial interest in new issues among the public. However, once the existence of a hot issue market is established in the investing community, customers actively solicit broker/dealers demanding a share of the next offering. In addition, a relatively limited number of broker/dealer firms involved in the distribution of low-priced speculative issues increased the possibility that one or more of the participants in the market will be in a sufficiently dominant position to exert control over the marketplace in order to artifically establish or maintain prices which may be unrelated to the actual value of the securities. The following are examples of the market abuses which can be supported by such a market:

- o best efforts underwritings with heavy retention by the managing underwriter to the extent that it will sell either all or a substantial majority of the shares to its own customers;

- o domination and control of the market utilized to manipulate the price of the shares in the aftermarket;

- o "tie-in" sales where a customer is required to purchase a "cold" new issue in order to purchase a "hot" issue;

- o "tie-in" sales requiring customers to buy shares of other issues in the aftermarket at premium prices if they are to receive a "hot" issue allotment;

- o broker/dealer commission schedules which give extra compensation for sales to customers of favored stocks while providing no compensation for liquidations of those securities;

- o tactics designed to avoid the delivery of certificates to customers thereby allowing the broker/dealer to maintain the customer's position. Other broker/dealers are reluctant to accept a customer's sell order without presentation of the certificate;

- o use of nominee accounts, sales to favored customers and controlled accounts;

- o companies going public having little or no operating experience;

- o salesmen making forecasts and price projections without a reasonable basis in fact;

In addition, a willing public that views the market for low priced speculative issues more as gambling than as investing is an important factor to be taken into account in determining and evaluating the causes of a Denver type "penny stock" market. Customers' avaricious attitudes toward this type of market create at least two substantiated problems in regulating the market. First, customers have little, if any, inclination to come forward with complaints of improper conduct by brokers since they wish to continue to participate in the market and "whistle blowing" would preclude such participation. To the contrary, customers complain that they could not obtain shares in an offering or that their orders were filled for less than the desired amount. Second, customers either do not read or pay little heed to the prospectus, irrespective of whether the issue is low or high priced. Indeed, the Association has noted that in such markets some customers follow the unique practice of opening accounts with a large number of firms so they may receive an allotment of as many new offerings as possible.

This is not inconsistent with discussions by the Special Study which noted that hot issue markets, even those unrelated to general market performance, tend to develop a momentum of their own so that improper sales practices and activities by professionals which may have been utilized to engender initial interest in the issues may be less necessary as the market progresses and the speculative fervor of the investing public increases. Such intense interest was seen in the 1981 Denver market, where customers and potential customers of broker/dealer firms were vying for shares of almost any issue which was offered. The particular public danger, of course, in the low price speculative market is that at some point the cycle comes to a close, the fervor is diminished, and prices for the securities which have reached artifically high levels fall back to a level more nearly reflecting their actual worth. At this point, those holding the securities are faced with the potential of substantial losses. In a market comprised of more broadly distributed issues of securities by more substantial issuers, the danger of such is substantially lessened though, of course, declines do occur.

As evidence of the broad ramifications of the "downside" of a speculative, low priced market, one need only look to the fact that in Denver in the latter part of 1981 through early 1982, there was a sharp decline in the number of new issue offerings of low-priced speculative stocks and a general reduction in market prices and after-market trading in

such stocks. In reaction to this, the NASD and the SEC during February and March, 1982, combined in a joint Task Force to conduct special financial and operational examinations of 41 firms in the Denver area to determine the effect this had on these firms and their customers. In the Denver market many of the firms engaged exclusively in the underwriting of, and secondary market trading in, low-priced speculative issues. Notwithstanding the Association's ongoing and intense monitoring of sales practices in this area, when investor interest in these issues ceased, so did the only or at least primary source of income for these firms. Faced with extremely high overhead and monthly fixed expenses, what had been comfortable capital bases quickly eroded. The Association assigned 32 of its most experienced examiners, plus supervisory personnel, from 10 different offices and from its Executive Office in Washington, D.C. to assist its Denver staff and the SEC in a massive three-week effort. These examinations disclosed financial and operational problems of varying degrees and severity in 21 of the 41 firms examined, and 9 of these firms were referred to the Securities Investor Protection Corporation under Section 5(a) of the Securities Investor Protection Act as in or approaching financial difficulty. Most of the 41 firms agreed with the NASD's recommendations to take some form of corrective action either through reduction of business or other restrictions on their scope and type of activity. Ten firms went out of business. However, only three required that a SIPC trustee be

appointed. The remaining seven firms were self-liquidated under NASD supervision utilizing the firm's own assets to satisfy outstanding obligations with the result that there were no losses to customers, other broker-dealers or the SIPC fund as a result of the demise of these firms.

One problem which can affect the market involving low priced securities especially when public interest is on the rise is that of free-riding and withholding, an area in which the NASD has the primary enforcement responsibility. Free-riding and witholding results in a failure by broker/dealers participating in a public offering of securities to make a bona fide public distribution of those securities. Withholding is the practice of retaining in the broker/dealers own accounts or those in which it has a beneficial interest, a portion of an offering which rises to a premium in the aftermarket rather than selling such shares to members of the investing public. Free-riding is the practice of selling shares of such an offering to select individuals and in particular persons affiliated with the broker/dealer community or to certain favored customers for the purpose of securing future business for the broker/dealer by allowing those individuals to partake in the short term profits available in the aftermarket. Free-riding and withholding practices may, in some instances, form a part of a scheme of manipulative activity with respect to a particular issue, but such is not necessary to make the practices inconsistent with the just and equitable principles of trade expected of NASD member broker/dealers. The failure to

make an actual public distribution of the securities constitues a sufficiently serious impairment of the marketplace to warrant a proscription of the practices.

The Securities and Exchange Commission noted the impropriety of these practices as early as 1946 and the NASD has had an Interpretation with Respect to Free-Riding and Withholding as a part of its Rules of Fair Practice since 1950. This Interpretation has been modified a number of times over the years and today contains either absolute or conditional prohibitions on the sale of hot issues to eight different categories of accounts, primarily focusing on the broker/dealers "insiders" and certain institutional type accounts from whom the broker/dealer may wish to curry favor.

Before describing the specific regulatory programs which are in place at the NASD, some background on the over-the-counter marketplace which is regulated by the Association, is in order. Essentially, the over-the-counter market involves all securities activities not taking place on the floor of a stock exchange. This includes the public distribution of all new issues. Secondary or aftermarket trading in over-the-counter securities is conducted through a system of market makers, broker/dealers who stand ready to buy or sell for their own account on a continuing basis. Until 1971, over-the-counter quotations were disseminated only in written form via the so-called "pink sheets" and were frequently out of date by the time they were received. This marketplace has dramatically changed

since that time with the advent of the Association's automated quotations system called NASDAQ. With NASDAQ, market makers are able to display the quotations nationwide and update then "on-line" through computer terminals in their offices by way of the NASDAQ communication system. This system also enables the investing public to receive up to the second quotations for securities in which they are interested. Share volume on NASDAQ is second only to that on the New York Stock Exchange. At this time, there are in excess of 4700 securities quoted in the NASDAQ System. A growing part of the system which is part of the implementation of the National Market System mandated by Congress in the 1975 amendments to the federal securities laws is the the NASDAQ/National Market System, a group of securities meeting certain criteria for which broker/dealers report not only quotations, but actual transactions in a manner similar to the major stock exchanges.

The NASDAQ System generates a wealth of information which the NASD utilizes in monitoring the OTC marketplace. A review of the initial public offerings of equity securities for 1984 shows in excess of 2200 offerings. Very few of these offerings have initially listed on a national securities exchange rather than being traded over-the-counter. Almost all of the remainder are quoted through the NASDAQ System. The market information collected by the NASD from the System, therefore, represents trading in virtually all recent new over-the-counter issues.

The NASD's activity in the areas of market maker and sales practice regulation is concentrated primarily in four areas. The focus of the first program, which is exclusively on new issues involves enforcement of the Free-Riding and Withholding Interpretation.

The Association's regulatory program in this area requires that every public offering of securities underwritten by NASD members be reviewed, including all primary and secondary offerings. All such new issues, including NASDAQ, listed and other over-the-counter securities, are monitored to determine the price at which each security is quoted in the after market whenever secondary trading begins. Those issues which the Association determines traded at premiums above the public offering price are made the subject of questionnaires which are issued to all underwriters and selling group members participating in the particular distribution. As previously noted, the primary purpose of free-riding compliance is to ensure a bona-fide public distribution of securities for which there is substantial public demand. Prohibited sales by a member are per se violations of the NASD's Rules of Fair Practice.

Each questionnaire seeks detailed information about how the shares were alloted by the managing underwriter and requires disclosure of all sales other than those made to bona-fide public customers at the public offering price (i.e., those sales to restricted accounts). Members are subject to separate disciplinary action by the NASD for failure to accurately and

truthfully respond to the questionnaire. Completed questionnaires are then forwarded to the District office having jurisdiction over the member's activity and any restricted sales are subject to an investigation by the District. Throughout the course of its monitoring for free-riding activity, the Association gathers large amounts of information about trading in new issues which can reveal the possibility of the existence of other violations which are then investigated by the Association's field examination staff.

All questionnaires and reports of investigations are presented for review to District Business Conduct Committtees within each District and disciplinary action is taken where appropriate. During the period from January, 1983 through November, 1983 which constituted the most recent "hot" new issue market (although not primarily in low priced issues), a total of 7367 questionnaires were forwarded to members in the review of 126 public offerings that went to an immediate premium in the aftermarket. As a part of the Association's field examination program of NASD members, whereby about 3,400 field examinations of broker/dealer member firms are conducted annually in accordance with prescribed frequency cycles, Association examiners routinely conduct reviews, among many other areas, for compliance with the Free-Riding and Withholding Interpretation.

As a result of the Association's Free-Riding program, its District Business Conduct Committees have brought a substantial number of disciplinary actions against members or

persons associated with members for violations of the Free-Riding Interpretation.

Another aspect of the Association's regulatory program that monitors activity in new issues as well as trading in all NASDAQ securities is its Market Surveillance Section. This activity embodies a fully automated and centrally-operated market surveillance system which combines the state of the art technological resources of the NASDAQ System with surveillance procedures aimed at deterring a variety of potential abuses.

First among these market surveillance capabilities is NASDAQ's computerized On-Line Stockwatch System. This provides continuous on-line monitoring of all NASDAQ securities and provides real-time alerts to significant price fluctuations as they occur during the trading day. In immediate reaction to these price alerts, the Market Surveillance Section initiates a review of the security to determine the nature of the activity in question. In responding to these situations, Market Surveillance uses a full complement of on-line CRT retrieval devices which provide corporate and market-related news, historical price and volume data for the previous day, week, month and year to date and company financial information. These on-line early warning systems together with the interviews of members of broker/dealer firms trading departments initiated by Market Surveillance provide the Association with the ability to immediately identify and react to problems in need of immediate attention.

A complement to the on-line stockwatch program is the Market Information Data Access System (MIDAS). This on-line computerized system provides instantaneous access to as much as 60 days of historical market quoatations in any NASDAQ security displayed on a CRT in a time sequence identical to the way they appeared on the actual trading day. Thus, MIDAS provides an automated "instant-replay," showing on a second-by-second basis a reconstruction of all market maker quotation upticks and downticks as recorded in the NASDAQ market. Obviously, these on-line sytems are invaluable when considering the need for detailed market information usually associated with the investigation of market manipulations as well as other trading abuses.

The detection and analysis of suspicious price movements and/or volume abberations occurring over a longer period of time are also closely monitored by the Market Surveillance Section through a series of automated off-line stock monitoring systems and reports. Again using the technological advantages of the NASDAQ system, specially designed computerized exception reports are in place to track longer term price and volume patterns as well as concentrations of trading by particular firms. By programming pre-set parameters into the NASDAQ system, stocks exceeding one or more of several such parameters will trigger exception reports that are reviewed by Market Surveillance to determine whether further investigation of the trading pattern is needed. Other surveillance reports provide daily, weekly, and monthly recaps of high, low and closing price

information, purchases and sales volume by market maker as well as other trading data. In total, over 15 separate off-line reporting systems are in place, specifically designed to monitor trading in NASDAQ securities.

A further aspect of the Association's regulatory framework for dealing with hot issues are its 14 District Offices referenced earlier. Briefly, almost 4,000 routine and special examinations are conducted each year by the examiners located across the country. An important aspect of these examinations is a comprehensive review of a member's fairness in dealing with its customers, and its overall sales practices. Examinations include a review of new issue activity, such as hot issues, distribution practices and possible manipulative activity. Examinations of NASD member firms are also instituted by the Association in response to complaints filed by members of the investing public. Each NASD district office is equipped to receive customer complaints of any nature but in particular, those relating to sales practices which may be encountered by the customer in dealing with member firms. Customer complaints are an integral part of the NASD's regulatory programs, and especially important to the Association in the sales practice area. In this regard, the NASD maintains a computerized central customer complaint file in Washington, D.C. which contains substantial amounts of information about all such complaints received from the public by the NASD as well as complaints involving sales practices matters received by the SEC. Every

customer complaint received by the Association is reviewed by one of its district offices. Further, notices of alleged misconduct by registered representatives required to be filed with the NASD are also reviewed and follow-up investigations and disciplinary actions taken wherever necessary. The State of New Jersey is served by two NASD district offices to which your citizens may turn to for assistance. The district office located in New York City has responsibility for the counties of Bergen, Essex, Hudson, Passaic and Union and an office in Philadelphia has jurisdiction over the remainder of the state.

As a result of examinations, both routine and customer initiated, the NASD brought some 385 formal disciplinary actions during 1984 involving both member firms and individuals registered with those firms. During 1984, 10 member firms were expelled and 58 individuals barred from further association with any NASD member. In addition, 3 member firms and 54 individuals were suspended for varying periods of time. Because of recent amendments to the Securities Exchange Act of 1934 which with limited excetions eliminated the ability of federally registered broker/dealers to function without becoming NASD members, suspension or expulsion by the NASD effectively terminates the ability of an individual or firm to function in the securities industry. Over and above these sanctions, the Association during 1984 imposed fines upon 153 firms and 219 representatives and censured 155 firms and 396 representatives. It is, therefore, obvious that the Association plays an extremely active role in

regulating the activities of its members wich engage in the over-the-counter securities markets.

In addition to the on-site examinations conducted by the District Offices' examiners the Association also has an Anti-Fraud Unit to deal with abuses in the marketplace. The unit, which is comprised of experienced senior staff members and managed out of Washington, is available to supplement the activities of the Districts in pursuing complex cases involving apparent substantial abuses. The Association, through its Anti-Fraud Unit, has conducted a number of investigations both on its own and jointly with the SEC and various state securities departments. Recent examples of these efforts have included task forces and special examination groups investigating hot issue markets in Denver, Los Angeles, New York, and Salt Lake City.

In addition to the foregoing activities, the Association has recently received approval from the Securities and Exchange Commission to create in addition to the 14 District Committees, a specialized market surveillance committee as a standing committee of the Association. This committee, the first members of which were appointed by the Board of Governors only last month, is a disciplinary committee with jurisdiction to oversee the Market Surveillance Section of the Association's surveillance department and to handle all market-related violations flowing from that section including allegations of insider trading, trade reporting violations, market manipulations, and other market related violations which will be

of particular importance in enhancing the Association's ability to deal with abuses involving low-priced securities. This committee will have authority comparable to that of the District Business Conduct Committee with respect to all market related matters. The committee will review investigations conducted by the market surveillance section and may authorize all forms of disciplinary actions currently available to the District Committees. The committee will be empowered to conduct hearings and to render decisions comparable to those of the District Business Conduct Committees. The committee is composed of individuals with particular expertise in the areas of trading, options, corporate financing, and compliance as well as representatives of NASDAQ issuers, current and former members of the District Business Conduct Committees and former members of the NASD Board of Governors. The Association believes that this specialized committee and the expertise which it will bring to bear upon market related issues will constitute a substantial enhancement to the Association's regulatory capabilities.

The ultimate object for this panel and for the legislature is a determination of the need for or the advisability of legislation to address abuses which may exist with respect to low priced or "penny" stock offerings. The NASD believes that, on the federal level, current law and rules provide adequate enforement capability and that state legislatures should attempt to ensure the fact that the resources available to the state securities commissioners will be utilized

in a manner which will provide the most efficient allocation of the state's resources.

The NASD does not believe that specific legislation is required to address the problems presented by the low-priced securities issues being offered within the State of New Jersey. The Association does not believe that it would be practical to attempt to institute legislation to insulate prospective investors from losses as a result of the purchase of highly speculative issues when those investors themselves many times choose to ignore the disclosures which have been provided to them in conjunction with those issues. However, the Association is fully supportive of substantial sanctions for violations of existing laws and rules. The Association believes that existing provisions such as the Free-Riding and Withholding Interpretation, the general anti-fraud provisions of the federal and states securities laws and the rules and regulations thereunder including those of the Association provide an adequate basis for regulating improper activities with respect to speculative low price securities in the same manner as they do for other aspects of the securities business. It is the Association's belief that the combined resources of the state securities administrators, the NASD and the Securities and Exchange Commission provide adequate safeguards to the investing public if those provisions are properly enforced.

The Association is pleased to have been provided the opportunity to present its views to this committee and would be

more than willing to provide any further information which the committee or the legislature may find useful.

NEW JERSEY ASSEMBLY

Banking and Insurance Committee

Testimony of William J. Fitzpatrick

My name is William J. Fitzpatrick, and I am a Senior Vice President and General Counsel of the Securities Industry Association ("SIA"). The SIA is a trade association representing more than 530 broker-dealers and investment bankers. Our members are engaged in all aspects of the securities industry, and collectively account for approximately 90-95% of all of the securities transactions conducted in the United States and Canada. I appreciate the opportunity to present to you our views on the State of New Jersey's Blue Sky Law, and prospects for amending it.

I am sure that we have all seen the statistics indicating the amount of new employment and growth in the economy generated by new small businesses, of which New Jersey must surely get its share. Not surprisingly, one of the biggest problems of small companies is the matter of raising capital. A company which chooses to go public is undertaking a very expensive proposition. There will be bills to pay from printers, accountants, and lawyers. Filing fees are another

expense. An SEC study determined that for certain types of offerings by small business the expenses related to going public absorbed an average of over 18% of the total proceeds of the offering.[1/]

In recognition of the very considerable costs that regulation can impose upon the process of capital formation, particularly for small businesses, Congress has attempted to help. For instance, the enactment of the Small Business Investment Incentive Act of 1980 lead to the recent adoption of Regulation D by the SEC. That regulation is designed to assist small businesses to raise capital by relieving them of many of the regulatory burdens placed upon public offerings.

When Congress established the Securities and Exchange Commission and a national system of regulation for securities offerings, it failed to address the issue of interaction with state statutes governing the same activities. As the marketplace has developed in the 50 years since the creation of the SEC, the need for uniform standards of regulation governing the offering of securities has become increasingly obvious. A system of nationally consistent regulation can be brought about only in one of two ways. One is for the state laws governing the issuance of securities to be preempted and the power centralized in the SEC. The second and more desirable alternative is for state laws to become uniform and coordinated with the federal system. The federal securities laws are

---

1/ An Analysis of the Use of Regulation A for Small Public Offerings, p. 65 (1982).

"disclosure" laws protecting investors by requiring the complete disclosure of all material facts about a company and its officers and directors. Approximately half of the states have "disclosure" statutes, and New Jersey is one of them.[2/]

All 50 states have their individual securities statute, and although many are modeled on the Uniform Securities Act, each statute is unique and requires an understanding of its subtleties as interpreted by its securities commissioner. In short, there are as many systems of securities regulation in the states as there are states.

In many states the securities statute gives the commissioner authority to refuse to approve an offering of securities if he finds the terms of the offering are not "fair, just and equitable." This is called "merit review." Please notice that this is not an antifraud provision; all 50 states, including New Jersey, have statutory provisions permitting the state administrator to take action against anyone engaged in the distribution of an offering which would constitute a fraud upon purchasers.[3/] Only about half the states have merit review.

Under the broad discretion granted by merit review statutes, a state administrator in reviewing an offering is

---

2/ Non-exempt securities may not be offered or sold in New Jersey unless registered under the federal Securities Act of 1933 or registered under the New Jersey Uniform Securities Law. N.J. Rev. Stat. §49:3-60 (1967). A filing under either statute is a public record and available to anyone for inspection.

3/ N.J. Rev. Stat. §§49:3-52, 49:3-69 (1967).

involved in deciding whether he is personally satisfied with the amount and nature of the underwriting commissions, the amount of stock issued to insiders and promoters in return for their efforts in organizing the company, the issuance of options and warrants to key officers, the offering price to the public, shareholder voting rights, and interest and dividend coverage. While any one of these individual categories could be the source of an abuse, taken as a whole the net effect is that the state securities commissioner is involved in each securities issue not as a regulator but as a corporate financier. He actually structures the deal as if he had an interest in the economic outcome. Of course, this adds substantially to the time and cost involved in "clearing" an issue. This is all the more so because of the lack of uniformity in applying such a subjective standard by different states and is true even within the same state.

Under a merit review standard, an issue can admittedly be free of fraud but be unacceptable in the subjective judgment of the securities commissioner, and therefore not be approved for sale to the public. Exercising merit review authority, securities commissioners have refused to approve the initial public offering of, among others, Apple Computer, Genentech, and U.S. Telephone. The subsequent performance of those companies has revealed how dubious were those refusals and costly to potential investors.

More importantly, broker-dealers are united in their belief that the chilling effect on the raising of capital in those states that are known as "tough" merit review jurisdictions is

significant. Without question merit review adds costs to the issuance of securities, and the fact that the standard varies from state to state means an issue must run a gauntlet of state commissioners, each applying his own personal view of what is "fair, just, and equitable". And please remember, all of this has nothing to do with fraud. All the states, including New Jersey, can keep a fraudulent issue from being sold.

The securities industry believes coordination of state securities registration requirements with those of the federal securities laws is essential. The rapid developement of national markets for securities can not proceed in the face of merit review. Individual commissioners reviewing offerings act in good faith but without full understanding of the increasing national and internationalization of our marketplaces, and without the staff, training, funding and other resources to do the type of in depth corporate financial analysis that merit review requires.

Redirection of business away from states with obsolete regulatory systems such as merit review is a reality. These factors were considered by the legislatures of Illinois, Iowa and Wisconsin when, over the objection of their state securities commissioners, and NASAA, they recently modified their statutes and eliminated almost all merit review in favor of disclosure standard similar to those of the SEC. One need only review the testimony recently given in Illinois on this issue, particularly that of the Honorable James Edgar, the Secretary of State of Illinois, who supported and sponsored the elimination of merit review in his state as the result of

personally witnessing merit review drive away new businesses from Illinois.

Texas is about to introduce legislation which will largely eliminate merit review, and the states of Ohio, Indiana, Kentucky, and Arizona either are or have considered abolishing merit review. In short, to suggest that New Jersey become a merit state is to suggest that it alone buck the increasingly national trend towards eliminating merit review. In the last year three states eliminated merit review; no state has recently proposed becoming a merit state.

With regard to the perceived problem in New Jersey of abuses of the penny stock market, we believe the securities laws in this state provide the commissioner with adequate authority to address frauds that are perpetrated on the public.

The series of articles published recently in the Newark Star-Ledger did highlight several illustrations where investors lost money by investing in so called "penny stocks". While there is nothing inherently wrong with low-priced stocks, these sorts of securities are recognized by the broker-dealer community as very speculative investments which are not suitable for everyone. Many of SIA's members have long established policies of discouraging selling "penny stocks" to members of the general public. For instance, salesmen in many broker-dealers receive no commission for buying or selling a stock with a price of $3 or less. In addition, in many firms a broker has to receive special permission from his superiors before entering an order for such securities, and almost none of SIA's members will underwrite a low-priced security. It

should also be remembered, as commissioner Smith pointed out, that more than 1100 broker-dealers are licensed in New Jersey; only 50 actively deal in penny stocks. New Jersey must be very careful not to discourage an entire industry from operating in the state because of the occasional abuse by a very small segment of that industry.

If the problem is fraud, we agree that the state securities commissioner should be given adequate staff to actively enforce the law. However, it must be realized that if New Jersey opts for merit review it will require a much larger and more sophisticated securities staff with the resultant budgetary demands. Although this would be required by the adoption of merit review, it would not enhance the commissioner's ability to combat fraud.

If the laws of New Jersey are to be changed, care should be taken to ensure uniformity with other states so as not to isolate New Jersey from the mainstream of the financial industry. Other states are eliminating merit review. To remain in the mainstream, New Jersey should heed the lesson of industrial states such as Illinois and Wisconsin and do nothing to make itself appear reactionary. The state of New Jersey, with its hopes of playing a major role in the field of high technology, cannot afford such a giant step backwards.

1188