Securities Fraud Prosecutions: Still Viable Under California Securities Law After *Simon*?*

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In January 1995, the California Supreme Court issued an opinion that had the impact of a bombshell on California securities fraud prosecutions. In *People v. Simon*, California's Supreme Court overturned a Lutheran minister's criminal conviction for securities fraud.[1] The court based its decision on jury instructions it considered inappropriate. The instructions stated that neither "guilty knowledge" nor "criminal intent"

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* On April 3, 1996, the Honorable John G. Davies of the United States District Court of the Central District of California granted a writ of habeas corpus to Charles H. Keating, Jr., effectively overturning his conviction for violations of Corporations Code section 25401. Keating v. Hood, 922 F. Supp. 1482 (1996). Applying *Simon* to the instructions given the Keating jury, Judge Davies found a denial of due process in the failure to determine the appropriate intent required to convict the defendant as either a direct perpetrator or an aider and abettor. *Id.* at 1486, 1493.

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The opinions stated herein are those of the authors and not necessarily those of the California Commissioner or the Department of Corporations.

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1. 9 Cal. 4th 493, 886 P.2d 1271, 37 Cal. Rptr. 2d 278 (1995). Noting that different jury instructions could have led to a finding that there had been a preexisting relationship sufficient to warrant an exemption, the court also overturned Simon's conviction for the sale of unqualified securities.

was required for a criminal conviction under Corporations Code section 25401, California's anti-fraud provision.[2]

California's appellate decisions have played a major role for years in the development and interpretation of securities law throughout the country. It is uncertain, therefore, whether *Simon* portends a nationwide trend or is merely an aberration—or realignment—of California law. Nonetheless, the case raises the question whether criminal prosecution is still a viable tool for enforcing California's anti-fraud provision.[3]

In the opinion of the authors, criminal prosecution for securities fraud is still "alive and well" both in California and throughout the country. *Simon* should best be read as a "common sense" realignment of California case law limited to prosecutions for violations of section 25401. With minor modifications of jury instructions, pleadings, and memoranda of points and authorities, it is expected that prosecutors will continue to obtain criminal convictions for violations of section 25401.

I. CALIFORNIA'S CRIMINAL LIABILITY STATUTE

In a manner similar to section 604 of the Uniform Securities Act, California Corporations Code 25540[4] provides criminal sanctions for the

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2. Section 25401 provides:

> It is unlawful for any person to offer or sell a security in this state or buy or offer to buy a security in this state by means of any written or oral communication which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

CAL. CORP. CODE § 25401 (West 1977).

Section 25401 is very similar to § 501 of the Uniform Securities Act, which states:

> In connection with an offer to sell, sale, offer to purchase, or purchase, of a security, a person may not, directly or indirectly:
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> (1) employ a device, scheme, or artifice to defraud;
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> (2) make an untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made not misleading, in the light of the circumstances under which they are made; or
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> (3) engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon a person.

UNIF. SEC. ACT § 501, 7B U.L.A. 138 (Supp. 1996).

3. *Simon* may prove to be the last word on the subject for quite some time from the California Supreme Court. It had been anticipated that the court would consider some or all of the issues raised in *Simon* in response to Charles H. Keating's petition for review of his criminal conviction. However, on March 23, 1995, the California Supreme Court dismissed Keating's petition. People v. Keating, 890 P.2d 1119, 39 Cal. Rptr. 2d 410 (Cal. 1995).

4. Allowing for punishment either as a felony or misdemeanor, § 25540 states that:

> (a) Except as provided for in subdivision (b), any person who willfully violates any provision of this division [the Corporate Securities Law of 1968], or who willfully violates any rule or order under this division, shall upon

"willful" violation of any provision of California's Corporate Securities Law of 1968 (CSL).[5] All CSL violations subject to criminal sanctions have one thing in common: The District Attorney must show that the defendant acted "willfully." Thus, a finding of "willful" behavior has been the key to criminal prosecution under the CSL.

Section 7(1) of the California Penal Code defines "willfully."

> The word "willfully," when applied to the intent with which an act is done or omitted, implies simply a purpose or willingness to commit the act, or make

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> conviction be fined not more than one million dollars ($1,000,000), or imprisoned in the state prison, or in a county jail for not more than one year, or be punished by both such fine and imprisonment; but no person may be imprisoned for the violation of any rule or order if he or she proves that he or she had no knowledge of the rule or order.
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> (b) Any person who willfully violates Section 25400, 25401, or 25402, or who willfully violates any rule or order under this division adopted pursuant to those provisions, shall upon conviction be fined not more than ten million dollars ($10,000,000), or imprisoned in the state prison for two, three, or five years, or be punished by both such fine and imprisonment.

CAL. CORP. CODE § 25540 (West Supp. 1996).

Similarly, § 604 of the Uniform Securities Act states, in relevant part:

> (a) A person who willfully violates a provision of this [Act], except Section 504, or a rule of the [Administrator] under this [Act], or who violates Section 504, knowing the statement made to be false or misleading in any material respect, is guilty of a [insert the language for felony under applicable state law].
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> . . . .
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> (c) A person convicted of violating a rule or order under this [Act] may be fined, but may not be imprisoned, if the person proves lack of knowledge of the rule or order.

UNIF. SEC. ACT § 604, 7B U.L.A. 145 (Supp. 1996) (brackets in original).

This provision and the comments analyzing it have been cited and applied frequently in decisions throughout the country, referring to the pre-1985 number of the provision, section 409. *See, e.g.*, State v. Bilbrey, 349 N.W.2d 1, 3 (N.D. 1984); People v. Blair, 579 P.2d 1133, 1139 (Colo. 1978); State v. Hodge, 460 P.2d 596, 604 (Kan. 1969); Buffo v. State, 415 So. 2d, 1158, 1165 (Ala. 1969); Commonwealth v. Jones, [1978-1981 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 71,550, at 68,854 (Pa. C. Apr. 24, 1980).

In prohibiting "false filings," § 504 of the Uniform Act expressly incorporates a requirement of knowledge:

> A person may not make or cause to be made, in a document filed with the [Administrator] or in a proceeding under this [Act], a statement that the person knows or has reasonable grounds to know is, at the time and in the light of the circumstances under which it is made, false or misleading in a material respect.

UNIF. SEC. ACT § 504, 7B U.L.A. 141 (Supp. 1996) (brackets in original).

5. CAL. CORP. CODE §§ 25000-25804 (West Supp. 1996).

the omission referred to. It does not require any intent to violate law, or to injure another, or to acquire any advantage.[6]

That definition is incorporated into the jury instruction given in number 1.20 of California Jury Instructions Criminal (CALJIC).[7] A similar definition appears at section 212, comment 4, of the Uniform Securities Act.[8]

The concept of "willfulness" has both an express volitional aspect and an implicit cognitive aspect. In a manner somewhat reminiscent of the M'Naghten Rule,[9] the perpetrator must know the nature and quality of the act, otherwise he or she cannot be said logically to have had the "purpose or willingness to commit the act." While a "mistake of fact" may prove to be a defense, a "mistake of law" is not.[10] California Penal Code section 26 is in accord.[11]

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6. CAL. PENAL CODE § 7(1) (West 1988).

7. CALJIC No. 1.20 states:

> The word "willfully" when applied to the intent with which an act is done or omitted means with a purpose or willingness to commit the act or to make the omission in question. The word "willfully" does not require any intent to violate the law, or to injure another, or to acquire any advantage.

1 CALIFORNIA JURY INSTRUCTIONS CRIMINAL No. 1.20 (Arnold Levin ed., 5th ed. 1988).

8. As the federal courts and the Securities and Exchange Commission have construed the term "willfully" in Section 15(b) of the Securities Exchange Act of 1934, all that is required is proof that the person acted intentionally in the sense that the person was aware of what he or she was doing.

UNIF. SEC. ACT § 212 cmt. 4, 7B U.L.A. 114 (Supp. 1996).

9. The M'Naghten rule requires that a defendant "be able to both know and understand the nature and quality of his act and to distinguish between right and wrong at the time of the commission of the offense" before that defendant can be criminally responsible for his action. BLACK'S LAW DICTIONARY 1003 (6th ed. 1990) (citing People v. Crosier, 41 Cal. App. 3d 712, 716, 116 Cal. Rptr. 467, 471 (1974)).

10. By way of example, a mistake of law as to the requirement for qualification of a particular security would be no defense. A mistake of fact as to the identity of a purchaser of a security would probably not constitute a defense to a charge of the unqualified sale of a security, but a valid mistake-of-fact defense conceivably could be found in the "good faith" reliance of a salesperson on his supervisor's written assurance that the securities had been qualified. As for the fraudulent sale of securities, a reasonable and non-negligent mistake of fact would also be a defense. For example, provided he had demonstrated suitable diligence in attempting to determine the pertinent facts, the promoter of a mining venture reasonably mistaken as to the amount of gold ore in the company's mine would presumably have a valid defense.

11. Section 26 provides:

> All persons are capable of committing crimes except those belonging to the following classes:
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> . . . .
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> . . . Persons who committed the act or made the omission charged under an ignorance or mistake of fact, which disproves any criminal intent.
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> . . . .
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> . . . Persons who committed the act or made the omission charged through misfortune or by accident, when it appears that there was no evil design, intention, or culpable negligence.

In general, California courts have remained true to the definition of "willful" given in Penal Code section 7(1) and comment 4 to section 212 of the Uniform Securities Act. In *People v. Clem*[12] the defendants were charged under section 25540 with willfully violating Corporations Code section 25110, which prohibits the offer or sale of unqualified securities.[13] The court of appeal upheld the conviction, stating that the term "willful" calls only for proof that the person acted intentionally and concluded that the defendants were properly convicted even though they may not have possessed any criminal intent.[14] The inaccurate advice of counsel concerning the CSL was held to be an invalid defense. Other California cases are in accord.[15]

II. PRE-*SIMON* "WILLFUL" VIOLATIONS OF SECTION 25401

In 1989 and 1990, however, California's appellate courts issued two decisions which appeared to delete the cognitive aspect of "willfulness" from the elements of a criminal prosecution for securities fraud.

In *People v. Johnson*, the defendant told investors that their investment in any of four medical centers would not be used to support the other medical centers.[16] When it became apparent that some of the centers needed additional capital, the defendant moved funds between the centers as needed. Eventually all but one of the centers failed, and many investors lost their investments. After the trial court instructed the jury based on Penal Code section 7(1)'s definition of "willfully," the defendant was convicted of willfully selling securities by means of a false statement even though he did not know at the time of solicitation that his statement was or would become false. The defendant appealed, squarely presenting the court of appeal with the question of what mens rea was required to convict for a violation of section 25401.

The court of appeal conclusively dismissed the requirement of guilty knowledge for a section 25401 violation by stating,

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CAL. PENAL CODE § 26 (West 1988).

12. 39 Cal. App. 3d 539, 114 Cal.Rptr. 359 (1974).

13. CAL. CORP. CODE § 25110 (West 1977).

14. Clem, 39 Cal. App. 3d at 541-42, 114 Cal. Rptr. at 361.

15. *See, e.g.*, Boags v. Municipal Court, 197 Cal. App. 3d 65, 242 Cal.Rptr. 681 (1987); People v. Gonda, 138 Cal. App. 3d 774, 188 Cal.Rptr. 295 (1982); People v. Williams, 102 Cal. App. 3d 1018, 162 Cal.Rptr. 748 (1980).

16. 213 Cal. App. 3d 1369, 262 Cal.Rptr. 366 (1989).

> It is settled that the omission of "knowingly" from a penal statute indicates that guilty knowledge is not an element of the offense. Had the Legislature intended to require proof of guilty knowledge or scienter under section 25540, it could have so stated by using the word "knowingly."[17]

The court went on to hold that, although in most section 25401 violations the defendant did in fact know of the material misrepresentation or omission or acted in reckless disregard for the truth, "[t]he statute . . . does not require the prosecutor to prove the defendant's specific intent or knowledge at the time representation is made."[18] Thus, the court stretched its reasoning to hold that even when, as in *Johnson*, the defendant makes a statement that is true at the time he makes it, his subsequent acts contradicting the statement may cause that statement to be a material misrepresentation in violation of section 25401.[19]

Harold Marsh and Robert Volk, two of the drafters of the CSL,[20] were unflinchingly critical of *Johnson*. They referred to the court's interpretation of legislative intent as "purely fictional."[21] Marsh and Volk were especially critical of the holding that, what they considered to be in essence, a breach of contract could be a criminal violation of section 25401, calling it "totally unwarranted."[22]

Nevertheless, in *People v. Baumgart*[23] the court of appeal seemingly reaffirmed *Johnson*. The court held that section 25401 violations were "strict liability"[24] crimes.[25] The *Baumgart* court, however, attempted

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17. *Id.* at 1375, 262 Cal. Rptr. at 369 (citation omitted); *see also* People v. Kuhn, 216 Cal. App. 2d 695, 31 Cal. Rptr. 253 (1963).

18. *Johnson*, 213 Cal. App. 3d at 1375, 262 Cal. Rptr. at 369.

19. *Id.* "To put it another way, section 25401 requires [a seller] to keep his promises." *Id.* This sentence inexcusably blurs the distinction between "breach of contract" and "fraud."

20. Commissioner Volk motivated the 1968 revision of California securities law, and Professor Marsh reported for the drafting committee. Brian R. Van Camp, *Introduction to the Revised Edition* of HAROLD MARSH, JR. & ROBERT H. VOLK, PRACTICE UNDER THE CALIFORNIA SECURITIES LAWS at xvii (rev. ed. 1996).

21. People v. Simon, 9 Cal. 4th 493, 513, 886 P.2d 1271, 1285, 37 Cal. Rptr. 2d 278, 291 (1995).

22. *Id.*

23. 218 Cal. App. 3d 1207, 267 Cal.Rptr. 534 (1990).

24. In the opinion of the authors, a factor contributing to the current impact of the *Simon* decision has been a relative overuse of the terms "strict liability," "general intent," and "specific intent." There is an apparent lack of consensus as to the meaning of the terms; individuals will often mean different things while using the same words.

Black's Law Dictionary defines "strict liability" crimes as: "Unlawful acts whose elements do not contain the need for criminal intent or *mens rea*. These crimes are usually acts that endanger the public welfare, such as illegal dumping of toxic wastes." BLACK'S LAW DICTIONARY 1422 (6th ed. 1990).

Black's further defines "general intent." "In criminal law, the intent to do that which the law prohibits. It is not necessary for the prosecution to prove that the defendant intended the precise harm or the precise result which eventuated." *Id.* at 810.

to create a basis for its decision that was independent of *Johnson*. The court cited *People v. Gonda*[26] for the proposition that Penal Code section 7(1)'s definition of "willfully" does not require any intent to violate the law or injure another and that, where a "statute requires a 'willful' violation, public welfare offenses . . . are punishable without proof of criminal intent."[27] Likewise, the *Baumgart* court relied on the reasoning in *Clem* that the California Legislature intended to apply "strict liability" to CSL violations.[28] However, *Clem* deals with violations of section 25110, and, in order to apply strict liability to section 25401, the *Baumgart* court was forced to rely on *Johnson*.[29]

"Specific intent" is initially defined as: "In criminal law, the intent to accomplish the precise act which the law prohibits; *e.g.* assault with intent to rape." *Id.*

A further definition is:

> The mental purpose to accomplish a specific act prohibited by law. The most common usage of "specific intent" is to designate a special mental element which is required above and beyond any mental state required with respect to the *actus reus* of the crime. Common law larceny, for example, requires the taking and carrying away of the property of another, and the defendant's mental state as to this act must be established, but in addition it must be shown that there was an "intent to steal" the property. Similarly, common law burglary requires a breaking and entry into the dwelling of another, but in addition to the mental state connected with these acts it must also be established that the defendant acted "with intent to commit a felony therein." The subjective desire or knowledge that the prohibited result will occur.

Id. at 1399.

Finally, *Black's* defines "specific intent crime" as: "Crime in which defendant must not only intend the act charged, but also intend to violate law. One in which a particular intent is a necessary element of the crime itself." *Id.* (citation omitted).

In a very insightful comment, the Colorado Supreme Court stated:

> With regard to these securities law violations the use of the term "specific intent" confuses matters and adds little or nothing productive or illuminating. Thus, we disapprove of its use in securities cases and indicate that in the future instructions given in section 11-51-124 cases are to be phrased only in terms of "knowingly," "willfully," and "aware."

People v. Blair, 579 P.2d 1133, 1139 (Colo. 1978) (citation omitted).

The authors agree with this comment from the Colorado Supreme Court. Applying the concepts of "strict liability," "general intent," and "specific intent" to the criminal prosecution of securities fraud is somewhat like the proverbial pounding of square pegs into round holes. The authors are deliberately avoiding use of these terms, considering it preferable to focus on the question of *exactly* what "guilty knowledge" *is* required by *Simon* and the concept of "willfulness."

25. *Baumgart*, 218 Cal. App. 3d at 1219-20, 267 Cal. Rptr at 540-41.
26. 138 Cal. App. 3d 774, 188 Cal. Rptr. 295 (1982)
27. *Baumgart*, 218 Cal. App. 3d at 1219, 267 Cal.Rptr. at 540 (quoting *Gonda*).
28. *Id.* at 1219, 267 Cal. Rptr. at 540.
29. *Id.*

Thus, prior to *Simon*, the landscape facing criminal prosecutions of the CSL was very hospitable. *Baumgart* and *Johnson* gave the impression that prosecutors only had to show that the defendant did the act the CSL defined as unlawful. However, as *Simon* would demonstrate, this ease of prosecution was too good to be true. Securities regulators are fond of reminding the public that, "If it sounds too good to be true, it probably is." In this case, it certainly was.

III. *PEOPLE V. SIMON*

A. Facts

The defendant, Reverend John M. Simon, was charged with multiple counts of having violated section 25401.[30] At trial, the court issued the following jury instructions in keeping with *Johnson* and *Baumgart*:

> (1) The defendant's intent or knowledge at the time of the misrepresentation is irrelevant;
> (2) Only a "general intent," not a "specific intent," is required; and
> (3) If later events make the statement untrue, section 25401 is violated.[31]

The jury found the defendant guilty. He appealed, contending that violations of section 25401 require some sort of "guilty knowledge." The California Supreme Court took the extraordinary step of hearing the appeal directly from the trial court.[32]

B. Holding

The court overturned Simon's conviction, concluding that *Johnson* had wrongly determined that "guilty knowledge" was not required for a section 25401 criminal conviction.[33]

Allowing for a "knew or should-have-known" standard, the court stated its holding as follows:

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30. The charges were based on extensive findings by the California Department of Corporations (DOC) and the securities fraud receiver appointed at the request of the DOC over Simon's Vesper Corporation doing business as Clergy Tax and Financial Services. People v. Vesper Corp., No. C 632677 (L.A.S.C.). The injunctive action against Vesper and the subsequent referral for criminal prosecution were both brought by one of the authors of this article, who remains convinced that Simon could have been convicted of multiple counts of securities fraud even with the more stringent standard adopted by the California Supreme Court.

31. *See* People v. Simon, 9 Cal. 4th 493, 498-99, 886 P.2d 1271, 1274, 37 Cal. Rptr. 2d 278, 281 (1995).

32. *Id.* at 496 n.2, 886 P.2d at 1273 n.2, 37 Cal. Rptr. 2d at 279 n.2.

33. *Id.* at 509, 886 P.2d at 1281, 37 Cal. Rptr. 2d at 288.

> We conclude therefore that *knowledge of the falsity or misleading nature of a statement or of the materiality of an omission, or criminal negligence in failing to investigate and discover them*, are elements of the criminal offense described in section 25401.[34]

The court also restated this holding more narrowly to overrule the idea that subsequent acts contrary to a statement can cause a statement to become a material misrepresentation:

> [F]or purposes of criminal liability, unless an issuer is aware or should have been aware at the time of the sale that a material representation is untrue, or knew or should have known that an unstated fact was material, he has not sold the security by means of an untrue statement of a material fact or omission to state a material fact within the meaning of section 25401. *The truth or falsity of a representation and the materiality of an omission must be determined on the basis of what the seller knew or should have known at the time of the sale.*[35]

Thus, a criminal conviction for a "willful" violation of section 25401 will require a showing of a cognitive state such that the perpetrator knew or should have known:[36] (a) that a misrepresentation had been made to

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34. *Id.* at 522, 886 P.2d at 1290-91, 37 Cal. Rptr. 2d at 296 (emphasis added).

35. *Id.* at 523, 886 P.2d at 1291, 37 Cal. Rptr. 2d at 297 (emphasis added).

It should be noted that while *Simon* overturns a fraud conviction based on nondisclosed commingling of funds between partnerships, the key to the California Supreme Court's action is not so much the commingling as the fact that the defendant was not shown to have known at the time the investors were solicited that the funds would need to be commingled. *Simon* leaves open the possibility of a section 25401 conviction for nondisclosed commingling where a pattern or history of such commingling exists within the company or business at the time of solicitation and it is at least probable that the investor's funds will be commingled. In such a case, the promoter could easily be found to know—or that he should have known—of the true state of facts at the time of solicitation. The nondisclosure of the ongoing commingling of investor funds—and the probable future commingling of the solicited investor's funds—can and should be reasonably expected to be something that a "reasonable investor" would consider "material," i.e., something he or she would consider in deciding whether to invest.

36. The court's use of the phrases "criminal negligence" and "knew or should have known" is somewhat ambiguous as to the degree of negligence that will be sufficient for a criminal conviction. Using terminology unsuited to the consequences of economic crime, CALJIC 3.36 defines "criminal negligence" as:

> [C]onduct which is more than ordinary negligence. Ordinary negligence is the failure to exercise ordinary or reasonable care.
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> ["Criminal negligence"] . . . refers to [a] negligent act[s] which [is] . . . aggravated, reckless and gross and which [is] . . . such a departure from what would be the conduct of an ordinarily prudent, careful person under the same circumstances as to be contrary to a proper regard for [human life] [danger to

a prospective investor; and (b) of the falsity *and* "materiality" of the misrepresentation; *or* (c) that an omission had been made to a prospective investor; and (d) that the omitted information was "material."[37]

When the reader probes beyond the terminology and into the state of mind actually required, state statutes and case law throughout the majority of the United States are clearly in accord with *Simon*.[38]

The authors believe that nearly all of the criminal convictions historically obtained for violations of the CSL—and virtually all of the cases which have been or will be referred for prosecution, including *Simon*[39]—have involved and will continue to involve individuals who knew or reasonably should have known that misrepresentations or omissions of material fact had occurred.

C. *What* Simon *Does Not Do*

It is important to recognize what *Simon* does not do. First, *Simon* does not impede either administrative enforcement actions by the DOC pursuant to Corporations Code section 25532 or civil enforcement

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> human life] or to constitute indifference to the consequences of such act[s]. The facts must be such that the consequences of the negligent act[s] could reasonably have been foreseen and it must appear that the [death] [danger to human life] was not the result of inattention, mistaken judgement or misadventure but the natural and probable result of an aggravated, reckless or grossly negligent act.

1 CALIFORNIA JURY INSTRUCTIONS CRIMINAL, *supra* note 7, No. 3.36 (brackets in original).

The court's use of the phrase "knew or should have known" seems to imply that something less than the state of mind described in CALJIC 3.36 will be required. However, prosecutors should take pains to demonstrate the egregiousness of the promoter's disregard of specific facts which he or she "should have known."

37. *See Simon*, 9 Cal. 4th at 523, 886 P.2d at 1291, 37 Cal. Rptr. 2d at 297. It should be recalled that "materiality" is based on whether a "reasonable prospective investor" would consider the information significant in deciding whether to invest. *See* Insurance Underwriters Clearing House, Inc. v. Natomas Co., 184 Cal.App. 3d 1520, 1526, 228 Cal.Rptr. 449, 453 (1986).

38. People v. Whitlow, 433 N.E.2d 629 (Ill. 1982); People v. Blair, 579 P.2d 1133 (Colo. 1978) (upholding jury instruction regarding securities fraud that recognized knowledge of pertinent facts as an essential part of "willful" conduct and further recognizing that the defendant need not intend to violate the law in order to be criminally liable); State v. Jacobs, 637 P.2d 1377 (Or. Ct. App. 1981); State v. Burrow, 474 P.2d 849 (Ariz. Ct. App. 1970) (upholding jury instruction concerning the sale of unregistered securities that stated that lack of knowledge of unlawfulness was no defense when conduct was voluntary).

39. As noted *supra* note 31, the Los Angeles County Superior Court previously permanently enjoined Reverend Simon from violating section 25401 and placed the assets of his company under receivership. The specific violations alleged in the criminal complaint were discovered during the receivership. Those violations were so egregious that, in the opinion of the DOC, Simon clearly knew or should have known of the misrepresentations or the omissions and their materiality.

actions pursuant to section 25530(a) for injunctions and section 25535 for civil penalties. The court reasoned that administrative and civil enforcement actions are designed to protect the public. The defendant's state of mind in making a sales pitch is irrelevant to the protection of the public from misleading sales pitches.[40] Citing sections 25530 and 25535, the court went so far as to state:

> An enforcement action by the commissioner to enjoin future sales by means of false or misleading statements is designed to protect the public. . . . For that reason, it is irrelevant that the defendant knows that the statements or omissions are false or misleading. In light of the language of section 25401, it is reasonable to conclude that the Legislature did not intend to permit members of the public to be harmed by such sales simply because the offeror was unaware that his or her sales pitch was misleading. The relatively small civil penalty authorized implies that administrative enforcement of section 25401 was permissible regardless of whether a violation . . . of that section was a knowing violation.[41]

Therefore, civil injunctions and civil penalties can still be sought and imposed by the superior court regardless of what the defendant knew or should have known.

Second, *Simon* does not alter private civil actions brought by injured investors pursuant to section 25501[42] for violations of section 25401. The court found that these actions supplement the administrative actions and are designed to deter fraud and encourage full disclosure of information in securities transactions. The court read the language of section 25501 to allow the injured investor to recover damages only if the offeror was aware, or with reasonable care should have been aware, of the misleading nature of his statements. Therefore, as before, an injured investor must demonstrate that the offeror knew or should have known that his statements were misleading.[43]

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40. *Simon*, 9 Cal. 4th at 515-16; 886 P.2d at 1286, 37 Cal. Rptr. 2d at 292.
41. *Id.* (citations omitted).
42. Section 25501 provides in pertinent part:

> Any person who violates Section 25401 shall be liable to the person who purchases a security from him or sells a security to him, who may sue either for rescission or for damages (if the plaintiff or the defendant, as the case may be, no longer owns the security), unless the defendant proves that the plaintiff knew the facts concerning the untruth or omission or that the defendant exercised reasonable care and did not know (or if he had exercised reasonable care would not have known) of the untruth or omission.

CAL. CORP. CODE § 25501 (West 1977).
43. *Simon*, 9 Cal. 4th at 516, 886 P.2d at 1287, 37 Cal. Rptr. 2d at 293.

Third, *Simon* does not significantly affect the responsibility of the prosecution in situations where criminal liability is essentially vicarious, i.e., for the conduct of another.[44] This is increasingly important due to the tendency of securities fraud promoters to insulate themselves by delegating the actual contact with investors to a relatively ignorant sales force. California case law has historically recognized such promoters as criminally culpable.[45]

In pre-trial proceedings during the prosecution of Charles H. Keating Jr., the DOC submitted briefs arguing a two-pronged doctrine of vicarious liability that squares easily with *Simon* and the cognitive and volitional aspects of "willfulness." Citing *People v. Conway*,[46] the DOC argued that a promoter should be vicariously liable for the criminal conduct of his staff where he or she: (1) knew or should have known of the fraudulent or illegal marketing of securities; and (2) *either* procured or, despite having requisite control, permitted or did nothing to prevent the fraudulent or illegal marketing of the securities.[47]

Finally, *Simon* does not affect prosecutions for violations of sections other than section 25401. *Simon* does not overrule or disapprove *Clem*. For the reasons noted herein, the authors are of the opinion that *Simon*

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44. In a footnote, the court expressly deferred the question of criminal aider and abettor liability by stating:

> It is also unnecessary to consider defendant's claim that the court erred in instructing the jury that he could be convicted as an aider and abettor on the section 25401 charge. We note for purposes of retrial, however, that petitioner appears to have been a principal in the sale of the limited partnership interests. The actual salespersons were his agents. If so, it may not be appropriate to instruct on aiding and abetting liability.

Id. at 522 n.19, 886 P.2d at 1291 n.19, 37 Cal. Rptr. 2d at 297 n.19.

However, as noted *supra* note 3, the California Supreme Court subsequently dismissed the Petition for Review filed by Charles H. Keating, Jr. Keating's petition challenged the opinion of the court of appeal finding him criminally liable for the aiding and abetting of multiple violations of 25401. People v. Keating, 890 P.2d 1119, 39 Cal. Rptr. 2d 410 (Cal. 1995).

45. *See, e.g.*, People v. Miller, 192 Cal. App. 3d 1505, 238 Cal. Rptr. 168 (1987). In *Miller*, the court of appeal upheld a criminal conviction for violating sections 25110 and 25401 despite an apparently total lack of contact between Miller and the investors. "The parties stipulated [that] Miller never personally met with the investors . . ., nor did he personally provide them with any information." *Id.* at 1509 n.10, 238 Cal. Rptr. at 170 n.10. The court rejected Miller's argument that "the only person liable" was the individual "whose public solicitation garnered the many investors to create his own investment pool." *Id.* at 1509-12; 238 Cal. Rptr. at 170-72.

46. 42 Cal. App. 3d 875, 117 Cal.Rptr. 251 (1974).

47. By order dated March 23, 1995, the California Supreme Court dismissed Keating's appeal of his conviction for violations of section 25401. *Keating*, 890 P.2d 1119, 39 Cal. Rptr. 2d 410.

essentially applies the concept of "willfulness" recognized in *Clem* to prosecutions for the violation of section 25401.[48]

IV. HOW TO LIVE WITH *SIMON*

Whether or not *Simon* was correctly decided, California securities regulators and prosecutors must adapt to it and react appropriately. This can be done by demonstrating "guilty knowledge" in securities fraud prosecutions and by using appropriate points and authorities and jury instructions.

A. "Guilty" Knowledge

Corresponding roughly to the distinction between "direct" and "circumstantial" evidence, the requisite knowledge can be shown either by testimony or documents demonstrating actual knowledge or by evidence demonstrating inferentially that the individual had to have had the requisite knowledge.[49]

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48. CALJIC 15.26 presents an interesting contrast to section 25401. That instruction defines "intent to defraud" as:

> An intent to defraud is an intent to deceive another person for the purpose of gaining some material advantage over that person or to induce that person to part with property or to alter that person's position to [his] [her] [its] injury or risk, and to accomplish that purpose by some false statement, false representation of fact, wrongful concealment or suppression of truth, or by any other artifice or act designed to deceive.

2 CALIFORNIA JURY INSTRUCTIONS CRIMINAL, *supra* note 7, No. 15.26 (brackets in original).

Finding an intent to defraud within the meaning of CALJIC 15.26 would appear to require more than is required to find a violation of section 25401 after *Simon*. Section 25401 will merely require the volitional misrepresentation or omission of material fact, with sufficient knowledge and in connection with the offer or sale of a security. In contrast, CALJIC 15.26 also focuses on whether there was an intent to alter the victim's status, financial or otherwise, and will require a determination that there was an intent to defraud the victim to his or her detriment.

49. CALJIC 2.00 states:

> Evidence consists of testimony of witnesses, writings, material objects, or anything presented to the senses and offered to prove the existence or non-existence of a fact.
>
> Evidence is either direct or circumstantial.
>
> Direct evidence is evidence that directly proves a fact, without the necessity of an inference. It is evidence which by itself, if found to be true, establishes that fact.

Two examples are typical of the former category. One is the testimony of a mid-echelon "insider," "turned" by the prosecution. Another is the memorandum from the defendant to the head of a sales force, with attached "pitch sheet," prescribing the sales tactics for the "boiler-room" offer of limited partnership interests.

Without exhausting all possibilities, the latter, inferential, approach could be taken by showing that the company was of a comparatively small size, that the defendant required all correspondence to be routed through his office, that he participated in all major decisions of the company, and that a significant majority of the business activity and income of the company derived from the fraudulent offer and sale of the illegal securities.

B. Points & Authorities and Jury Instructions

A slight modification of memoranda of points and authorities and jury instructions is essential to a successful prosecution for securities fraud. Jury instructions illustrate the point most dramatically. Contrary to those given in the *Simon* trial—and rejected by the California Supreme Court—the jury instruction must reflect the requirement that some degree of knowledge is essential. Suggested possible instruction(s) would read as follows:

> *ELEMENTS OF SECTION 25401 VIOLATION.* In order to prove a violation of section 25401 the following elements must be proven beyond a reasonable doubt:
>
> 1. That a security was offered or sold in this state;
> 2. That such offer or sale was made by means of a written or oral communication;
> 3. That such communication either
>
> a. included an untrue statement of a material fact or facts; or
>
> b. omitted to state a material fact or facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading;
>
> 4. That such conduct was either
>
> a. knowing; or
>
> b. of a nature that the promoter should have known that the misrepresentation or omission was made and of its misleading character.

> Circumstantial evidence is evidence that, if found to be true, proves a fact from which an inference of the existence of another fact may be drawn.
>
> An inference is a deduction of fact that may logically and reasonably be drawn from another fact or group of facts established by the evidence.
>
> It is not necessary that facts be proved by direct evidence. They may be proved also by circumstantial evidence or by a combination of direct evidence and circumstantial evidence. Both direct evidence and circumstantial evidence are acceptable as a means of proof. Neither is entitled to any greater weight than the other.

1 CALIFORNIA JURY INSTRUCTIONS CRIMINAL, *supra* note 7, No. 2.00

MATERIALITY. In a prosecution for violation of section 25401, it is necessary to show that the defendant knew or should have known that a reasonable investor would have wanted to know the misrepresented or omitted information before making his investment decision.

MISREPRESENTATIONS/OMISSIONS. In a prosecution for violation of section 25401 it is not necessary to show that the defendant knew that making the alleged false statement(s) or omission(s) was against the law. It is only necessary to show that the defendant knew or should have known that his statement was untrue or omitted information which a "reasonable" investor would consider significant in deciding whether to invest.

V. CONCLUSION

Criminal prosecutions for securities fraud are still viable. Prosecutors will need to prove that the promoter knew or should have known pertinent facts. However, this does not require a showing that the defendant knew that his false statement or material omission was unlawful. In nearly all CSL cases prosecuted since *Johnson* and *Baumgart*, evidence existed that would have met the *Simon* standard. However, prosecutors chose not to stress the evidence because it was deemed unnecessary for a section 25401 conviction. Changing memoranda of points and authorities and jury instructions to demonstrate the defendant's guilty knowledge will allow prosecutors to continue the successful criminal prosecution of securities fraud within the state of California.