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PERSPECTIVE

SB538: Overhauled anti-securities fraud provision

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Signed by Gov. Jerry Brown on Sept. 23, Senate Bill 538 overhauls the anti-fraud provision of the California Securities Law of 1968.

Specifically, the new law revises California Corporations Code Section 25401 to make it unlawful, in connection with the offer, sale or purchase of a security, to: (a) employ a device, scheme or artifice to defraud; (b) make an untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading; and (c) engage in an act, practice or course of business that operates or would operate as a fraud or deceit upon another person.

In its historic form, the statute didn't include clauses (a) and (c). According to bill sponsor Sen. Jerry Hill (D-San Mateo), the changes were intended to bring California's anti-fraud provision in line with federal law. And, indeed, the U.S. Securities and Exchange Commission's Rule 10b-5 — an essential anti-securities fraud rule promulgated under Section 10(b) of the Securities Exchange Act of 1934 — is fundamentally identical to the modified California statute.

Interestingly, however, the original version of Section 25401 was already based on federal law. Section 12(a)(2) of the Securities Act of 1933 creates liability for any person who offers or sells a security through a prospectus or an oral communication containing a material misstatement or omission — virtually the same as clause (b), which more or less survived the recent rewrite of Section 25401, with the exception that clause (b) also imposes liability on buyers and those who offer to buy.

To sue under Section 12(a)(2) and the previous version of Section 25401, a plaintiff in a civil case would not have to allege that the defendant made a material misstatement or omission intentionally or negligently. Similarly, a plaintiff would not have to allege that he or she relied on the misstatement or omission when determining whether to buy or sell a security, or that there was a causal connection between the material misstatement or omission and any damage suffered.

Now that the California Legislature has remodeled Section 25401 based on Rule 10b-5, it stands to reason that courts may interpret the new version in a way consistent with how the federal courts have interpreted Rule 10b-5. Unlike for Section 12(a)(2) claims, plaintiffs bringing a claim under Rule 10b-5 must allege scienter, reliance and causation. Accordingly, if the California courts import federal courts' Rule 10b-5 jurisprudence in their interpretation of the revamped Section 25401, they may end up creating a new pleading hurdle for theoretically aggrieved investors (and their counsel) — and a ground for demurrer if plaintiffs do not plead what they must.

Additionally, to the extent that Rule 10b-5 has been interpreted by the federal courts to impose liability for insider trading, the overhaul of Section 25401 may have rendered somewhat redundant Section 25402 of the California Corporations Code, which itself already prohibits insider trading. Thus, we can expect that plaintiffs who pursue insider trading causes of action under both the new Section 25401 and the existing Section 25402 will face motions to strike at least one of the causes of action as duplicative.

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