

A New Paradigm for Securities Regulation in California: Senate Bill 434 and its Implications

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Overview

Senate Bill 434 provides the Attorney General of California with extraordinary new powers to enforce securities, commodities and corporations laws. This paper will explain the operation of the Act, its legislative history, its relative scope, and its implications for securities regulation nationally. Section One describes the powers given to the Attorney General. Section Two discusses the legislative history of the bill and attempts to explain both the dearth of media coverage and the lack of opposition. Section Three compares California Attorney General's power under Senate Bill 434 with the power of the Attorney General of New York under the Martin Act in an effort to determine the relative scope of the law. Finally, Section Four discusses the implications of Senate Bill 434 and other state enforcement in the "market for securities regulation."

Introduction

The era of state deference to federal regulation of securities is over. Increasingly, state attorneys general refuse to defer to what they regard as inadequate federal enforcement of securities laws. The lead attorney general in this effort is Eliot Spitzer of New York, whose recent enforcement actions include bringing criminal charges against a number of securities professionals and corporations, investigating conflicts of interest at brokerage houses and investigating market timing in the mutual fund industry. In this regard, Attorney General Spitzer has had great success: He has negotiated a settlement with the United States' ten largest investment firms, implementing a series of reforms designed to ensure the independence of research analysts and a ban on issuing I.P.O. stocks to corporate executives, collected fines totaling \$1.4 billion and brought a number of successful criminal law enforcement actions. However, New York is not alone in its enforcement actions, a few other states have also brought civil actions, and one state, Oklahoma indicted former WorldCom board members and the company itself. The market timing scandal is also likely to draw more states into the enforcement arena. It is now clear that enforcement action by state attorneys general represents a significant new source of securities regulation and that this role will continue to expand absent federal action to limit it.

Conspicuously absent in most of these enforcement actions is California. It is an absence which is significant, because despite the lingering effects of recession, California now ranks as the world's fifth or six largest economy. Thus, what it does in relation to securities regulation has not only national, but international implications. California is also home to a large number of investors, some of the largest securities corporations, and several important mutual fund firms, making it a convenient forum for enforcement actions.

There are important indications that the sleeping giant is about to wake. On October 12, 2003, then Governor Davis signed Senate Bill 434, a measure sponsored by Senator Escutia, which provides the Attorney General of California with substantial new investigatory and enforcement powers under that state's Corporations, Government and Commodities Codes. The measure places the weight of the Corporations Code behind the Attorney General, allowing him or her to exercise unprecedented investigatory powers and to bring new forms of civil action. These powers, coupled with the creation of a new crime for providing misleading or false information to the Attorney General and other agency heads, mean that the Attorney General is now California's top securities and commodities enforcement authority (in conjunction with the Commissioner of Corporations). As explained below, the consequences of this authority are profound.

Section One: The New Powers Given to the Attorney General Defined Introduction

Senate Bill 434 provides the Attorney General with unprecedented powers to administer the Corporations Code and relevant securities and commodities laws. Primary among these are the power to initiate criminal proceedings for Corporations Code violations and the power to initiate new forms of civil action for injunctive relief (including the right to place corporations into receivership), for disgorgement (in which harmed parties can collect parts of the judgment in collateral actions), and for as yet unspecified ancillary relief. The Act also creates a crime for knowingly misrepresenting or concealing a fact in connection with a securities investigation by state officials. These powers, taken together with the broad new investigatory powers and greatly stiffened penalties for violations of the code, make it clear that Senate Bill 434 represents a profound change in California's securities regulation.

The Initial Condition

Previous California law provided only for limited enforcement powers by the Attorney General. Statutorily, the Attorney General's enforcement of securities and commodities law was limited, by California Corporation Code Section 25533, to actions based on referrals from the Department of Corporations and to anti-trust actions under the so-called mini-FTC Act. In practice, this power was rarely used: for example since the start of the market timing scandal, the Attorney General has not had a single referral. At common law, the Attorney General's remedies were severely limited by unfavorable court decisions. Thus, given the lack of authority under statute and the strictly limited nature of the Attorney General's common law authority, it is fair to say that prior to the passage of Senate Bill 434, the Attorney General had very limited authority.

Senate Bill 434: The New Regime

New Criminal Authority: Corporations Code Section 25533

Corporations Code Section 25533, as amended, divests the Department of Corporations of its sole jurisdiction to bring or refer criminal prosecutions under the

Code and creates a concurrent regime in which the Attorney General and local district attorneys can institute criminal proceedings for any violations of the code without referral. In practice, this represents a rather potent power. Among the crimes he or she can now enforce: creating false or misleading statements or the appearance of active trading to induce purchase or sale or to manipulate price, making an untrue statement or omission in connection with purchase or sale, purchase or sale by a person connected with issuer with access to information not available to public (“insider trading”), and liability of person inducing or assisting violation (“accomplice liability”). Further, the punishment for these crimes is severe.

The code also contains a number of general crimes that are not conduct-specific, which could be adapted by the Attorney General to illegalize a wider variety of borderline market practices. For example, Section 28800 makes it a crime to willfully make untrue statements or omissions in any document or inquest relating to the department of corporations. The Corporations Code also makes it a felony for any director, officer or agent of any corporation, domestic or foreign to make false statements affecting the value of shares or refusing to make a book entry or post notice when it is required.

Within the context of corporate governance and law enforcement, the prospect of significant exposure to misdemeanor and felony indictments by the Attorney General or by district attorneys should be a significant deterrent to unlawful conduct. Law enforcement officials need no longer wait for a referral from the Department of Corporations; they now have discretion to bring indictments at a time of their choosing. However, in practice, this law enforcement capacity may not be exercised to prosecute every violation, given the scarcity of resources available to the Attorney General and local district attorneys and its status as an elective allocation.

In this regard, the new code provision will probably have its largest impact in large-scale investigations and in the settlement of civil actions. The powers vested in the Attorney General provide him or her with extraordinary leverage to extract more favorable settlement terms in the resolution of litigation. In other words, as corporate directors and officers become the target of potential criminal liability, their incentives to settle will inevitably become more self-interested and personal and they will be forced to accommodate regulation and curbs on their behavior to a greater extent than they would if only the corporations had exposure.

Scope of the Attorney General’s Power: California Government Section 12657 Senate Bill 434 is premised upon expansive definitions of both “Securities law” and “Commodities law.” For the purposes of the Act, Securities law is defined by the as “the Corporate Securities Law of 1968 . . . and any other rule or order issued by the Commissioner of Corporations under this law” and “Commodities law” is defined as “California Commodity Law of 1990 . . . and any other rule or order issued by the Commissioner of Corporations under this law.” This means that the Attorney General is free to sue for violations of not only the statutory language, but also under any rules and orders promulgated by the Commissioner of Corporations. This is an extraordinary grant

of power making the Attorney General the joint custodian of all of the enforcement capabilities available to the Commissioner of Corporations. It is important to keep that in mind when examining the scope of the new civil actions and investigative authorities created by the Act.

New Authority to Bring Civil Actions: California Government Code Section 12658
California Government Code Section 12658, provides the Attorney General with new authority to bring civil actions:

12658. (a) Whenever it appears to the Attorney General that any person has engaged or is about to engage in any act or practice constituting a violation of the securities law or the commodities law, the Attorney General may, in his or her discretion, bring an action in the name of the people of the State of California in the superior court to enjoin the acts or practices or to enforce compliance with the securities law or the commodities law. Upon a proper showing, a permanent or preliminary injunction, restraining order, or writ of mandate shall be granted and a receiver, monitor, conservator, or other designated fiduciary or officer of the court may be appointed for the defendant or the defendant's assets, or any other ancillary relief may be granted as appropriate. A receiver, monitor, conservator, or other designated fiduciary or officer of the court appointed by the superior court pursuant to this section may, with the approval of the court, exercise any or all of the powers of the defendant's officers, directors, partners, trustees or persons who exercise similar powers and perform similar duties, including the filing of a petition for bankruptcy. No action at law or in equity may be maintained by any party against the Attorney General, or a receiver, monitor, conservator, or other designated fiduciary or officer of the court, by reason of their exercising these powers or performing these duties pursuant to the order of, or with the approval of, the superior court.

(b) If the Attorney General determines it is in the public interest, the Attorney General may include in any action authorized by subdivision (a) a claim for ancillary relief, including, but not limited to, a claim for restitution or disgorgement or damages on behalf of the persons injured by the act or practice constituting the subject matter of the action, and the court shall have jurisdiction to award additional relief.

(c) In any case in which a defendant is ordered by the court to pay restitution to a victim, the court may in its order require the payment as a money judgment, which shall be enforceable by a victim as if the restitution order were a separate civil judgment, and enforceable in the same manner as is provided for the enforcement of any other money judgment. Any order issued under this subdivision shall contain provisions that are designed to achieve a fair and orderly satisfaction of the judgment in the name of the people of California, to collect for ancillary relief including claims for restitution, disgorgement and damages, and for equitable relief including injunctions that can place corporations in receivership.

Without question, this section will be the most powerful weapon in the Attorney General's litigation arsenal.

Subsection A

Subsection A provides the Attorney General with discretion to bring a civil action whenever “it appears to the Attorney General that any person has engaged or is about to engage in any act or practice constituting a violation of the securities law or the commodities law.”_ Significantly, the violation need not be knowing or willful under the statutory language for a civil action to arise. This means that the Attorney General can bring an action for injunctive relief at any time when it appears to him or her that a violation is about to occur, allowing him or her to take a proactive stance in regulatory enforcement; he or she need not wait for a nefarious result. Upon the mere appearance of impropriety, the Attorney General has the ability to bring test cases that will define the industry standard in California. Such a power has the potential benefit of avoiding such scenarios as the Enron and WorldCom debacles, because it allows the Attorney General to take action ahead of major disaster as soon as irregular or unethical behavior is reported.

Subsection A also provides for various levels of equitable relief ranging in potency from “permanent or preliminary injunction[s],” restraining order[s]” to a “writ of mandate [that] shall be granted and a receiver, monitor, conservator, or other designated fiduciary or officer of the court [that] may be appointed for the defendant or the defendant’s assets.”_ If a fiduciary official is appointed he or she “may exercise any or all of the powers of the defendant's officers, directors, partners, trustees or persons who exercise similar powers and perform similar duties, including the filing of a petition for bankruptcy.”_ The statute also provides for absolute immunity for the officials. The Attorney General and courts are granted the ability to choose from a variety of equitable solutions that could severally and adversely affect a securities or commodities concern’s ability to survive even in advance of an actual trial. This represents significant exposure that will urge caution in the adoption of financial and legal strategies in the state, especially in the hands of a proactive Attorney General.

Subsection A also provides that “any other ancillary relief may be granted as appropriate.”_ Conceivably, even without the provisions explicitly stated in Subsection B, this would allow a court possibly to provide for compensatory relief and punitive damages, the measure of relief left up to the court’s exercise of reasonable discretion. Subsections B and C

Subsections B and C both provide the Attorney General with power to seek ancillary relief in a claim of restitution or disgorgement on behalf of persons who were injured as a result of violations and other unspecified “additional relief.” It also provides the “victim[s]” with power to enforce a money judgment that results from a restitution order as a “separate civil judgment.”_ This creates substantial economic exposure for firms that would violate securities laws, because the law essentially allows the Attorney General to act as the head of a large class action in a manner similar to traditional *parens patriae* power, without needing to certify a class action. While the “victim[s]” are not entitled to enforce the “additional civil relief” component and are limited to restitution or

disgorgement, the practical limitation that this imposes is probably close to nil since most victims are easily identifiable and could receive the relief directly in the original action. Of course, while the full extent of the “additional relief” in Subsection B or the “ancillary relief” provided for in Subsection A will only be fleshed out through litigation, it seems likely that courts will be able to award compensatory and punitive damages as relief in these cases and that could cripple securities or commodities corporations or professionals who engage in violations of securities or commodities law.

CA Government Section 12661

As enacted, California Government Code Section 12661 authorizes the Attorney General to “take any actions as are authorized by Section 6d of the federal Commodity Exchange Act (7 U.S.C. Sec. 1 et seq.)”. While, the actual scope of these powers is limited to commodities and futures markets, it represents an expansion of state executive power. It enables the Attorney General to enforce federal law insofar as it is consistent with 7 U.S.C. §§ 1 et seq. and creates a complementary method of enforcement to the broad state powers granted under the Act.

California Government Code Section 12660 and California Corporations Code Section 29544

California Government Code Section 12660, Subsection A creates a new “civil penalty” for “[a]ny person who violates any provision of the securities law or the commodities law” in the amount of “twenty-five thousand dollars for each violation.” Subsection B makes clear that “the remedies provided by this section and by other sections of this article are not exclusive, and may be sought and employed in any combination to enforce the provisions of this article.” Subsection C provides for a four year statute of limitations as to this fine. Basically, the provisions of this subsection create an additional civil penalty for each violation on top of criminal, injunctive, and ancillary relief. While the size of this fine may appear rather minimal in comparison to that exposure, the Section may operate to discourage both relatively small infractions of the Code and wide-scale violations involving a large number of violations.

California Corporations Code Section 29544 raises the fine for a willful violation of the Code or rules and orders made pursuant to the code from \$2500 to \$25,000. Unquestionably, this will be less efficacious in generating fines than the Government Code’s fine because it requires proof of a willful violation. Moreover, the Attorney General is less likely to use it because any receipts go directly into the State Corporations Fund and will benefit the Department of Corporations exclusively.

New Investigatory Powers: California Government Code Sections 11180-11188 and 12659 and California Penal Code Section 131

New Abilities to Conduct Cooperative Investigations

The Act provides the Attorney General with extremely powerful investigative capabilities that enable him or her to reach across a wide variety of state and federal actors and share

information. While the interagency and intersovereign actors are free to decline to cooperate, when cooperation is achieved, the Act permits the Attorney General unprecedented information sharing capabilities and allows the department heads unprecedented legal powers under California law. Section 11181 gives the department heads the power to inspect books and records, hear complaints, administer oaths, issue subpoenas, promulgate interrogatories, and divulge said information to the Attorney General. Section 11183 effectively makes it a misdemeanor crime to leak information relating to the probe. Sections 11184-11188 create additional discovery powers and create rules governing the usage of those powers.

New Investigative Powers Exclusive to the Attorney General: Government Code Section 12659

To compliment the Attorney General's broad authority to bring a civil actions and criminal cases, the Act also grants him or her extensive authority to launch investigations and expanded methods of discovery.

Subsection A

Subsection A grants the Attorney General power to launch investigations and then to publish the results of those investigations:

(a) The Attorney General, in his or her discretion, (1) may make public or private investigations within or outside of this state that the Attorney General deems necessary to determine whether any person has violated or is about to violate the securities law or the commodities law or to aid in the enforcement of these laws or in the prescribing of rules and forms by the Commissioner of Corporations under these laws, and (2) may publish information concerning any violation of the securities law or the commodities law.

The Act allows the Attorney General naked discretion to make any investigation, inside or outside of California, whenever he or she deems it necessary to determine if a person has or is about to violate securities or commodities law (which under the act is any order or rule issued by the Commissioner of Corporations in addition to the statutory language). The Attorney General can then publish any information which concerns "any violation." One can hardly envision a grant of investigatory power that would be more expansive than the one authorized here. Broadly speaking, the Attorney General of California may now investigate any violation of any statute, rule, or order whenever he deems it necessary, subject only to traditional federal and state law constraints.

Subsection B

Subsection B creates a new discovery method by which the Attorney General may, upon launching an investigation, physically "take possession of the books, records, accounts, and other papers pertaining to the business of any broker-dealer or investment adviser and place a keeper in exclusive charge of them . . . for a reasonable time not exceeding 30 days." This power enables the Attorney General effectively to audit any broker or investment adviser against their will and without a subpoena (seemingly a court order would suffice). In many cases, this will probably be enough discovery to ascertain whether a prima facie violation of the securities or commodities law has occurred. It will

also give the Attorney General a powerful platform to convey the severity of the charges to the target persons or corporations.

Subsections C and D

Subsection C provides the Attorney General with broad authority in connection with “any investigation or proceeding” to “administer oaths . . . subpoena witnesses and compel their attendance, take evidence, and require production of books, papers, correspondence . . . documents or records.”_ This power attaches to any matter which the Attorney General deems “relevant or material” to the inquiry._

Subsection D merely provides for the Attorney General to seek a remedy to compel the testimony or production to which he is entitled under Subsection C under pain of contempt._ This power means that the Attorney General and not a judge controls the scope of discovery in an investigation and that the Attorney General determines what information is relevant or material to the inquiry. This is likely to result in nearly unfettered discovery, since there are no provisions in the Act for in camera proceedings to determine relevance and other such issues. Basically, the Attorney General can request any testimony or documentary evidence he desires and upon failure to comply with a request he can seek an order of contempt. Judicial review will be limited to comparing what the Attorney General has requested with what the target has produced; any mismatch, and an order for contempt is likely to follow.

Subsection E

Subsection E effectively destroys a person’s right against self-incrimination as it relates to the investigations of the Attorney General, the only exception being that no person can be charged, at least under the laws of California, with a criminal offense, subject to a penalty, or forfeiture._ The exact language of the Subsection is worth quoting:

e) No person is excused from attending and testifying or from producing any document or record before the Attorney General, or in obedience to the subpoena of the Attorney General or any officer designated by him or her, or in any proceeding instituted by the Attorney General, on the ground that the testimony or evidence, documentary or otherwise, required of him or her may tend to incriminate him or her or subject him or her to a penalty or forfeiture, but no individual may be prosecuted or subjected to any penalty or forfeiture for or on account of any transaction, matter, or thing concerning which he or she is compelled, after validly claiming his or her privilege against self-incrimination, to testify or produce evidence, documentary or otherwise, except that an individual testifying is not exempt from prosecution and punishment for perjury or contempt committed in testifying._

This statute means that the Attorney General may require a person to produce incriminating evidence or testify in an incriminating matter at any time. The normal

procedural protections have been rejected by the legislature in favor of requiring total disclosure.

The Act also enables the Attorney General to publish the results of these investigations (see Subsection A) and the judicial proceedings are always public, enabling countless civil actions and perhaps enabling federal criminal prosecutions or other state prosecutions that utilize the information and sworn testimony obtained in violation of the target's right against self-incrimination. Only litigation under the Act will determine the Constitutionality of the provision.

California Penal Code Section 131

Section 131 creates a misdemeanor crime in an effort to deter false testimony and/or the concealing of facts during the course of an investigation: Every person in any matter under investigation for a violation of the Corporate Securities Law of 1968 (Part 1 (commencing with Section 25000) of Division 1 of Title 4 of the Corporations Code), the California Commodity Law of 1990 (Chapter 1 (commencing with Section 29500) of Division 4.5 of Title 4 of the Corporations Code), Section 16755 of the Business and Professions Code, or in connection with an investigation conducted by the head of a department of the State of California relating to the business activities and subjects under the jurisdiction of the department, who knowingly and willfully falsifies, misrepresents, or conceals a material fact or makes any materially false, fictitious, misleading, or fraudulent statement or representation, and any person who knowingly and willfully procures or causes another to violate this section, is guilty of a misdemeanor punishable by imprisonment in a county jail not exceeding one year, or by a fine not exceeding twenty-five thousand dollars (\$25,000), or by both that imprisonment and fine for each violation of this section. This section does not apply to conduct charged as a violation of Section 118 of this code.

This provides a not insignificant criminal liability that should, along with possible contempt citations, effectively compel target corporations and individuals to cooperate with investigators.

Conclusion

Taken together, the broad definition of securities and commodities law, the new criminal authority of the Attorney General and local district attorneys, the new civil remedies, and the extraordinary new investigative powers given to the Attorney General and department heads mean that the Act represents a sea-change in the way that California regulates securities and commodities. The Attorney General is now free to bring a variety of criminal and civil actions to challenge unlawful conduct with nearly unfettered discretion.

Section Two: Legislative History

Given Senate Bill 434's implications for securities and commodities regulation in California, one might assume that it was heavily debated by the legislature and that it generated a considerable amount of controversy and media coverage. Curiously though, with the exception of a few objections by the California corrections and peace officers' unions and an "off the record" attempt by Department of Corporations' insiders and a prominent law firm to get a gubernatorial veto, industry never mounted significant opposition to Senate Bill 434. To understand this phenomenon, it is crucial to understand the bill's legislative history. In this regard, Section Two will proceed first by outlining how the bill's journey through the California Legislature, then by discussing interest group involvement, and finally addressing the dearth of media coverage.

Legislative Process

Introduction

On November 1, 2002, California Attorney General Bill Lockyer unveiled what would become SB 434 to an audience of notables at a national conference on "Restoring Corporate Integrity and Public Trust." The conference "focused on new federal rules to prevent and punish corporate wrongdoing and options for enforcing laws and restoring investor and public confidence in the market." In introducing the legislation, Attorney General Lockyer made clear that he felt that "states also should play a strong role in battling corporate fraud." Lockyer also expressed his displeasure with the then current state of affairs in California:

California law provides the Attorney General much less authority to enforce securities laws than other states, even though an estimated 60 percent of its residents have a financial stake in the stock market. In New York, for example, the Attorney General administers the securities laws, and has civil and criminal enforcement jurisdiction.

Thus, it was clear that Attorney General Lockyer wanted to alter fundamentally the way in which California policed securities. In essence, Attorney General Lockyer wanted to possess at least the same amount of authority as his counterpart in New York.

Legislative History

Senate Bill 434 was first introduced to the California Senate by the Chairman of the Judiciary Committee, Senator Martha Escutia, on February 20, 2003. According to a legislative assistant to Attorney General Lockyer, Senator Escutia was chosen to sponsor the bill because of her excellent reputation for getting things done and her very able staff. True to form, Senator Escutia cleared the bill quickly, passing it in the Judiciary Committee on March 22, 2003. In approving the bill, subject to referrals to other committees, the committee issued a telling statement:

This bill contains the Attorney General's corporate responsibility legislative package. This package is proposed as a result of the numerous recent incidents of corporate misconduct, including accounting and corporate securities fraud by large corporations and accounting firms that has severely impacted the retirement savings of Californians,

and efforts by energy companies to slow, stymie, and obstruct investigations into their conduct during the recent energy crisis.

The bill seeks to deter future misconduct by adding the Attorney General as an enforcement authority for California's securities and commodities fraud laws, which are currently enforceable only by the Corporations Commissioner. The bill also seeks to increase the efficacy of investigations by state agencies into corporate misconduct by clarifying in greater detail the procedures to be used for various evidence-gathering steps in the investigation process.

Finally, the bill seeks to give state prosecutors an additional tool in investigating corporate misconduct by creating a new false statements misdemeanor crime that could be used to prosecute those who deliberately seek to mislead investigators. This new crime is modeled on a similar federal statute which has been used effectively by federal prosecutors in various cases.

Thus, to summarize, the bill's purported aims were to clamp down on corporate misconduct, including accounting and corporate securities fraud, and to assist the Attorney General in investigating energy companies' alleged misconduct during the energy crisis and in the future.

After March 26, 2003, Senate Bill 434 was amended only four times. Of these, three amendments warrant further mention. On June 4, 2003 the Senate passed an amendment which effectively prevents the Attorney General from seeking additional appropriations to put into operation the additional powers provided in the bill:

To the extent that the Attorney General exercises this authority, it shall be done using existing resources and no future budget augmentations shall be made for this purpose.

This amendment was inserted at the request of members of the Senate Appropriations Committee, a committee under tremendous fiscal pressure and a veritable "killing field for costly bills now and at that time." The amendment's impact is mitigated by the fact that much of the Department of Justice's budget is discretionary. For example in the FY 2003-2004 budget, much of the funding is relatively open:

0820-001-0001—For support of Department of Justice.. 291,841,000

...

(6) 30-Civil Law.....105,288,000

(7) 40-Criminal Law.....101,203,000

(8) 45-Public Rights 58,581,000

(9) 50-Law Enforcement.....147,407,000

...-

While a percentage of this funding is earmarked for specific projects in schedules below, it is nonetheless clear that the Attorney General possesses discretion over more than four hundred million dollars. Within bounds, the Attorney General could probably use funds from the criminal, civil, public rights, and law enforcement programs for the purposes of

implementing Senate Bill 434, since the bill's provisions fall into all of these categories. Thus, the amendment's effect is limited: If future attorneys general wish to secure additional appropriations to enforce Senate Bill 434, they only need do so in the form of a global increase in appropriations. However, the amendment is nettlesome for two reasons. First, because it makes it impossible to solicit funding directly for projects related to the bill, it will be difficult to fund special projects and extensive litigation related to the bill. Second, since it is drawing from the common fund it conveys the impression that increased enforcement activity in this area means a concomitant decrease in funding and enforcement activity in another area. In this regard, the Department of Justice plans to ask for legislative removal of this provision as soon as conditions warrant.

Another amendment passed in the Senate on May 12, 2003, adjusted the mens rea of the new misdemeanor disclosure crime to "knowingly and willfully" from an unspecified prior mens rea requirement. This amendment likely had little effect on the overall reach of the statute since the California Supreme Court has already imposed a mens rea/scienter requirement in a similarly worded Corporations Code statute to avoid imposition of strict liability for a criminal offense; however this may have been a debatable matter under California law.

The third amendment passed on August 8, 2003 exempted "state public safety officers" from the provisions of Government Code Section 11181 and the new Penal Code Section 832.5. This amendment is significant not for its substantive effect in relation to securities and commodities but for its role in the legislative process. Recently, amid allegations of officer misconduct there has been much labor strife in California's penal institutions and the officers' unions were afraid that the new administrative subpoena powers given to department heads would embolden the Department of Corrections to undertake more investigations. Therefore, they lobbied hard for an amendment and got it. According to a legislative aide, the amendment was of "zero importance to [the Department of Justice] and of great importance to them, so we didn't oppose it." On September 5, 2003, approximately one month before the gubernatorial recall election (on October 7, 2003), Senate Bill 434 passed the California Assembly, without substantial alteration from its original form (a previous version having been approved by the Senate on June 5, 2003). The vote was forty-seven to thirty-two, assemblypersons dividing along straight party lines. The Senate soon followed suit, adopting the bill exactly as it was passed in the Assembly on September 9, 2003. Again, the vote was along straight party lines. On October 12, 2003, a week after he had been defeated in the recall, then Governor Davis signed Senate Bill 434 into law (see below).

Interest Group Involvement

Conventional political theory holds that *ceteris paribus*, an interest group with a concentrated interest in defeating legislation that provides a diffuse public benefit will often succeed in defeating such legislation or at least in securing significant concessions. Indeed, in relation to the peace officers' amendment, that is exactly what happened. Perhaps that is what makes the relatively easy passage of Senate Bill 434 so

surprising. Here securities and commodities firms had an extraordinarily powerful interest to derail this legislation and to prevent further regulation and its attendant costs, but instead they failed uniformly to defeat the bill or extract significant concessions.

In this regard, it is telling that no major securities firm even bothered to lobby in either house on the issue; all of the parties initially registering opposition to the bill were insurance companies:

Opposition:

First American Corporation, Insurance Agents and Brokers Legislative Council, Liberty Mutual Group, Nationwide Insurance Enterprise, Personal Insurance Federation of California (PIFC), State Farm Insurance, Former Commissioners of Corporations Willie R. Barnes, Anthony Pierno and Robert L. Toms._

Of those registering opposition, the primary argument registered in opposition was that providing the Attorney General with dual enforcement authority would result in a “duplicate and confusing enforcement system.”_ Eventually, even these few industry groups dropped their opposition to Senate Bill 434 after Department of Justice lobbyists suggested to them that the bill would have minimal effects on the insurance industry._ Perhaps the most credible attack on Senate Bill 434 occurred not at the legislative but at the gubernatorial level, organized by forces within the Department of Corporations. According to a legislative aide, unnamed high-level officials in the Department approached lobbyists from a “prominent Republican law firm” and asked it to raise issues with the governor’s office._ This was a surprising move given that the Department of Corporations had come out publicly in support of the bill. Little else is known about what transpired in then Governor Davis’s office and what if any role the governor’s recall election defeat played in his approving the bill. Nevertheless, the behind the scenes lobbying ultimately failed and the bill was signed into law on October 12, 2003._

So what accounts for this surprising lack of lobbying effort on the part of securities, commodities, accounting and other affected firms? Was it simple ignorance of the pendency of a significant regulatory bill or an unwillingness to take on the Attorney General or get poor “PR”? Perhaps, the behind the scenes lobbying took originated in the Department of Corporations was sought by such industries? There seems to be no evident rational reason why the regulated entities did not lobby forcefully during the legislative process.

One might speculate that there are several reasons why the regulated parties failed to show up and be heard. First, there is the possibility that the firms simply misapprehended the depth and breadth of the bill and that there existed an inadequate amount of information to rally industry. A rational actor that does not appreciate the totality of information will not seem objectively rational because it lacks the requisite knowledge to make an informed choice._ Second, geography may have played a role: While insurance companies are regulated at the state level because of the McCarran-Ferguson Bill and have direct experience with California regulators, Wall Street firms and other entities that are primarily regulated may simply not have the resources at the

state level to influence legislators. They may suppose incorrectly that they cannot be dragged into the far-flung forum of California in litigation over securities issues. Third, there may be an issue of fundamental lack of appreciation for the sheer power of California attorneys general to exact large amounts of harm to their bottom-line. As has been shown, the California Department of Justice is a large and well-funded organization with vast resources and personnel. While it is probably correct to presume that it focuses its energy on issues that are intrastate and parochial, if it is sufficiently enabled and positioned for action, it can exact a startlingly high amount of exposure. Fourth, there is the obvious distraction of the California Recall campaign and the already large federal and state securities enforcement actions to contend with. In a sea of information and scandal, industry may simply have been preoccupied.

Finally, as a legislative assistant close to the bill pointed out, perhaps it was just a difficult bill to lobby against: “The message of the bill was clear, we are not creating any new laws here, and we are just bringing in new enforcement to work alongside the Department of Corporations.” From a public relations standpoint, lobbying against such a bill, especially in this time of corporate scandal, might seem to suggest that the corporations sought a free pass to violate the law. Whatever the cause, it is clear that industry failed to influence the development of Senate Bill 434 and the result is a bill that dramatically increases their exposure to governmental liability.

Media Coverage

Similarly, media coverage of Senate Bill 434 was nonexistent both during the legislative process and after passage of the bill. A Lexis-Nexis search performed on November, 24, 2003 for the terms "SB 434" or "Senate Bill 434" for all publications in the past two years turns up a paltry five relevant articles. What is more, all five are versions of the same article that addresses Attorney General Lockyer's effort to create companion legislation to Senate Bill 434 for non-profit entities. Similarly, a search of all securities law newsletters came up empty, suggesting that Senate Bill 434 is completely underneath the radar screen.

Only by conducting a comprehensive search of relevant terminology was one relevant story uncovered in the San Francisco Chronicle. The editorial article essentially complains about the lack of regulatory action by California authorities in relation to the recent mutual fund scandal:

California is home to more mutual fund companies than any state except New York, and home to more mutual fund assets than any state except Massachusetts. But California regulators and law-enforcement authorities are taking a backseat, if any seat at all, in the mutual fund scandal.

It also bemoans the woefully inadequate resources of the Department of Corporations which the article claims “laid off all 13 of its investigators in late September, due to budget woes.” The article goes on to discuss the mutual fund industry in California and Eliot Spitzer's actions in New York, in the end recognizing that Senate Bill 434 gives the

Attorney General in California similar authority to that given the Attorney General of New York under the Martin Act, it also correctly states anticipates that the Senate Bill 434 becomes effective on January 1, 2004 and the Attorney General is free to file actions after that date._

Conclusion

The relevant interest groups seemed to have fundamentally misapprehended the nature and power of Senate Bill 434. Not only was the Act passed with little controversy, it was also passed without substantial revisions. While there was some backroom dealing with the governor's office by insiders at the Department of Corporations and a "prominent Republican law firm," the opposition seemed to amount to very little. Further, the dearth of media coverage suggests that this was probably due at least in part to the recent gubernatorial election. It remains to be seen if securities concerns, the media and other actors will mobilize after the law takes effect and the Attorney General's office begins enforcement actions.

Section Three: Senate Bill 434 Compared to New York's Martin Act

Introduction

Originally enacted in 1921, Chapter 20, Article 23-A of the General Business Law grants to the Attorney General of New York extensive powers to combat fraud in the securities industry._ Indeed, as the New York State Attorney General's Office Bureau Chief recently said, "the Martin Act is one of the broadest anti-fraud statutes ever devised . . . in a democratic society."_ Among the Act's powerful provisions are nearly per se criminal and civil liability for designated acts, ex parte injunctive relief and extensive administrative discovery._

However, the Act's power has lain largely dormant. After the advent of federal securities regulation in the 1930s and 1940s, the Martin Act ceased to be a serious force in the regulation of securities. The sole exception was its brief use during the 1970s when Attorney General Lefkowitz brought Martin Act actions "against a handful of improper securities offerings and to correct defective brokerage firm accounting."_ It was not until recently, in the wake of numerous accounting scandals, that the act was resurrected by Attorney General Elliot Spitzer._

Substantive Provisions

The Act's powers are designed for use in "broker and dealer licensing and it requires only minimal filings for the commencement of business."_ The Act's force begins when "a notice filed with the Secretary of State identifies securities to be sold, but no review is made to determine whether such securities have economic merit."_ The Martin Act makes "the dealers indirectly responsible for policing their own activities."_ Originally the Act was intended only to give rise to an enforcement action when this "self-policing mechanism fails, as in cases of fraud."_

The Act does not limit itself to exchanges where there has been an offer or a sale, instead, “[i]t authorizes the Attorney General to investigate when he believes it to be in the public interest that an investigation be made, and also to take action to prevent fraudulent practices.”_ “Actions which, if fraudulent, give rise to jurisdiction under the Act are the issuance, exchange, purchase, sale, promotion, negotiation, advertisement, investment advice or distribution within or from this state of securities or instruments deemed to be securities.”_ Under the Act, fraudulent practices include the use of “any device, scheme or artifice to defraud or for obtaining money or property by means of any false pretense, representation or promise ... fictitious or pretended purchases or sales of securities or commodities ... any deception, misrepresentation, concealment, suppression fraud, false pretense or false promise ... any practice or transaction or course of business relating to the purchase, exchange, investment advice or sale of securities or commodities which is fraudulent or in violation of law and which has operated or which would operate as a fraud upon the purchaser.”_

Under Section 352-c of the Martin Act, the terms “fraud” and “fraudulent conduct,” are given broad meaning. “Omission of a fact that likely would have been significant to an investor in determining whether to invest in an enterprise constitutes fraud under the Martin Act.”_ The standard is similar “to that employed by the federal courts in applying Securities & Exchange Act Rule 10b-5.”_ However unlike Rule 10b-5 “there is no private right of action under the Martin Act, . . . [o]nly the New York attorney general may bring suit to enforce its provisions.”_

Administrative Discovery Provisions

The Martin Act provides for extensive administrative discovery. Section 352 “authorizes the Attorney General to initiate a confidential securities fraud investigation upon complaint or otherwise, to require a company to file with him a written statement about all the facts and circumstances concerning the subject matter, and to require such other data and information as he may deem relevant.”_ Further, Section 352(2) provides the Attorney General with the authority to “issue subpoenas and to require the production of any books or papers which he deems relevant or material to the inquiry.”_ “Failure to obey the command of a subpoena without reasonable cause is a misdemeanor.”_

The Attorney General may also conduct Martin Act Hearings, proceedings in which he or she may subpoena witnesses and examine them confidentially._ At these hearings, a witness has no constitutional right to counsel, no right to obtain a transcript of the examination, and no right to divulge what occurred at the meeting to anyone other than his or her attorney._ A witness at such a hearing may divulge to no one but his or her lawyers what took place at the hearing (including what questions were asked and what answers were given). Further, under Section 359 of the Martin Act, like a corresponding provision in Senate Bill 434, a witness may be directed to answer questions by the Attorney General, even if that witness has invoked his or her right to self-incrimination (subject to a grant of immunity)._

Under Section 354, when the “Attorney General decides to commence an action under the act, he may conduct an inquiry by order of the Supreme Court, and obtain such a preliminary injunction as is proper and expedient.”_ Orders pursuant to Section 354 are wholly public, as are the affidavits of the Attorney General setting forth the basis for the order and the media and other potential parties have free access to them._ “Witness examinations pursuant to Section 354 orders must be conducted before a Justice of the Supreme Court or a referee designated by a Supreme Court Justice, and the testimony must be publicly filed in the office of the county clerk.”_

The Martin Act and Senate Bill 434 Compared

Even absent any case law interpreting Senate Bill 434, it is clear that at the very least, it contains powers that are quite similar to those incorporated in the Martin Act. Both acts allow attorneys general to bring actions for violations of the criminal code, both provide for injunctive relief and restitution of unlawfully obtained assets and both provide attorneys general with above average discretion (compared to other law enforcement agencies) in launching investigations and compelling discovery. However, in many respects Senate Bill 434 seems to go even further than the Martin Act.

One crucial difference between the Martin Act and Senate Bill 434 is the way that unlawful activity is classified. In New York, the Attorney General is limited to those acts that are specifically enumerated as fraudulent, while in California, any act that violates any of the provisions of the securities or commodities laws or any rule or order of the Commissioner of Corporations is fair game. This means that the attorneys general in California will always have the full scope of that state’s securities and commodities rules and laws to draw upon no matter how they may change. While the Martin Act’s provisions are remarkably supple and have enabled sophisticated litigation more than 80 years after the Act’s inception, it cannot keep pace with all of the developments in corporations law in the same way as Senate Bill 434 has. Under Senate Bill 434, as goes the California legislature or the Commissioner of Corporations, so goes the concurrent authority of the Attorney General.

Another important difference is the scope of the relief available under the two acts. While the criminal liability and injunctive relief engendered in the Martin Act provide powerful incentives for corporations to abide by its strictures, it lacks the ancillary relief or unspecified “other relief” that is incorporated under Senate Bill 434. This means that the New York Attorney General is not able to seek compensatory or perhaps punitive damages that the California Attorney General may be authorized to seek under Senate Bill 434.

Further while both acts provide for extraordinary investigatory capabilities. The Martin Act does not provide any method to coordinate investigations with other state agencies or federal authorities as is found in Senate Bill 434. Similarly, New York attorneys general cannot seize the books of a broker-dealer or investment adviser or determine the relevancy and materiality of documents and testimony in an inquiry.

Conclusion

When compared in their entirety, it is clear that Senate Bill 434 and the Martin Act both provide their respective attorneys general with substantial enforcement authority. However, it is nonetheless clear that Senate Bill 434 goes even further than the Martin Act and will enable attorneys general in California to conduct even more wide-ranging inquiries and to extract even larger civil settlements and criminal penalties. While it remains to be seen whether California attorneys general will utilize these new authorities to the same extent as Eliot Spitzer of New York has, it is nonetheless clear that it is an extremely powerful act. When compared with the Martin Act, which has resulted in billions of dollars in fines and extraordinary changes to brokerage and mutual fund companies structure and management, it is clear that Senate Bill 434 has the potential to be at least as effective.

Section Four: Senate Bill 434's Implications on the Regulatory Market

While Senate Bill 434 places extraordinary powers in the hands of the California Attorney General, it is difficult to say how large an impact the bill will actually have on corporate governance and securities trading. In practical terms, it seems likely that the relative importance of the law will be a function of the zealotry of its enforcement and its overall contribution to the national regulatory mix.

Zeal of enforcement

As with any discretionary grant of power, along with the power to act comes the concomitant power to do nothing. After all, until its revival by Eliot Spitzer, the Martin Act lay largely dormant, its only application in a few obscure cases three decades ago. Arguably the same fate could befall Senate Bill 434, leaving the potential energy of the bill to remain in abeyance until it is later activated by some catalyst—creating an enforcement capability that is neither reliably exercised nor proactive. This would mean that Senate Bill 434 will have no reliable influence on corporate governance over the long-term and will only be useful for the sort of sizeable, short-term corrective action and reform that is now sweeping securities and commodities industries.

Depending on one's worldview, such a result is either desirable or objectionable. If one believes, as some do, that the market is largely self-corrective and that governmental regulation is only warranted in the most clear cases of abuse, then intermittent use of Senate Bill 434 would serve a useful deterrent influence on the market, pressuring the market to undertake self-governance levels up to the level that will satisfy governmental actors and prevent intervention. In practical terms, this means that rational, morally neutral actors would exploit market inequities up to the level of raising governmental ire and back off in the face of government action. Of course, sometimes in the pursuit of profit actors will overstep from the merely unethical to the illegal and the government will step in with its proverbial big stick. Although, even then such an outcome would only occur after federal options have failed to work and it remained to the state as the last actor to take action.

On the other hand, if one believes that the system is in need of more than periodic correction and that there is a need for a market referee to prevent industry actors from constantly pushing the limits of securities regulations than the outcome is more dismal. Lacking an enduring incentive to abide by the law, actors can gain a competitive advantage in the marketplace if they are willing to thwart the law. This, opponents of a periodic enforcement regime might say, is basically what occurred in the Enron case (Arthur Anderson reaped huge profits by violating or seriously manipulating accounting standards and rules) and what is occurring in the mutual fund market (where Putnam and many other mutual fund dealers engaged in unethical and unlawful conduct in the execution of trades).

Of course both viewpoints are overstated. In reality, many would advocate an enforcement regime somewhere in the middle; one that provides reliable and predictable enforcement to ensure liquidity and procedural fairness in capital markets. In this regard, many had hoped that the Security and Exchange Commission (SEC) could provide such a regime and in some respects it has. However, even the most ardent supporters of the free market would acknowledge that the SEC is failing to meet the full scope of its mandate. While federal reform now seems likely, it is worthwhile to note that such reform was probably spurred not by intra-agency forces, but by competition in the form of state governments, and most specifically the New York Attorney's General office.

Given this situation at the federal level, some might say the ideal use of Senate Bill 434 would be to help fill the enforcement gap left by the SEC's failure and to provide further competition in the "market" for securities regulation.

Direct Competition with the SEC: A possible roadmap for Senate Bill 434?
In this regard, moderately zealous use of Senate Bill 434 to regulate securities would put California in direct competition with the SEC in the "market for enforcement." If behavioral economic theory is correct, such an entrance should improve the quality and overall predictability of all enforcement actions. To understand why this would occur, it is necessary first to briefly explain the behavioral deficiencies that are currently undermining the effectiveness of the SEC.

As the recent work of Professors Choi and Prichard demonstrates, the vast majority of the SEC's recent regulatory failures result not from external political pressure, but instead from important organizational/behavioral defects that are created by virtue of its homogenous nature.

Cognitive biases within the SEC are magnified by pervasive organizational groupthink. Groupthink occurs when individuals come to identify with the organization and accept its mission uncritically due to their perceived membership in the group. Once a commitment has been made, group members will downplay feedback that is inconsistent with that position in order to minimize tensions within the group.

The SEC is known for its strong organizational culture. Often praised as hard-working and dedicated, the mission of investor protection is taken to heart by virtually all SEC

staffers. This tendency is no doubt reinforced by self-selection among those seeking SEC employment. The type of people who choose to become regulators and enforcement officials may have a heightened sense of justice and fairness. Such traits may lead regulators to work hard for relatively low pay. Such a culture helps maintain morale and focuses SEC staffers on the task of regulating the capital markets.

Despite these benefits, the strong investor protection culture within the SEC may also lead to groupthink. Homogeneous groups like the self-selected SEC staffers are particularly susceptible to the confirmation bias and are perhaps more likely to engage in self-serving inferences (to the extent that all the staffers have a homogeneous interest). Once the SEC has committed to a policy initiative through a rulemaking proposal--thereby tentatively committing to the "group"--feedback on the proposal may get less weight than it would have if the information had been solicited before the SEC fixated upon a specific proposal._

Thus, as Professors Choi and Prichard suggest, the SEC suffers from a lack of intellectual diversity that cripples its responsiveness and makes its responses in some cases more harmful to the market than good. In the face of exogenous turmoil and widespread failure they are unlikely to take swift corrective action because of their status as a regulatory monopoly.

However as Professors Choi and Prichard point out (in the context of promoting competition from private actors):

Our current regime, under which competition counters the behavioral biases of investors, but not those of regulators, is not preordained. One could, instead, subject securities regulation to the forces of market competition. Securities regulators faced with competition would have less latitude to ignore their own behavioral biases. Regulators that failed to organize their institutional structure to reduce the impact of such biases would lose companies and investors to competing jurisdictions._

Simply put, according to behavioral economic theory, competition from outside actors is a good thing. Not only does it help to root out pervasive biases at the SEC, it might actually serve to attract ethical corporate entities and risk-averse investors to the jurisdictions that have adequate protections.

Such a viewpoint seems to have more than abstract legal economic theory to recommend it; reality seems to have borne it out. After all, it was only after Eliot Spitzer uncovered massive conflicts of interest in Wall Street investment firms, that the SEC took corrective action to help restore investor confidence. The same can be said of the recent Mutual Fund actions, where but for the actions of Eliot Spitzer, the SEC would likely have never uncovered the pervasive market-timing improprieties. When faced with pressure and a threat to its enforcement monopoly, the SEC is responding. While one can question the adequacy of the response, the market for securities regulation seems to be operating in the manner described in the behavioral economic literature.

California's pending entrance into the regulatory market could dramatically increase the stakes for the SEC. California is, for all intents and purposes, a nation within a nation, whose inhabitants control a substantial share of the nation's equities. Coupled with the already important enforcement actions of New York and other states, significant enforcement actions by it would arguably force change at the national level, because the SEC's monopoly would be put in considerable jeopardy.

Indeed, California entering into the regulatory market could have even further reaching side-effects as other state actors follow suit and attempt securities regulation. After all, as has been noted, California is largely modeling its regulatory venture on the already successful interventions of the state of New York. Politics may demand such a move as corporations increasingly globalize and states struggle to protect their citizen's interests. Such an action will likely produce strong reactions from securities corporations and other regulated entities. First, the investment community will likely demand a national solution because of the increasing cost of responding to multiple law suits in far-flung jurisdictions as a cost-cutting device. In this regard, a weak national regime that supercedes state enforcement regimes (perhaps through the Supremacy Clause) serves their interests by avoiding national litigation. It is difficult to say how successful a reaction would be.

Conclusion

In sum, behavioral economics theory predicts that increased competition in the regulatory market will cure many of the systematic defects that now plague the SEC's enforcement efforts. Further, as the recent enforcement actions by Attorney General Elliot Spitzer demonstrate, practical experience with state competition seems to bear such a theory out. California's pending entry into the market, if executed with sufficient zealotry, is likely to speed this process and perhaps produce strong reactions from regulated industries and national government.

Conclusion

Senate Bill 434: A Necessary Bill for California

On balance, Senate Bill 434 is a necessary and important bill for several reasons. First, enforcement by the Department of Corporations is grossly inadequate. For example, the Department is now so poorly funded and organized that it does not currently employ any investigators. Clearly then, California needs some reliable enforcement authority to back its corporations' laws, if they are to have any meaning. While one can query whether better funding could have ameliorated the situation, it is clear that prior to Senate Bill 434, California was without an effective governmental watchdog to implement the Corporations Code and correct securities abuses. In effect, this meant that there was an effective moratorium on enforcement of California corporations' law, an outcome that all but the most extreme capitalists would regard as dangerous to the health of California's economy, citizens and investors.

Second, California can ill afford to allow other states and authorities to control the regulatory market to its exclusion. At a minimum, California needs to be able to enforce the interests of its citizens, corporations and investors in the national market for securities through effective enforcement of state securities laws. In the conflict of interest cases, for example, California could not meaningfully participate in formulating national regulatory policy and it could not contribute leverage to negotiations that may have resulted in more meaningful settlements on its citizens' behalf.

Finally, in some ways this bill is just a codification and expansion of *parens patriae* authority that ought not to have been stripped in the first place. By stripping the Attorney General of *parens patriae* authority over securities, California courts (or arguably the Legislature) did their citizens a great disservice. State attorneys general can play an important role in their respective states by representing with one voice the collective interests of their states and safeguarding important rights. When this authority is undermined through judicial action it means that important rights become dependent on single institutions and no failsafe exists. For example, in this case it meant that the corporations' laws of California were effectively irrelevant while the Department of Corporations lacked sufficient funds or will power to enforce them.

Concerns about Transparency

However, both Senate Bill 434 by its terms and the process used to pass it raise important concerns about transparency and the quality of democracy in California. As has been shown, Senate Bill 434 has large implications for both the securities and commodities fields and for administrative investigations in the California. Yet it was not covered at all by the media prior to passage and there was no vigorous and effective debate: the measure was passed by simple party-line votes in both houses, it allows for a large and significant special interest exemption for Peace Officers and transparent and effective debate was marred by Department of Corporations officials behind-the-scenes entreaties to then Governor Davis. While perhaps these are problems endemic to the California legislature or legislatures as a whole, it is a shame that an issue of great importance like securities law enforcement took on such a bitter partisan edge and that at a minimum, there was not more meaningful debate and/or collaboration.

Further, Senate Bill 434's heavy use of administrative subpoenas, prosecutorial grants of immunity and its largely discretionary nature (enforcement is wholly optional) raise troubling concerns about transparency in enforcement. While clearly a powerful tool in the hands of any attorney general for good, there are also clear opportunities for abuse and corruption. For example, during the discovery process the Attorney General, not a judge, determines many key issues with regard to relevancy and the like, leaving their decisions without effective redress or appeal. This may induce abuse of discretion and allow attorneys general to push the envelope and erode important Constitutional rights and common law privileges. Further, there is no method for impartial case selection; every matter of enforcement is purely a matter of prosecutorial discretion. This encourages abuse of two sorts. First, it invites cronyism; attorneys general may not prosecute important campaign contributors or large employers since they are not required

to (compare to an administrative agency which is subject to judicial review of procedure). Second, it invites selective prosecution; attorneys general may be tempted to pick only those high-profile cases that will give high political dividends or that are truly egregious, enforcement with regard to smaller cases and companies may be nonexistent. This concern is only increased by the lack of independent funding provided in Senate Bill 434.

Conclusion

While imperfect in the sense that it lacks independent funding and sufficient transparency, Senate Bill 434 provides important new legal authority that will allow California to become a major player in the national market for securities regulation. Taken together, Senate Bill 434's broad definitions of securities and commodities law, new criminal and civil authority, and investigative powers give California attorneys general unprecedented capabilities to enforce their state's securities laws. Not only does it take California much closer to the New York model of enforcement, in some cases it provides California with legal authority that exceeds New York's. Finally, while it is too early to say whether Senate Bill 434 will translate into steady and predictable enforcement or if instead it will suffer the same latency period as originally befell the Martin Act, it is nonetheless clear that it represents a significant new entry by California into the market for securities regulation that should be taken seriously by both regulated entities and regulators alike.

_ Diana B. Henriques & Riva D. Atlas, Trust Company Is Said to Be Facing Charges In Fund Inquiry, N.Y. Times, November 25, 2003, at C1.

_ Robert A. McTamane, New York's Martin Act: Expanding Enforcement in an Era of Federal Securities Regulation. 9 No. 13 ANDERLR 11 (2003).

_ Katie Zezima, A Job Transformed: Paper-Pusher to Junkyard Dog, N.Y. Times, November 27, 2003, at C3.

_ Oklahoma Drops Ebberts Charges, Chicago Tribune, November 21, 2003, at C3.

_ Tim Simmers, Mutual Concern; San Mateo's Franklin Resources maintains its fund trading proper, Alameda Times-Star, Nov. 30, 2003, at Bus. News.

_ Dan Walters, Size Doesn't Matter in Silly Debate, Fresno Bee, Oct. 6, 2002, at B3.

_ Kathleen Pender, State Drags Feet on Fund Scandal, S.F. Chron., Nov. 4, 2003, at B1.

_ California Legislative Information Service, Full Bill History, 1 (Nov. 23, 2003), available at _ HYPERLINK "http://www.leginfo.ca.gov/pub/bill/sen/sb_0401-0450/sb_434_bill_20031012_history.html"

__http://www.leginfo.ca.gov/pub/bill/sen/sb_0401-0450/sb_434_bill_20031012_history.html._

_ Cal. Corp. Code § 25533 (West 2003); Senate Judiciary Committee, Report: SB 434, 1-2 (March 23, 2003), available at _ HYPERLINK

"http://www.leginfo.ca.gov/pub/bill/sen/sb_0401-0450/sb_434_cfa_20030423_141608_sen_comm.html"

http://www.leginfo.ca.gov/pub/bill/sen/sb_0401-0450/sb_434_cfa_20030423_141608_sen_comm.html.

_ Pender, at B1.

_ Van De Kamp v. Gumbiner, 221 Cal. App. 3d 1260, 1290 (Cal. Ct. App. 1990) (holding Corporation Code's vesting of authority to the Department of Corporations, stripped the Attorney General of his common law *parens patriae* authority); see also State of Cal. ex rel. RoNo, LLC v. Altus Finance, S.A., 2002 WL 1008251 (C.D.Cal., May 08, 2002). It is unclear what the effect of the Senate Bill 434 will be on these holdings.

_ SB 434, Chaptered Version, (Oct. 12, 2003), available at _ HYPERLINK

"http://www.leginfo.ca.gov/pub/bill/sen/sb_0401-0450/sb_434_bill_20031012_chaptered.pdf"

http://www.leginfo.ca.gov/pub/bill/sen/sb_0401-0450/sb_434_bill_20031012_chaptered.pdf.

_ Cal. Corp. Code § 25400 (West 2003).

_ Cal. Corp. Code § 25401 (West 2003).

_ Cal. Corp. Code § 25402 (West 2003).

_ Cal. Corp. Code § 25403 (West 2003).

_ E.g.: Cal. Corp. Code § 25540 (West 2003).

§ 25540. Willful violations; Punishment; Lack of knowledge of rule or order

(a) Except as provided for in subdivision (b), any person who willfully violates any provision of this division, or who willfully violates any rule or order under this division, shall upon 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.

(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 § 25400 (West 2003). (False statements affecting value of shares; Refusal to make book entry or post notice required; Felony).

Every director, officer or agent of any corporation, domestic or foreign, is guilty of a felony (a) who knowingly concurs in making, publishing or posting either generally or privately to the shareholders or other persons (1) any written report, exhibit, statement of its affairs or pecuniary condition or notice containing any material statement which is false, or (2) any untrue or willfully or fraudulently exaggerated report, prospectus, account, statement of operations, values, business, profits, expenditures or prospects, or (3) any other paper or document intended to produce or give, or having a tendency to produce or give, the shares of stock in such corporation a greater value or a less apparent or market value than they really possess, or (b) who refuses to make any book entry or post any notice required by law in the manner required by law.

_ This is not to say that their concessions will be *prima facie* improper or that the prosecutions will be conducted merely for this purpose, only that personal criminal exposure is likely to enter their calculus.

_ SB 434, Chaptered Version, (Oct. 12, 2003), available at _ HYPERLINK
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0450/sb_434_bill_20031012_chaptered.pdf"
_ http://www.leginfo.ca.gov/pub/bill/sen/sb_0401-
0450/sb_434_bill_20031012_chaptered.pdf_.

- _ Id.

_ Id.; 7 U.S.C. § 6d.

Dealing by unregistered futures commission merchants or introducing brokers prohibited;
duties in handling customer receipts; rules to avoid duplicative regulations

(a) Registration requirements; duties of merchants in handling customer receipts

It shall be unlawful for any person to engage as futures commission merchant or
introducing broker in soliciting orders or accepting orders for the purchase or sale of any
commodity for future delivery, or involving any contracts of sale of any commodity for
future delivery, on or subject to the rules of any contract market or derivatives transaction
execution facility unless--

(1) such person shall have registered, under this chapter, with the Commission as such
futures commission merchant or introducing broker and such registration shall not have
expired nor been suspended nor revoked; and

(2) such person shall, if a futures commission merchant, whether a member or
nonmember of a contract market or derivatives transaction execution facility, treat and
deal with all money, securities, and property received by such person to margin,
guarantee, or secure the trades or contracts of any customer of such person, or accruing to
such customer as the result of such trades or contracts, as belonging to such customer.
Such money, securities, and property shall be separately accounted for and shall not be
commingled with the funds of such commission merchant or be used to margin or
guarantee the trades or contracts, or to secure or extend the credit, of any customer or
person other than the one for whom the same are held: Provided, however, That such
money, securities, and property of the customers of such futures commission merchant
may, for convenience, be commingled and deposited in the same account or accounts
with any bank or trust company or with the clearing house organization of such contract
market or derivatives transaction execution facility, and that such share thereof as in the
normal course of business shall be necessary to margin, guarantee, secure, transfer,
adjust, or settle the contracts or trades of such customers, or resulting market positions,
with the clearinghouse organization of such contract market or derivatives transaction
execution facility or with any member of such contract market or derivatives transaction
execution facility, may be withdrawn and applied to such purposes, including the
payment of commissions, brokerage, interest, taxes, storage, and other charges, lawfully
accruing in connection with such contracts and trades: Provided further, That in
accordance with such terms and conditions as the Commission may prescribe by rule,

regulation, or order, such money, securities, and property of the customers of such futures commission merchant may be commingled and deposited as provided in this section with any other money, securities, and property received by such futures commission merchant and required by the Commission to be separately accounted for and treated and dealt with as belonging to the customers of such futures commission merchant: Provided further, That such money may be invested in obligations of the United States, in general obligations of any State or of any political subdivision thereof, and in obligations fully guaranteed as to principal and interest by the United States, such investments to be made in accordance with such rules and regulations and subject to such conditions as the Commission may prescribe.

(b) Duties of clearing agencies, depositories, and others in handling customer receipts
It shall be unlawful for any person, including but not limited to any clearing agency of a contract market or derivatives transaction execution facility and any depository, that has received any money, securities, or property for deposit in a separate account as provided in paragraph (2) of this section, to hold, dispose of, or use any such money, securities, or property as belonging to the depositing futures commission merchant or any person other than the customers of such futures commission merchant.

(c) Rules to avoid duplicative regulation of dual registrants
Consistent with this chapter, the Commission, in consultation with the securities and exchange Commission, shall issue such rules, regulations, or orders as are necessary to avoid duplicative or conflicting regulations applicable to any futures Commission merchant registered with the Commission pursuant to section 6f(a) of this title (except paragraph (2) thereof), that is also registered with the Securities and Exchange Commission pursuant to section 78o(b) of Title 15 (except paragraph (11) thereof), involving the application of--

(1) section 78h, of Title 15, section 78o(c)(3), and section 78q of Title 15 and the rules and regulations thereunder related to the treatment of customer funds, securities, or property, maintenance of books and records, financial reporting or other financial responsibility rules (as defined in section 78c(a)(40) of Title 15), involving security futures products; and

(2) similar provisions of this chapter and the rules and regulations thereunder involving security futures products.

_ SB 434, Chaptered Version, (Oct. 12, 2003), available at _ HYPERLINK
"http://www.leginfo.ca.gov/pub/bill/sen/sb_0401-0450/sb_434_bill_20031012_chaptered.pdf"

__http://www.leginfo.ca.gov/pub/bill/sen/sb_0401-0450/sb_434_bill_20031012_chaptered.pdf_.

_ Id.

_ Id.

_ Id.

_ Id.

_ Id. (New Government Code § 11180.5).

_ SB 434, Chaptered Version, (Oct. 12, 2003), available at _ HYPERLINK
"http://www.leginfo.ca.gov/pub/bill/sen/sb_0401-0450/sb_434_bill_20031012_chaptered.pdf"

http://www.leginfo.ca.gov/pub/bill/sen/sb_0401-0450/sb_434_bill_20031012_chaptered.pdf.

_ Id.

_ Telephone Interview with Steven Gevercer, Legislative Assistant, California Department of Justice (Dec. 15, 2003).

_ Office of the Attorney General, Press Release, Attorney General Lockyer Announces Proposal to Strengthen California Laws to Protect Investors And Fight Corporate Fraud, 1, (Nov. 1, 2002), available at _ HYPERLINK

"<http://caag.state.ca.us/newsalerts/2002/02-127.htm>"

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_ Other attorneys general who participated in the conference included event co-sponsor Carla Stovall of Kansas, Christine Gregoire of Washington, Don Stenberg of Nebraska and David Samson of New Jersey. Notable panelists also included: Nobel Laureate Milton Friedman; Richard Grasso, chairman of the New York Stock Exchange; columnist Arianna Huffington; David Gergen, director of Harvard University's Center for Public Leadership; and Marvin Kalb of the Shorenstein Center. Id. at 1.

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