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Texas Annual Survey: Securities Regulation

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SECURITIES REGULATION

George Lee Flint, Jr.*

SECURITIES regulation deals primarily with the laws preventing and providing remedies for fraud in the sale of stocks and bonds. Since business entities issue most of the securities, the prior annual Surveys treated securities regulation as a subset of corporate law.¹ This article initiates the separate treatment of the subject.

Due to the minimal coverage of securities developments in past annual Surveys, this article will discuss previous years' changes as they impinge on current trends. Immediately before this Survey period, the 77th Texas Legislature passed Sunset Legislation with respect to the Texas State Securities Board (the Board).² This legislation's impact appears in the Board's new rules and enforcement proceedings.

Past annual Surveys discussing developments for securities included developments in federal law.³ This article will similarly mention major federal statutory and regulatory developments since they impact Texas issuers. Congress passed the Sarbanes-Oxley Act of 2002⁴ during the Survey period. The Texas Legislature based portions of the Texas Securities

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1. See, e.g., Robert F. Gray, Jr. & Gregory J. Sergeshtetter, *Corporations*, 46 SMU L. REV. 1171, 1184 (1993) (two securities cases); Robert F. Gray, Jr. et al., *Corporations*, 45 SMU L. REV. 1525, 1549 (1992) (federal and state securities cases, an amendment to the federal statute); Alan W. Tompkins & Ted S. O'Neill, *Corporations and Limited Liability Companies*, 51 SMU L. REV. 817, 830 (1998) (short section on Texas Securities Act amendments and federal securities cases).

2. Act of June 15, 2001, 77th Leg., R.S., ch. 1091, 2001 Tex. Gen. Laws 2399; see James R. Peacock, III, *Changes to Business Organization Laws, E-Sign, and the Tax Code*, 54 TEX. B.J. 741, 742 (2001) (providing a short explanation of the changes).

3. See, e.g., Simon Sokolow, *Corporations and Partnerships*, 39 SW. L.J. 203, 232-36 (1985) (federal statute, Fifth Circuit cases, as well as Texas cases and State Securities Board rules); Robert Hamilton, *Corporations and Partnerships*, 38 SW. L.J. 235, 277-79 (1984) (federal rules, Supreme Court decisions, as well as one paragraph on Texas State Securities Board); David Sokolow, *Corporations and Partnerships*, 37 SW. L.J. 165, 178-88 (1983) (federal rules, Supreme Court and Fifth Circuit cases, as well as Texas State Securities Board rules and Texas cases).

4. Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (2002). This article does not discuss those portions of the Sarbanes-Oxley Act relating to (1) creation of the Public Company Accounting Oversight Board, *id.* at 750-70; (2) accountants and auditing, *id.* at 770-77; (3) forfeiture of bonuses in certain circumstances, *id.* at 778; (4) analyst conflict of interests, *id.* at 791-93; (5) non-dischargeability of certain debts in bankruptcy, *id.* at 801; (6) the protection of "whistle blowers," *id.* at 806-04; and (7) tampering with records or otherwise impeding investigations. *Id.* at 807-09.

Act on the federal statutes.⁵ As a result, Texas courts rely on federal decisions to interpret the corresponding sections of the Texas Securities Act.⁶ This article will also examine federal court developments in the Fifth Circuit.

I. SCOPE OF THE SECURITY ACTS

Definitions, especially those relating to personal liability and transactions constituting a security, determine the scope of the securities acts. The major change wrought by the sunset legislation of 2001 expanded criminal liability for corporations and civil liability for investment advisors. In fact, these legislative changes mandated corresponding Board rule amendments. The Texas courts, meanwhile, struggled with what evidence establishes a "control person" for liability and "evidence of indebtedness" for a security.

When the Texas Legislature extended most penalties applicable to individuals to business entities in 1971,⁷ it omitted corporate criminal liability because the penal code at that time did not provide for corporate criminal liability.⁸ Recently, organized crime has engaged in fraudulent securities schemes.⁹ They perpetrate fraud by having a corporation hire employees to replace any employees removed by securities regulators, thereby circumventing traditional securities enforcement.¹⁰ The Sunset Commission feared Texas would become a haven for this type of fraud,¹¹ because it is the only state that does not provide for corporate criminal liability for securities fraud. So the Sunset Legislation added corporate criminal liability to the Texas Securities Act.¹²

In the past the Board regulated investment advisors. Since investment advisors maintain a continuous relationship with the investor and influence investor decisions, breaches of fiduciary duties through conflicts of interest and fraudulent advice with respect to their services occur more frequently than with dealers. But since the Texas Securities Act did not

5. See, e.g., COMMITTEE ON SECURITIES AND INVESTMENT BANKING OF THE SECTION ON BANKING AND BUSINESS LAW OF THE STATE BAR OF TEXAS, COMMENT—1977 *Amendment*, following TEX. REV. CIV. STAT. ANN. art. 581-33 (Vernon Supp. 2002).

6. See *infra* note 179 and accompanying text (using this principle to interpret TEX. REV. CIV. STAT. ANN. art. 581-33 (Vernon Supp. 2002) on civil liability for fraud).

7. Act of Apr. 15, 1971, 62nd Leg., R.S., ch. 235, 1971 Tex. Gen. Laws 1085 (amending TEX. REV. CIV. STAT. ANN. art. 581-4B to include corporations and other business entities for purposes of civil liability under TEX. REV. CIV. STAT. ANN. art. 581-33).

8. That situation changed in 1974 when the legislature amended the penal code to permit corporate criminal liability. Act of May 16, 1973, 63rd Leg., R.S., ch. 399, § 1, 1973 Tex. Gen. Laws 883, 885 (adding TEX. PEN. CODE § 7.21ff (1994)).

9. See, e.g., *Organized Crime on Wall Street: Hearing Before the U.S. Congress, House Commerce Committee Subcommittee on Finance and Hazardous Materials*, (statement of Bradley W. Skolnik, Indiana Securities Commissioner and President of the North American Securities Administrators Association, Inc.).

10. SUNSET ADVISORY COMM'N, STAFF REPORT ON STATE SECURITIES BOARD 11 (2000).

11. *Id.*

12. Act of June 15, 2001, 77th Leg., R.S., ch. 1091, § 3.11, 2001 Tex. Gen. Laws 2399, 2427 (adding TEX. REV. CIV. STAT. ANN. art. 581-29-3).

provide for civil liability for investment advisors, as did the acts in twenty-eight states, the Board could only impose a criminal penalty.¹³ In 1999, the Board used the threat of criminal penalties to secure restitution of \$13 million for investors.¹⁴ But investors could not sue to recover fees or losses associated with the fraudulent advice under the Texas Securities Act.¹⁵ Investors might sue under the Texas Deceptive Trade Practices Act and collect multiple damages if they could prove scienter, almost on a strict liability basis.¹⁶ However, the statute's application to a transaction otherwise covered by the Texas Securities Act remains doubtful.¹⁷ So the Sunset Legislation added a civil penalty for investment advisor's defalcations with the same due diligence defense and statute of limitations that apply to dealers.¹⁸ Now investors as well as the Board, can enforce liabilities against investment advisors.

The Board amended its rules to comport with the prior year's legislation by adding definitions for "rendering services as an investment advisor" and for "federal covered investment advisor."¹⁹ Prior Board regulation of investment advisors encompassed these terms in the definition of dealer as did the Texas Securities Act.²⁰ The Sunset Commission noted that the functions of investment advisors differed from those of dealers.²¹ The confusion caused by mingling investment advisors with dealers allowed investment advisors to argue that certain provisions of the Texas Securities Act did not apply to them because the provision applied to the functions of a dealer, not an investment advisor.²² So the sunset legislation placed Texas with the forty-four other states that distin-

13. SUNSET ADVISORY COMMISSION, STAFF REPORT ON STATE SECURITIES BOARD 12 (2000).

14. *Id.*

15. *Id.*

16. TEX. BUS. & COM. CODE ANN. §§ 17.50 (for sale of goods or services) & 17.506 (damages and defenses) (2002).

17. See *Portland Sav. & Loan v. Beville, Bresler & Schulman Gov't Sec., Inc.*, 619 S.W.2d 241 (Tex. App.—Corpus Christi 1981, no writ) (securities are not goods because not tangible); compare *Allais v. Donaldson, Lufkin & Jenrette*, 532 F. Supp. 749 (S.D. Tex. 1982) (investment advice is not a service to a consumer due to coverage by the Texas Securities Act with its due diligence defense), with *Frizzell v. Cook*, 790 S.W.2d 41 (Tex. App.—San Antonio 1990, writ denied) (investment advice is a service, but the due diligence defense of the Texas Securities Act is allowed); see generally Mark C. Watter, *The Applicability of the Texas Deceptive Trade Practices Act to Securities Cases*, 64 TEX. B.J. 542 (2001) (Texas Supreme Court yet to make a pronouncement, but such a decision is irrelevant to securities arbitrations where arbiters routinely consider it); *E.F. Hutton & Co. v. Youngblood*, 741 S.W.2d 363, 364 (Tex. 1987) (refusing to decide whether investment advice is a service).

18. Act of June 15, 2001, 77th Leg., R.S., ch. 1091, §§ 3.02-3.18, 2001 Tex. Gen. Laws 2399, 2420-30 (amending TEX. REV. CIV. STAT. ANN. art. 581-14 to art. 581-33, including investment advisor liability among other amendments).

19. 26 Tex. Reg. 9578 (2002) (amending 7 TEX. ADMIN. CODE § 107.2); see 26 Tex. Reg. 6204 (2001) (for the proposal). A commentator expressed concern over dual definitions appearing in other sections.

20. See, e.g., TEX. REV. CIV. STAT. ANN. art. 581-4C (Vernon 1964).

21. SUNSET ADVISORY COMMISSION, STAFF REPORT ON STATE SECURITIES BOARD 32-33 (2000).

22. *Id.*

guish between securities dealers and investment advisors.²³ The Board added these new definitions to comport with the new law. Other Board amendments to the definitions expanded the definition of “telephone and telegram” for purposes of communicating federal effective dates and the like to the Board to include email, the modern method of communicating.²⁴

In *Texas Capital Securities Management, Inc. v. Sandefer*,²⁵ the Court of Appeals wrestled with what evidence would establish “control person” liability.²⁶ The investors had previously successfully sued the company issuing the recommended stock, its stock promoter, the broker making the investment recommendation, and the broker’s employing corporation.²⁷ The investors next sued three shareholders and a management subsidiary of the employing corporation as control persons.²⁸ The lower court granted the investors a summary judgment. According to the Court of Appeals, the investors failed to hold these individuals liable under collateral estoppel doctrines since they had not proved privity with those found liable in the earlier case.²⁹ The court confronted the issue of how much evidence demonstrated control.³⁰ The comments to the Texas Securities Act provision³¹ indicate the statute uses the term “control person” in the same broad sense as the federal securities laws.³² Under those federal securities laws, the court claimed the Fifth Circuit had determined a plaintiff makes a *prima facie* case by proving actual power or influence over the controlled person *and* an inducement or participation in the violation.³³ Clearly this is a misstatement of the Fifth Circuit’s position. The Fifth Circuit concluded that status alone is not enough.³⁴ The

23. Act of June 15, 2001, 77th Leg., R.S., ch. 1091, §§ 2.01-2.22, 2001 Tex. Gen. Laws 2399, 2403-2418 (amending TEX. REV. CIV. STAT. ANN. art. 581-4 to art. 581-42); see James R. Peacock, III, *Changes to Business Organization Laws, E-Sign, and the Tax Code*, 54 TEX. B.J. 741, 743 (2001) (bemoaning the absence of a de minimus exception in the Texas definition that is present in the federal exemption, 15 U.S.C. § 80b-2(a)(11) (2003)).

24. 27 Tex. Reg. 4934 (2002) (amending 7 TEX. ADMIN. CODE § 107.2 again, without comment, for purposes of TEX. REV. CIV. STAT. ANN. art. 7C(2)(c) dealing with registration by coordination); see 26 Tex. Reg. 10195 (2001) (for the proposal). The amendment also alphabetizes defined terms, conforms the terminology with the Texas Securities Act (“applicant,” “license,” “within this state”) and eliminates duplications (some for relocation to 7 TEX. ADMIN. CODE § 109.13 (2002)). See *infra* note 91.

25. *Tex. Capital Sec. Mgmt., Inc. v. Sandefer*, 80 S.W.3d 260 (Tex. App.—Texarkana 2002, no pet. h.).

26. *Sandefer*, 80 S.W.3d at 267. This article omits any lengthy discussion of collateral estoppel (attempting to hold the control person liable on a judgment against the controlled person), on which the investors lost.

27. *Id.* at 262; see *Tex. Capital Sec., Inc. v. Sandefer*, 58 S.W.3d 760 (Tex. App.—Houston [1st Dist.] 2001, pet. denied).

28. *Sandefer*, 80 S.W.3d at 268-69.

29. *Id.* at 264-67.

30. *Id.* at 267.

31. TEX. REV. CIV. STAT. ANN. art. 581-33F (Vernon Supp. 2002).

32. *Sandefer*, 80 S.W.3d at 267; see Securities Act of 1933, 15 U.S.C. § 77o (1997).

33. *Sandefer*, 80 S.W.3d at 268 (citing *Dennis v. Gen. Imaging, Inc.*, 918 F.2d 496, 509 (5th Cir. 1990); *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 958 (5th Cir. 1981)).

34. *Dennis*, 918 F.2d at 509 (control does not come from status alone; investor had no evidence to counter perpetrators’ affidavits).

court held that investors must introduce some evidence in order to meet the burden of showing “control” and “influence” over the decision making process of the controlled entity generally, but not necessarily with respect to the fraudulent act. Inducement and participation in the violation relate to the defense of the perpetrator, for which the perpetrator has the burden of proof.³⁵ The Texas Securities Act is similarly organized, providing a defense for control person liability showing that the control person did not know, or could not have known through use of reasonable care, of the facts establishing liability.³⁶ Requiring the investors to prove participation in the violation renders this defense useless.

As evidence of control person status under the Texas Securities Act, the investors in *Sandefur* submitted only the Form BD filed with the National Association of Securities Dealers (NASD) by the employing corporation, which listed the three shareholders as “control persons.” Two were listed as shareholders, one as president, one as vice-president, and one as secretary and treasurer. The investors also submitted an annual report of the employing corporation describing an indemnity agreement for liabilities to former customers of, and management fees paid to, the subsidiary.³⁷ The counter evidence consisted of affidavits. The president said he did not have responsibility for reviewing information from companies seeking investors and had no knowledge of customer investments in the recommended company.³⁸ The secretary said he had no license to supervise registered brokers, did not have responsibility for supervising brokers, and also had no knowledge of customer investments in the recommended company.³⁹ The alleged vice-president stated he was only a shareholder.⁴⁰ The court concluded that the NASD use of the phrase “control person” was not the same as in the Texas Securities Act, that the investors must prove both actual power over the controlled entity and participation in the violation, that the affidavits relating to participation created fact questions defeating the summary judgment for the investors, and that the annual statement did not establish the form of power or influence required.⁴¹ The *Sandefur* court may have reached the correct result, despite a muddled analysis. Everyone in the securities industry knows what a control person is.⁴² When the NASD uses this term, it

35. *G.A. Thompson*, 636 F.2d at 958 (participation relates to the defense and is not in the statute or the rule, 17 C.F.R. § 405(f) (defining “control”).

36. TEX. REV. CIV. STAT. ANN. art. 581-33F (Vernon Supp. 2002).

37. *Sandefur*, 80 S.W.3d at 268-69.

38. *Id.*

39. *Id.*

40. *Id.*

41. *Id.*

42. The term appears in the federal statutes for liability, *see, e.g.*, 15 U.S.C. § 77o(a) (1997) (control person liability under the Securities Act of 1933); 15 U.S.C. § 78t(a) (1997) (control person liability under the Exchange Act of 1934), and in scattered sections of the SEC rules, *see, e.g.*, 17 C.F.R. §§ 230.484 (2003) (undertakings for registration under the Securities Act of 1933).

means the same.⁴³ The Texas Securities Act term derives from the same source.⁴⁴ The statement on the Form BD is some documentary evidence of the requisite influence. Next, the court erroneously required *both* actual power and participation.⁴⁵ Both the federal and state statute establish a *prima facie* case of control over the controlled entity that the investors must prove, and a defense of lack of knowledge concerning the facts related to the violation that the perpetrators must prove.⁴⁶ The affidavits of the control persons primarily related to their defense, to which the investors provided no counter-evidence. The federal courts have held that no investor evidence on the control person's defense defeats summary judgment.⁴⁷ This decision points out the difficulty for investors trying to prove control person status.

In *Thomas v. State*,⁴⁸ the Court of Criminal Appeals confronted a defrauder who had bilked his fellow church-goer of a \$60,000 investment in a company that sold electronic kiosks that could dispense videotapes. The defrauder orally represented that the investor would recover his principal in thirty to sixty days, five times that amount in several months, and five times more within a year.⁴⁹ The lower court convicted the defrauder of criminal securities fraud in the sale of a security,⁵⁰ namely an "evidence of indebtedness," by failing to disclose he had previously used invested moneys for personal expenses and had filed for personal bankruptcy.⁵¹ The courts had reviewed the case several times before.⁵² The

43. The SEC proceedings use the term in its traditional sense when dealing with Form BD. See, e.g., *In re* ICapital Markets LLC, SEC Release Nos. 33-8059 & 34-45438, 2002 WL 89036 (Jan. 24, 2002) (violated Rule 15b3-1 by filing Form BD concealing and failing to disclose the control persons of the firm); Self-Regulatory Organizations, Rel. No. 34-28757, 1991 WL 286712 (Jan. 9, 1991) (approving NASD rule change with the requirement to file revised Form BD when ownership or control changes).

44. COMMITTEE ON SECURITIES AND INVESTMENT BANKING OF THE SECTION ON BANKING AND BUSINESS LAW OF THE STATE BAR OF TEXAS, *Comment—1977 Amendment* (following TEX. REV. CIV. STAT. ANN. art. 581-33 (Vernon Supp. 2002) (controlling person liability in art. 581-33F comes from the federal statute, 15 U.S.C. § 77o(a) (1997))).

45. *Sandefur*, 80 S.W.3d at 268 (quoting *Dennis v. Gen. Imaging, Inc.*, 918 F.2d 496, 509 (5th Cir. 1990)); *but see* *Abbott v. Equity Group, Inc.*, 2 F.3d 613, 620 (5th Cir. 1993) (explaining that *Dennis* misquoted the requirements).

46. For the Fifth Circuit's version of the federal law, see *Abbott*, 2 F.3d at 620 (pointing out that *G.A. Thompson*, 636 F.2d at 958, rejected participation as part of the *prima facie* case, that *Dennis*, 918 F.2d at 509, got the participation requirement wrong, but did stand for the requirement of actual control). For the Texas version, see TEX. REV. CIV. STAT. ANN. art. 581-33F (Vernon Supp. 2003) (providing the control person with a lack of knowledge defense).

47. *Dennis*, 918 F.2d at 509.

48. *Thomas v. State*, 65 S.W.3d 38 (Tex. Crim. App. 2001).

49. *Id.* at 40.

50. See TEX. REV. CIV. STAT. ANN. art. 581-29C (Vernon Supp. 2003) (criminal penalties).

51. *Thomas*, 65 S.W.3d at 40.

52. *Id.* See *Thomas v. State*, No. 05-92-01844-CR, 1994 WL 605946 (Tex. App.—Dallas Oct. 31, 1994) (rejecting the Texas Supreme Court's definition of the term "evidence of indebtedness" as too liberal for use in a criminal context), *rev'd*, 919 S.W.2d 427 (Tex. Crim. App. 1996) (adopting the Texas Supreme Court's definition and remanding to consider whether the Texas Securities Act requires a writing), *remanded to* 3 S.W.3d 89 (Tex. App.—Dallas 1999, *pet. granted*) (determining the act requires a writing). The Texas Su-

issue for this court was whether that portion of the definition of a security dealing with “other evidence of indebtedness” contained in the Texas Securities Act⁵³ required a writing, which was absent in this case.⁵⁴ The court noted that the state legislature took the definition from the almost identical federal statute.⁵⁵ The court then looked at both Texas and federal cases dealing with this language, all of which involved some sort of writing, such as commitment letters, checks, receipts, and option contracts. These cases had various results depending on the accompanying oral representations.⁵⁶ The dispositive case for the court, *S.E.C. v. Addison*,⁵⁷ dealt with moneys received by the venture from lenders, the earlier of whom received notes, while the later ones did not. The *Addison* court depicted the securities held by the early lenders as evidences of indebtedness and the securities held by the later lenders as investment contracts.⁵⁸ So this court concluded that for evidences of indebtedness there must be a writing.⁵⁹ The court bolstered its position by noting that commentators in much earlier treatises had stated that the term “evidence of indebtedness” only embraced documents that establish a repayment obligation.⁶⁰ Similarly, editions of Black’s Dictionary before and after the passage of the federal statute defined “evidence of debt” as a term applied to written documents.⁶¹ The court noted, however, that its decision did not specify the form of the writing, does not preclude a conviction for an attempt to sell an “evidence of indebtedness” that does not exist, and does not foreclose convictions based oral contracts as other types of securities.⁶² The case is of utmost importance to criminal prosecutors since they are subject to making sure the pleadings support the findings.⁶³ Civil litigants in

preme Court’s definition is “all contractual obligations to pay in the future for consideration presently received.” *Searsy v. Commercial Trading Corp.*, 560 S.W.2d 637, 641 (Tex. 1977) (determining that an agreement to repurchase commodity options was “evidence of indebtedness” under the Texas Securities Act). The appellate court’s first rejection of the Supreme Court’s definition makes little sense. What would otherwise involve a civil matter should rise to the criminal level based on the perpetrator’s mental state, not the form of the security.

53. TEX. REV. CIV. STAT. ANN. art. 581-4(A) (Vernon Supp. 2002).

54. *Thomas*, 65 S.W.3d at 41.

55. *Id.* at 42 (citing *Searsy*, 560 S.W.2d at 639 (Securities Act of 1933; federal decisions accepted by Texas courts on this definition)); *Grotjohn Precise Connexiones Int’l v. J.E.M. Fin., Inc.*, 12 S.W.3d 859, 868 (Tex. App.—Texarkana 2000, no pet.) (same); *Campbell v. C.D. Payne & Geldermann Sec.*, 894 S.W.2d 411, 417 (Tex. App.—Amarillo 1995, writ denied) (same)).

56. *Thomas*, 65 S.W.3d at 43.

57. *S.E.C. v. Addison*, 194 F. Supp. 709 (N.D. Tex. 1961).

58. *Id.* at 721-22.

59. *Thomas*, 65 S.W.3d at 44.

60. *Id.*

61. *Id.*

62. *Id.* at 45.

63. Texas criminal law uses the fatal variance doctrine, requiring that the evidence must correspond and support the material allegations. *See, e.g., Stevens v. State*, 891 S.W.2d 649, 650 (Tex. Crim. App. 1995). Under this doctrine, the court may disregard unnecessary words in the allegation, except those that are descriptive of a matter essential to charge the crime. *See, e.g., Ferguson v. State*, 572 S.W.2d 521, 524 (Tex. Crim. App. 1978) (determining that the word “copy” in the indictment for securities fraud was not fatal

Texas need not plead facts.⁶⁴ A general pleading of “security” should be sufficient for this situation when the transaction is either an “evidence of indebtedness” or an “investment contract,” which does not require the written document.

II. ORGANIZATION OF THE STATE SECURITIES BOARD

The Texas securities laws generally create a regulatory body to handle the registrations required by those laws, as well as to serve an enforcement mechanism. The Sunset Legislation expanded the size of the Board, separated policy decisions of the Board from management decisions of the Texas Securities Commissioner, and specified investor education as a goal of the Board.

The legislature created the Board as a three-member organization in 1957.⁶⁵ Subsequently, the Open Meeting Act deemed a meeting to occur anytime a quorum gets together.⁶⁶ A quorum for a three-member organization is typically two members.⁶⁷ The Board members, therefore, can not meet informally to discuss the agency’s work.⁶⁸ Three-member Boards also have difficulty in delegating tasks to multiple subcommittees.⁶⁹ To remedy these problems the Sunset Legislation expanded the Board to five members and added requirements for their qualification such as training and barring members of trade organizations regulated by the Board.⁷⁰

A major goal of the Sunset Legislation was to provide for the education of Texas investors. The Sunset Commission observed that the trends in Texas and the nation are to shift funds from traditional bank savings into securities.⁷¹ Retirement plans are also shifting the investment risk of retirement moneys to the individual with the replacement of defined benefit plans by individual-directed investment accounts provided with 401k plans and with the proposal to permit individuals to invest a portion of the government retirement moneys.⁷² With future securities markets of

when evidence did not have the word “copy” since it was not descriptive of the security). So the allegation that the perpetrator sold an “evidence of indebtedness,” descriptive of a debt security, required evidence of a debt security and not an investment contract, which also is a security.

64. See TEX. R. CIV. P. 47 (Vernon Supp. 2003) (a short statement of the cause of action sufficient to give fair notice of the claim involved).

65. TEX. REV. CIV. STAT. ANN. art. 581-2 (Vernon 1964 & Supp. 2003).

66. TEX. GOV’T CODE ANN. § 551ff (Vernon 1994).

67. TEX. GOV’T CODE ANN. § 551.001(6) (Vernon Supp. 2003) (quorum is majority unless defined differently by law, rule, or charter).

68. SUNSET ADVISORY COMMISSION, STAFF REPORT ON STATE SECURITIES BOARD 6 (2000).

69. *Id.*

70. Act of June 15, 2001, 77th Leg., R.S., ch. 1091, § 1.01, 2001 Tex. Gen. Laws 2399, 2399 (amending TEX. REV. CIV. STAT. ANN. art. 581-82); Act of June 15, 2001, 77th Leg., R.S., ch. 1091, § 31.02, 2001 Tex. Gen. Laws 2399, 2401 (adding art. 581-2-1 to art. 581-2-8 concerning requirements and procedures for the Board members).

71. SUNSET ADVISORY COMMISSION, STAFF REPORT ON STATE SECURITIES BOARD 24 (2000).

72. *Id.*

the size envisioned, the traditional Board's prevention of fraud through registrations and inspections will no longer suffice.⁷³ Future markets will require investor education so that investors can avoid fraudulent schemes and learn to contact the Board for information.⁷⁴ But the lack of authority to accept gifts has thwarted past Board efforts to raise moneys for investor education.⁷⁵ Consequently, the Sunset Legislation specifies that investor education is a function of the Board and authorizes the gifts.⁷⁶ The Sunset Commission also recommended a toll-free telephone number and email address for investors to request educational materials from the Board.⁷⁷

The Board also amended two of its rules to bring the organization of the Board into compliance with recent legislation. For example, the Sunset Legislation had as an objective the separation of the policymaking responsibilities of the Board from the management responsibilities of the Securities Commissioner and the employees of the Board.⁷⁸ To carry out this mandate, the Board amended its authority rule to clearly delineate these functions.⁷⁹

III. REGISTRATION OF SECURITIES

The basic rule of most securities laws is that registration is required unless an exemption applies. The 77th Texas Legislature created a transaction exemption for gifts of securities to charitable organizations and expanded the transaction exemption for the compensatory issuance of securities. The Board similarly amended the oil and gas auction exemption and created an additional exemption for limited sales to Canadians. The Board's enforcement actions for failure to register securities reveal problems with investment contracts and the Board's efforts against internet defrauders.

The Texas Legislature added a transaction exemption for the exercise of gifted options to charitable organizations.⁸⁰ The high-tech society in

73. *Id.* at 25; see also Bureau of Investor Protection and Securities, *New York State Attorney General Report on Micro-Cap Stock Fraud* 45 (1997) (prevention of micro-cap fraud only possible with investor education concerning the schemes).

74. SUNSET ADVISORY COMMISSION, STAFF REPORT ON STATE SECURITIES BOARD 25-26 (2000).

75. *Id.* at 26; see TEX. GOV'T CODE ANN. § 575.003 (Vernon 1994 & Supp. 2003) (permitting gifts to agencies if authorized by agency rule and statute).

76. Act of June 15, 2001, 77th Leg., R.S., ch. 1091, § 1.03, 2001 Tex. Gen. Laws 2399, 2403 (adding TEX. REV. CIV. STAT. ANN. art. 581-43); Act of June 15, 2001, 77th Leg., R.S., ch. 1091, § 1.05, 2001 Tex. Gen. Laws 2399 (requiring implementation by September 1, 2002).

77. SUNSET ADVISORY COMMISSION, STAFF REPORT ON STATE SECURITIES BOARD 26-27 (2000)

78. Act of June 15, 2001, 77th Leg., R.S., ch. 1091, 2001 Tex. Gen. Laws 2399, 2401 (adding art. 581-2-4, among several other provisions, so providing).

79. 27 Tex. Reg. 4933 (2002) (amending 7 TEX. ADMIN. CODE § 101.1, without comment); see 27 Tex. Reg. 2153 (2002) (for the proposal).

80. Act of June 11, 2001, 77th Leg., R.S., ch. 561, 2001 Tex. Gen. Laws 1078 (adding TEX. CIV. STAT. ANN. art. 581-5U).

Austin has produced the gift-giving of employee options.⁸¹ Such gifts result in wage income to the employee upon exercise, so these arrangements allow for donor direction of when to exercise and intermediary withholding of income taxes.⁸² The issuer generally must register the underlying stock for employee options.⁸³ This exemption obviates the need for such registration. The exemption covers transfers of securities to a religious, educational, benevolent, fraternal, charitable, or reformatory non-profit corporation or association.⁸⁴ The non-profit can provide no value for the securities other than the amount of the exercise price for a transfer of an option provided the exercise price was the fair market value of the underlying security when granted.⁸⁵ The transfer may not raise capital for the issuer or be part of a scheme to avoid the Texas Securities Act.⁸⁶ No person shall receive a commission for the transfer.⁸⁷

The Texas Legislature amended the employee plan exemption to permit coverage for the issuance of securities as compensation to a broader group of service providers than previously allowed.⁸⁸ Previously, the exemption only covered employee benefit plans for the issuer's employees. The amendment extends the exemption to compensation plans and contracts for consultants, advisors, and subsidiary employees.⁸⁹ One of the modern forms of business is to use independent contractors rather than employees. The courts have excluded independent contractors from inclusion in employee benefit plans.⁹⁰ As a result, the cashless method of compensation now requires security issuance outside of the employee benefit plans. Without this amendment, such an issuance would require registration. When the Board amended its rule to account for this change, it coordinated it more closely with its federal counterpart than the prior rule.⁹¹

81. See, e.g., Elizabeth Goldman, *Tech Losses Rippling Through Region; As Dust of Market Bust Settles, Central Texas Begins to Feel the Effects*, AUSTIN-AMERICAN STATESMAN, Jan. 7, 2001, available at 2001 WL 4574477.

82. See, e.g., Priv. Ltr. Rul. 97-37-015 (Sept. 12, 1997).

83. See, e.g., 7 TEX. ADMIN. CODE § 113.9 (Vernon 2002) (registration of underlying shares continues regardless of how long the delay in the exercise of the option).

84. TEX. REV. CIV. STAT. ANN. art. 581-5U (Vernon 2001).

85. *Id.*

86. *Id.*

87. *Id.*

88. Act of June 13, 2001, 77th Leg., R.S., ch. 663, § 1, 2001 Tex. Gen. Laws 1235 (amending TEX. REV. CIV. STAT. ANN. art. 581-5I(b) (Vernon 2001)).

89. *Id.*

90. See, e.g., *Vizcaino v. Microsoft Corp.*, 120 F.3d 1006, 1009 (5th Cir. 1997); 26 C.F.R. § 1.423-2(e)(2) (2003) (423 plans).

91. 27 Tex. Reg. 4934 (2002) (amending 7 TEX. ADMIN. CODE § 109.13, without comment); see 27 Tex. Reg. 2154 (the proposal). The amendment relocates definitions from 7 TEX. ADMIN. CODE § 107.2 to this specific provision, changes "employer" to "issuer," uses more terminology consistently, and coordinates the exemption more closely with its federal counterpart, Rule 701, 17 C.F.R. § 230.701 (2001) (also covers consultants and advisers). Additionally, it reflects recent changes to TEX. REV. CIV. STAT. ANN. art. 581-5I(b), Act of June 13, 2001, 77th Leg., R.S., ch. 663, 2001 Tex. Gen. Laws 1235, to broaden the employee plan exemption to cover consultants, advisors, and business trusts and to change "employee plans" to the less restrictive "compensatory or benefit plans."

The Board also amended its exemption by rule⁹² for an oil and gas auction to update cross-references and conform its terminology internally.⁹³ The exemption is for the sale of 100 % of an oil and gas interest, except for an overriding royalty retained by the seller, to a buyer who has no intent to resell or subdivide, has knowledge and experience in oil and gas business, and has the financial resources to bear the risk of the purchase.⁹⁴ The requirements of the exemption are standard for a private placement.

The Board added a new exemption for Canadian dealers and members of a Canadian self-regulatory agency, who have prior client relationships with, and selling to, Canadian residents in Texas who have self-directed retirement accounts.⁹⁵

One court had the opportunity to interpret a contract using a phrase connected to the registration process. In *Walden v. Affiliated Computer Services, Inc.*,⁹⁶ the court interpreted the phrase "initial public offering."⁹⁷ A corporation partially owned by Gibraltar Savings Association and First Texas Association adopted a non-qualified stock option plan to benefit former senior managers and key employees. Subsequent to Gibraltar Savings Association's and First Texas Association's receivership, the Office of Thrift Supervision ordered a cease and desist order relating to the issuance of stock under the stock option plan.⁹⁸ The cease and desist order terminated on September 26, 1997, allowing the issuance on that day.⁹⁹ The stock option plan stated that the options expired three years after an "initial public offering."¹⁰⁰ The corporation's registration statement had become effective by Securities and Exchange order at 4:30 p.m. on September 26, 1994.¹⁰¹ The issue was whether the option holders could receive the issuance of shares under the plan on September 26, 1997, for options exercised earlier.¹⁰² Using the plain meaning rule for contract interpretation, the court concluded that a public offering commences with the time of the effective order.¹⁰³ Therefore, these option

92. Authority for the Board to create exemptions for various transactions lies in TEX. REV. CIV. STAT. ANN. art. 581-5T (Vernon Supp. 2003).

93. 27 Tex. Reg. 4936 (2002) (amending 7 TEX. ADMIN. CODE § 139.12, without comment); see 27 Tex. Reg. 2158 (2002) (for the proposal).

94. 7 TEX. ADMIN. CODE § 139.12 (West 2002).

95. 26 Tex. Reg. 9585 (2001) (amending 7 TEX. ADMIN. CODE § 139.21); see 26 Tex. Reg. 6211 (2001) (for the proposal). The Board agreed to the commentator's change.

96. *Walden v. Affiliated Computer Servs., Inc.*, 97 S.W.3d 303 (Tex. App.—Houston [14th Dist.] 2003, pet. filed).

97. *Id.* at 326. This article omits the issues on contract breach, affirmative defenses, and damage calculation.

98. *Id.* at 311. The author in 1985-87, prior to the adoption of the plan involved in the case, worked for a law firm that represented both of the savings institutions involved in this case.

99. *Id.* at 327.

100. *Id.* at 326.

101. *Id.* at 327.

102. *Id.*

103. *Id.* (citing *Okley v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 3 (2d Cir. 1996) (for determination of the class for a class action)); see also *In re Amerifirst Securities Litigation*, 138 F.R.D. 423 (S.D. Fla. 1991) (same).

holders were entitled to the issuance of their stock and the failure to issue them resulted in money damages.¹⁰⁴

The Board had numerous enforcement actions against issuers who did not register their securities. By far the most numerous cases dealt with the sale of standard securities without registration, prompting cease and desist orders.¹⁰⁵ These proceedings reveal that there are still a large number of issuers who either do not realize that a particular transaction is an investment contract and hence is a security subject to the registration requirements, or choose to ignore the securities laws of Texas, all prompting proceedings for cease and desist orders.¹⁰⁶

104. *Walden*, 97 S.W.3d at 327.

105. See *In re* Agent Registration of Neil Wayne Brooks, No. 02-24, 2002 WL 1900308, at *1 (Tex. St. Sec. Bd. Aug. 13, 2002) (Robert Allen C. Limited Partnership sold partnership interests including exaggerated information about the return on an exotic option trading system, Board also issued a \$500 fine); *In re* Warren Resources Co., No. 02-23, 2002 WL 1840677, at *1 (Tex. St. Sec. Bd. Aug. 8, 2002) (limited liability company offered class B units); *In re* Starcash, Inc., No. 02-10, 2002 WL 546685, at *1 (Tex. St. Sec. Bd. Apr. 5, 2002) (sold interest in accounts receivable from payday advances, representing 30% returns without disclosing cease and desist orders in Washington and Pennsylvania; emergency); *In re* Roger Alan Bennett d/b/a Bennet Drilling, No. 02-04, 2002 WL 408085, at *1 (Tex. St. Sec. Bd. Mar. 5, 2002) (sold 3% of working interest in well without disclosing \$23,000 judgment against issuer; emergency); *In re* Globex Exploration, Inc., No. 02-01, 2002 WL 204940, at *1 (Tex. St. Sec. Bd. Feb. 6, 2002) (accepted moneys for purchase of working interests in oil and gas leases; Board also issued a \$5000 fine); *In re* James Gilbert Payne, No. 01-30, 2001 WL 1589637, at *1 (Tex. St. Sec. Bd. Nov. 26, 2001) (sold stock in Nevada company to operate pilot plant to extract precious metals from magnetic ore); *In re* U.S. Recycling Corp., No. 01-28, 2001 WL 1379882, at *1 (Tex. St. Sec. Bd. Oct. 31, 2001) (offered limited partnership interest and notes of subsidiary without disclosing cease and desist orders of South Dakota, Wisconsin, Illinois, and Pennsylvania; emergency); see also *In re* Hydrofuel Sys., Inc., No. 02-07, 2002 WL 517472, at *1 (Tex. St. Sec. Bd. Mar. 27, 2002) (corporation used unregistered agents to sell its shares; Board also issued a \$2500 fine; emergency).

For botched exemptions, see *In re* Randal Floyd, No. 02-27, 2002 WL 31108185, at *1 (Tex. St. Sec. Bd. Sept. 7, 2002) (Vision Rehab LLC offered debentures and stock by newspaper claiming a 506 exemption without filing a Form D); *In re* Integrated Direct Mktg. Corp., No. 02-22, 2002 WL 1828146, at *1 (Tex. St. Sec. Bd. Aug. 1, 2002) (offered interest in drilling program in Kansas to a non-accredited investor without disclosing past drilling failures, the absence of a certificate of doing business, and a misrepresentation of selling only to accredited investors; Board issued cease and desist order). Form D is the notice of sale filed for the federal small offering and private placement exemption under Regulation D. See 17 C.F.R. § 230.503 (2002). Sales to accredited investors are exempted from registration under the federal Securities Act of 1933. See 15 U.S.C. § 77d(6) (1997).

For investment contracts, see *infra* note 106 and accompanying text.

For emergency cease and desist orders, see *infra* note 110 and accompanying text.

106. See *In re* Herbert Tanzer d/b/a Tex. Senior Care, No. 02-13, 2002 WL 856286, at *1 (Tex. St. Sec. Bd. Apr. 29, 2002) (promoter offered seminar and sold ATMs with management contract and investment contract for tax credit without disclosure of prior injunctions); *In re* Todd Robert Fecht, No. 02-12, 2002 WL 927153, at *1 (Tex. St. Sec. Bd. Apr. 24, 2002) (promoter sold investment contracts in a customer-owned payphone equipment lease program); *In re* Abraham Martinez, No. 02-08, 2002 WL 529472, at *1 (Tex. St. Sec. Bd. Apr. 2, 2002) (promoter sold interests in a customer-owned, coin-operated telephone program); see also *In re* Ramiro "Ram" L. Amaya, No. 02-18, 2002 WL 1396028, at *1 (Tex. St. Sec. Bd. June 20, 2002) (promoter who sold an irrevocable fee agreement and an investment contract for investing in private placement program was sued by investor for \$38,000, settled); *In re* Orville Blake Brannon, Jr., No. 02-16, 2002 WL 1163601, at *1 (Tex. St. Sec. Bd. May 28, 2002) (promoter sold viatical settlements and investment contracts).

A more serious problem dealt with issuers selling on the internet in Texas after other state authorities barred them from selling in their states.¹⁰⁷ The Board handled all of these cases with their newly authorized emergency proceedings for cease and desist orders. In the past, Board cease and desist orders only went into effect after the Commissioner had held a hearing on thirty-days' notice to determine the validity of the order.¹⁰⁸ These proceedings often took over a year.¹⁰⁹ Modern internet fraud schemes occur much more quickly than that. The Sunset Legislation placed Texas with the thirty-six other states that grant the securities commissioner authority to issue an emergency cease and desist order with the hearing to occur after the order.¹¹⁰

IV. REGISTRATION OF MARKET OPERATORS

One of the underpinnings of state regulation of securities is the requirement to register as a seller of securities before one can sell securities in the state. Texas now requires the registration of both the dealers selling securities and those rendering investment advice.¹¹¹

The other significant change rendered by the Sunset Legislation was the authorization of surprise inspections by the Commissioner. The Board began its inspection program in 1990. Once every eight years, the Board inspects dealers and investment advisors not regularly inspected by the federal Securities and Exchange Commission (the SEC) or the National Association of Securities Dealers (the NASD).¹¹² The inspectees successfully challenged these unannounced, warrantless inspections because the Board based them on its authority to develop rules to ensure compliance with the Texas Securities Act. The rule under which the Board conducted inspections did not satisfy the constitutional requirements because it failed to properly define the scope of the inspection and

107. *See In re One Share of Stock, Inc.*, No. 02-19, 2002 WL 1476287, at *1 (Tex. St. Sec. Bd. July 1, 2002) (offered stock by email without disclosing cease and desist orders from Pennsylvania and Alabama on website; emergency); *In re Midas World Holdings S.A.*, Order No. CDO-1448, 2002 WL 370383, at *1 (Tex. St. Sec. Bd. Feb. 25, 2002) (sold through the internet securities of high yield income fund without disclosing failures to pay principal and interest and cease and desist order of Connecticut; emergency); *In re Int'l Bus. Consortium, Inc.*, No. 01-29, 2001 WL 1503263, at *1 (Tex. St. Sec. Bd. Nov. 20, 2001) (offered internet shares to return annual dividends of \$4000 to \$34,000 for each \$1000 invested without disclosing cease and desist orders of Pennsylvania, Washington, Ohio, and Wisconsin; emergency); *see also In re VIP Fin. Bank Group*, No. 02-17, 2002 WL 1396029, at *1 (Tex. St. Sec. Bd. June 18, 2002) (offered investments and services on website, including CD collateralized by bank assets assessed by opinion of Texas lawyer; emergency). Administrative fines must not exceed \$10,000 for a single violation, nor \$100,000 for multiple violations. TEX. REV. CIV. STAT. ANN. art. 581-23-1 (Vernon 2003).

108. TEX. REV. CIV. STAT. ANN. art. 581-23A (Vernon Supp. 2003).

109. SUNSET ADVISORY COMMISSION, STAFF REPORT ON STATE SECURITIES BOARD 13 (2000).

110. Act of June 15, 2001, 77th Leg., R.S., ch. 1091, § 3.05, 2001 Tex. Gen. Laws 2399, 2422 (adding TEX. REV. CIV. STAT. ANN. art. 581-23-2).

111. *See supra* notes 21-23 and accompanying text.

112. SUNSET ADVISORY COMMISSION, STAFF REPORT ON STATE SECURITIES BOARD 18 (2000).

limit the discretion of the inspectors.¹¹³ Moreover, the statute did not provide that information gleaned from such inspections was confidential.¹¹⁴ The Sunset Legislation therefore authorized these inspections and provided for confidentiality of the information so obtained.¹¹⁵ The confidentiality provision allows information sharing with other regulatory bodies, including the SEC, NASD,¹¹⁶ and associations of state securities commissioners.¹¹⁷ Consequently, the Board amended its guidelines for confidentiality of information to reflect this change.¹¹⁸

A. DEALERS

Changes in the statutes wrought by the 77th Texas Legislature prompted a number of rule changes for selling agents. The sunset legislation also empowered the Board with authority to use emergency cease and desist orders against unregistered selling agents.

The sunset legislation inspection authority means the Board no longer needs the consent of the registered entity to inspect records. So the Board repealed that consent form.¹¹⁹ Similarly, the Legislature repealed that portion of the Texas Business Corporation Code requiring the Board to obtain certificates that the issuer had paid its franchise taxes.¹²⁰ Consequently, the Board no longer needed the certificate concerning franchise taxes and so repealed that requirement.¹²¹ The Board then amended its rules for the registration of selling agents to eliminate the references to the repealed forms, to provide for automatic withdrawal of applications for dealer or agent registration, to correct a cross-reference, to remove a requirement to surrender evidences of registration for can-

113. Op. Tex. Att'y Gen. No. JC-0274 (2002).

114. SUNSET ADVISORY COMMISSION, STAFF REPORT ON STATE SECURITIES BOARD 19-20 (2000).

115. Act of June 15, 2001, 77th Leg., R.S., Ch. 1091, § 3.01, 2001 Tex. Gen. Laws 2399, 2419 (adding TEX. CIV. STAT. ANN. art. 581-13-1 authorizing the inspections); Act of June 15, 2001, 77th Leg., R.S., Ch. 1091, § 3.09, 2001 Tex. Gen. Laws 2399, 2424 (amending TEX. CIV. STAT. ANN. art. 581-28, providing for the confidentiality of the information gleaned from inspections).

116. SUNSET ADVISORY COMMISSION, STAFF REPORT ON STATE SECURITIES BOARD 18 (2000).

117. Act of June 15, 2001, 77th Leg., R.S., Ch. 1091, § 3.09, 2001 Tex. Gen. Laws 2399, 2424 (amending TEX. CIV. STAT. ANN. art. 581-28, allowing sharing with associations of governmental or regulatory authorities).

118. 27 Tex. Reg. 4935 (2002) (amending 7 TEX. ADMIN. CODE § 131.1, combining old § 131.1 and § 131.2 (now § 131.1(b)), without comment); *see* 27 Tex. Reg. 2156 (2002) (for the proposal).

119. 26 Tex. Reg. 9585 (2001) (repealing 7 TEX. ADMIN. CODE § 133.16, the form concerning the agreement for maintenance and inspection of records); *see* 26 Tex. Reg. 6211 (2001) (for the proposal).

120. Act of June 15, 2001, 77th Leg., R.S., ch. 1158, § 94, 2001 Tex. Gen. Laws 2570, 2615 (repealing Tex. Bus. Corp. Act art. 2.45 (Supp. 2001), which prohibited obtaining a permit or license from any state action if the corporation was delinquent in its franchise tax payments).

121. 27 Tex. Reg. 1476 (2002) (repealing 7 TEX. ADMIN. CODE § 133.23, the form concerning franchise tax certification for corporate applicants); *see* 26 Tex. Reg. 10199 (2001) (for the proposal).

cellation, and to conform terminology to the Texas Securities Act.¹²² The Board also amended the dealer application rule to eliminate the reference to the franchise tax form no longer required¹²³ and to remove the paper-filing requirement in light of the recently enacted Texas Uniform Electronic Transactions Act.¹²⁴

The Board initiated numerous enforcement actions against dealers, most resulting in reprimands, for various infractions of the Board's rules, such as refusal to supply the Board with information,¹²⁵ failure to put required information on the Forms U-4,¹²⁶ making unauthorized customer trades,¹²⁷ failure to supervise underlings,¹²⁸ and failure to

122. 26 Tex. Reg. 9581 (2001) (amending 7 TEX. ADMIN. CODE §§ 115.2, 115.3, 115.5, 115.7 & 115.8 on dealer applications, examination, minimum records, maintenance of records, and fee requirements); see 26 Tex. Reg. 6205 (2001) (for the proposal). One commentator feared Rule 115.7 would allow inspectors to take control of records to the exclusion of employees and copy free of charge. The rule, however, does not deviate from the language of TEX. REV. CIV. STAT. ANN. art. 581-13-1 (Vernon 2002). Another commentator supported the change in Rule 115.8.

123. 27 Tex. Reg. 1475 (2002) (amending 7 TEX. ADMIN. CODE § 115.2, without comment); see 26 Tex. Reg. 10197 (2001) (for the proposal).

124. 27 Tex. Reg. 4935 (2002) (amending 7 TEX. ADMIN. CODE § 115.2, without comment); see 27 Tex. Reg. 2156 (for the proposal); see also Act of June 13, 2001, 77th Leg., R.S., ch. 702, 2001 Tex. Gen. Laws 1341 (adding Tex. Bus. & Com. Code § 43 (Vernon 2002), the Uniform Electronic Transactions Act).

125. *In re* the Agent Registration of Stuart Charles Duncan, No. 02-28, 2002 WL 3119462, at *1 (Tex. St. Sec. Bd. Sept. 19, 2002) (failed to provide accurate information relating to a customer complaint requested by supervisor, Board issued a \$5000 fine); *In re* the Dealer Registration of the Barrington Capital Group, L.P., No. 02-25, 2002 WL 31039296, at *1 (Tex. St. Sec. Bd. Sept. 4, 2002) (failed to provide information requested by the Board's staff; Board revoked the registration); *In re* Agent Registration of Ronald Jay Clifton, No. 02-06, 2002 WL 483587, at *1 (Tex. St. Sec. Bd. Mar. 26, 2002) (upon Board inspection, it refused to provide information on repute, Board issued an undertaking barring registration for 5 years).

126. *In re* Agent Registration of Gary Randolph Hayden, No. 02-20, 2002 WL 1575117, at *1 (Tex. St. Sec. Bd. July 9, 2002) (did not disclose on Form U-4 sale of unregistered units in customer owned telephone program, Board issued a 65-day suspension); *In re* Agent Registration of David Jacob Herzog, No. 02-15, 2002 WL 1163601, at *1 (Tex. St. Sec. Bd. May 23, 2002) (did not disclose customer complaint in excess of \$5000 and settlement in excess of \$10,000 on U-4 until inquiry by Board, Board issued a \$1000 fine).

127. *In re* Agent Registration of Jeffrey Christian Leo, No. 02-09, 2002 WL 529473, at *1 (Tex. St. Sec. Bd. Apr. 2, 2002) (engaged in multiple unauthorized transactions in customer accounts with prior employer, Board withdrew application and issued a suspension for 5 years); *In re* Agent Registration of Robert Gerald Vanwassehnova, No. 02-05, 2002 WL 448722, at *1 (Tex. St. Sec. Bd. Mar. 19, 2002) (traded in customer account with respect to municipal bonds for which he had not taken the exam, had not discretionary authority from the customer, and did not disclose this trading to employer or on Form U-4; Board issued a \$2500 fine).

128. *In re* Dealer Registration of Wunderlich Sec., Inc., No. 02-26, 2002 WL 31050751, at *1 (Tex. St. Sec. Bd. Sept. 11, 2002) (Board inspection found various failures to maintain records, to account for customer moneys, to devise special supervision of previously disciplined agent engaged in unsuitable option investments and to register as investment advisor; Board issued a \$5000 fine); *In re* the Application for Agent Registration of Travis Nick Duren, No. 01-31, 2001 WL 1589636, at *1 (Tex. St. Sec. Bd. Nov. 31, 2001) (as compliance officer approved incomplete customer new accounts, allowed unregistered agent to sell, failed to maintain complete records, failed to update Form U-5 (termination) of agent for customer complaint; Board issued a \$5000 fine).

register.¹²⁹

The Board had numerous enforcement actions against unregistered selling agents. The Board issued cease and desist orders in all of these cases.¹³⁰ Before the Sunset amendments, the cease and desist orders could only cover unregistered dealers, not the agents of these dealers. The Board could only issue cease and desist orders against dealers not to use agents, unless the agents registered.¹³¹ But since micro-cap fraud involves legions of unregistered agents moving from scheme to scheme,¹³² the Sunset Commission perceived a gap in coverage.¹³³ Since agents make up 97 % of the registered sales force, they likely represent a large portion of the unregistered sales force.¹³⁴ The Sunset Legislation, therefore, allows cease and desist orders against unregistered agents of both dealers and investment advisors, and against fraudulent sales practices in general.¹³⁵ Now the Board issues cease and desist orders against agents not to offer unless they register.¹³⁶

Since a violation of a cease and desist order is now a crime, the Board frequently issues a notice with the cease and desist order to that effect.¹³⁷

129. *In re* the Agent Registration of Joe Edward Poe, Jr., No. 02-11, 2002 WL 545426, at *1 (Tex. St. Sec. Bd. Apr. 6, 2002) (sold securities without registration prior to registration application for two different employers; Board issued a \$5000 fine and 30 day suspension); *In re* the Agent Registration of James Galinsky, No. 01-32, 2001 WL 1589631, at *1 (Tex. St. Sec. Bd. Dec. 3, 2001) (sold interests in coin-operated, customer-owned telephone program without registering securities or agent); *In re* the Agent Registration of Charles Milton Coe, No. 01-27, 2001 WL 1295167, at *1 (Tex. St. Sec. Bd. Oct. 19, 2001) (sold coin-operated, customer owned telephone program without agent registration, failed to amend Form U-4 to reflect this business; Board issued a 5-day suspension).

130. *See, e.g., In re* Randal Floyd, No. 02-27, 2002 WL 31108185, at *1 (Tex. St. Sec. Bd. Sept. 7, 2002); *In re* U.S. Recycling Corp., No. 01-28, 2001 WL 1379882, at *1 (Tex. St. Sec. Bd. Oct. 31, 2001); *In re* One Share of Stock, Inc., No. 02-19 2002 WL 1476287, at *1 (Tex. St. Sec. Bd. July 1, 2002); *Ramiro "Ram" L. Amaya*, No. 02-18, 2002 WL 1396028, at *1 (Tex. St. Sec. Bd. June 20, 2002); *Todd Robert Fecht*, 2002 WL 927153, at *1 (Tex. St. Sec. Bd. Apr. 24, 2002); *Bennet Drilling*, 2002 WL 408085, at *1 (Tex. St. Sec. Bd. Mar. 5, 2002); *Int'l Bus. Consortium, Inc.*, No. 02-12, 2001 WL 1503263, at *1 (Tex. St. Sec. Bd. Nov. 20, 2001).

131. *See, e.g., In re* Charles Bunn DBA Capital Funding Trust, Ltd., No. 99-043, 1999 WL 1027730, at *1 (Tex. St. Sec. Bd. Oct. 25, 1999).

132. *See, e.g.,* Bureau of Investor Prot. & Sec., *New York State Attorney General Report on Micro-Cap Stock Fraud* 45 (1997) (boiler rooms persist by recruiting unregistered agents from a prior boiler room).

133. SUNSET ADVISORY COMMISSION, STAFF REPORT ON STATE SECURITIES BOARD 12-13 (2000).

134. *Id.*

135. Act of June 15, 2001, 77th Leg., R.S., ch. 109, § 3.03, 2001 Tex. Gen. Laws 2399, 2421 (amending TEX. REV. CIV. STAT. ANN. art. 581-23 to add cease and desist authority against the unregistered and against fraudulent sales practices), § 3.10 (amending TEX. REV. CIV. STAT. ANN. art. 581-29 to subject violation of a cease and desist order to criminal penalties), and § 3.16 (2001) (amending TEX. CIV. STAT. ANN. art. 581-33 to provide private remedies against violations of the new cease and desist orders).

136. *See supra* note 130 and accompanying text.

137. *See, e.g., Randal Floyd*, No. 02-27, 2002 WL 31108185, at *1 (Tex. St. Sec. Bd. Sept. 7, 2002); *Integrated Direct Mktg. Corp.*, No. CDO-1467, 2002 WL 1828146, at *1 (Tex. St. Sec. Bd. Aug. 1, 2002); *U.S. Recycling Corp.*, No. 01-28, 2001 WL 1379882, at *1 (Tex. St. Sec. Bd. Oct. 31, 2001); *One Share of Stock, Inc.*, No. 02-19, 2002 WL 1476287, at *1 (Tex. St. Sec. Bd. Apr. 21, 2002); *VIP Fin. Bank Group*, No. 02-17, 2002 WL 1396029, at *1 (Tex. St. Sec. Bd. June 18, 2002); *Texas Senior Care*, No. 02-13, 2002 WL 856286, at *1 (Tex. St.

Previously, the Board obtained agreements to criminal sanctions without sanctions.¹³⁸

B. INVESTMENT ADVISORS

One of the major changes of the Sunset Legislation was to distinguish the definition of “investment advisors” from “dealers” and require them to register. The Board amended the new investment advisor rules twice.¹³⁹ The second amendment conformed the definitions to the Sunset Legislation, eliminated the reference to the repealed franchise tax form and corrected cross references.¹⁴⁰

The Board issued some enforcement actions against investment advisors for various infractions of the Board’s rules, such as failure to put required information on the Forms U-4 and ADV,¹⁴¹ and failure to register.¹⁴² All resulted in reprimands.

V. REGISTRATION OF PUBLIC COMPANIES

The federal approach to the secondary market requires disclosure concerning the companies whose securities are publicly traded. Congress passed the Sarbanes-Oxley Act to correct for recently publicized deficiencies by requiring additional disclosure, limitations on directors and executive officers, increasing penalties for violations, and tightening the ethics of securities lawyers.

Sec. Bd. Apr. 24, 2002); *Starcash, Inc.*, No. 20-10, 2002 WL 546685, at *1 (Tex. St. Sec. Bd. Apr. 15, 2002); *Int’l Bus. Consortium, Inc.*, No. 01-29, 2001 WL 1503263, at *1 (Tex. St. Sec. Bd. Nov. 20, 2001).

138. See, e.g., *In re* Agent Application of Dennis E. Ward, No. 94-028, 1994 WL 370141, at *1 (Tex. St. Sec. Bd. July 12, 1994).

139. 26 Tex. Reg. 9582 (2001) (amending 7 TEX. ADMIN. CODE §§ 116.1, 116.2, 116.5, 116.7, 116.8, 116.13 & 116.15 on investment advisor general provisions, applications, minimum records, maintenance and inspection of records, fee requirements, advisory free requirements, and advertising restrictions); see 26 Tex. Reg. 6207 (2001) (for the proposal). The Board received several comments on the amendments and rejected most of them. The Board had adopted the whole § 116 series to comport with the Sunset Legislation. See 26 Tex. Reg. 5799 (2001) (adding 7 TEX. ADMIN. CODE §§ 116.1-116.15 (2001)); 26 Tex. Reg. 2602 (2001) (for the proposal). The separation of investment advisors from dealers also required the Board to adopt a whole new § 115 series. See 26 Tex. Reg. 5794 (2001) (replacing old 7 TEX. ADMIN. CODE §§ 115.1-115.7 (April 2001) with new 7 TEX. ADMIN. CODE §§ 115.1-115.10 (Aug. 2001)); 26 Tex. Reg. 2592 (2001) (for the proposal).

140. 27 Tex. Reg. 1475 (2002) (amending 7 TEX. ADMIN. CODE §§ 116.1 & 116.2 (2001)); see 26 Tex. Reg. 10198 (2001) (for the proposal). The comment suggested that federal covered investment advisors be excluded, contrary to the Texas Securities Act.

141. *In re* Inv. Adviser Representative Registration of John Randall Wilkes, No. 02-21, 2002 WL 1575132, at *2 (Tex. St. Sec. Bd. July 11, 2002) (failed to disclose 1988 felony charge for theft of property on U-4s Forms from 1992 to present; Board issued a \$3000 fine); *In re* Inv. Adviser Registration of James Franklin Forrester, No. 02-02, 2002 WL 232968, at *2 (Tex. St. Sec. Bd. Feb. 11, 2002) (failed to report 1996 consent order on four Form ADV amendments, failed to report 1998 fraud judgment on 2 Form ADV amendments; Board issued a \$500 fine).

142. *In re* Application for Inv. Adviser Registration of Asset Planning Group, Inc., No. 02-14, 2002 WL 1011300, at *1 (Tex. St. Sec. Bd. May 13, 2002) (rendered services as investment after registration had lapsed; Board issued a \$20,000 fine).

A. REPORTING

The major change made by the Sarbanes-Oxley Act relates to the accountability of chief executive officers and chief accounting officers of reporting companies. These officers must certify annual and quarterly reports of their reporting company that (1) the certifier has reviewed the report, (2) the report contains no inaccuracies, (3) the report fairly presents the financial condition of the reporting company, (4) the certifiers have established disclosure controls and procedures and evaluated them within the last ninety days, (5) the certifiers have disclosed significant deficiencies and fraud in those controls to the reporting company's auditors and audit committee, and (6) the certifiers have disclosed significant changes in the controls subsequent to their evaluation.¹⁴³ A new criminal penalty enforces this provision. The criminal statute requires the chief executive officer and chief financial officer to certify that the report fully complies with the Exchange Act and imposes a penalty of up to \$1 million or ten years imprisonment for failure to certify or knowingly certify to a false certification. The penalty increases to \$5 million or twenty years imprisonment for willful violations.¹⁴⁴ Fearing that hindsight might constitute "knowing" or "willful," some certifiers may require lower level officers and employees to make certifications to them. An Exchange Act violation further enforces the certification provision. Under Securities and Exchange Commission ("SEC") rules, it is unlawful to fraudulently influence the conduct of audits for the purpose of making financial statements materially misleading.¹⁴⁵ This provision may not be enforced by a private party.¹⁴⁶ Proposed SEC rules under this provision track the statute and provide examples of the following violations: causing an auditor to issue a report in violation of auditing standards, not to perform a procedure required by auditing standards, not to withdraw a report, or not communicate matters to the reporting company's audit committee.¹⁴⁷

The Sarbanes-Oxley Act has increased the amount of financial disclosures reporting companies must make to the public. The financial statements included in financial reports now must include all correcting adjustments identified by the auditors, and the SEC must issue rules relating to disclosures of off-balance sheet transactions and pro forma information included in any report to the SEC or the public under the securities laws.¹⁴⁸ The SEC has proposed rules requiring reporting companies to disclose off-balance sheet transactions in a separately captioned

143. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 777, § 302 (2002); 17 C.F.R. §§ 240.13a-14 & 240.15d-14 (2003) (the new SEC rules on the subject).

144. Sarbanes-Oxley Act of 2002, § 906 (2002) (adding 18 U.S.C. §1350).

145. *Id.* § 303.

146. *Id.* § 303.

147. Improper Influence on Conduct of Audits, SEC Release No. 34-46685, 2002 WL 31356568 (Oct. 18, 2002).

148. Sarbanes-Oxley Act of 2002, § 401 (2002).

subsection of Management's Discussion and Analysis.¹⁴⁹ For pro forma information, the SEC has proposed a new Regulation G requiring reporting companies to disclose the use of non-Generally Accepted Accounting Principles (GAAP), include a comparable GAAP measure, and reconcile the two.¹⁵⁰

The Sarbanes-Oxley Act also requires the SEC to issue rules concerning management's assessment of internal controls, codes of ethics for financial officers, and disclosures of financial experts on audit committees in the annual reports.¹⁵¹ The SEC's proposed rules would further require the reporting company's public accountants to report on management's evaluation of the internal controls, disclosure of the codes of ethics or an explanation for the failure to adopt one, along with amendments and waivers for specific officers, and disclosure of whether the financial expert is independent of management and if not, why not.¹⁵²

Critical to the Sarbanes-Oxley Act's disclosure requirements is the provision requiring rapid disclosure in plain English of material changes in financial conditions as determined by the SEC.¹⁵³ Currently, reporting companies must disclose material inside information only in connection with a filing with the SEC or to correct prior disclosed information. Fear that hindsight might determine the materiality of matters relating to the reporting company's financial condition suggests a broad interpretation of what information reporting companies should disclose, along with more frequent updates.

B. LIMITATIONS ON DIRECTORS AND EXECUTIVE OFFICERS

The Sarbanes-Oxley Act also limits the actions of directors and executive officers of reporting companies. The Sarbanes-Oxley Act makes it unlawful for reporting companies, directly or indirectly, to extend, or arrange to extend, credit to directors or executive officers, with specified exceptions for loans on market terms and certain home loans.¹⁵⁴ Directors and executive officers may have problems determining just what acts the statute prohibits. Problematic examples would include billing small matters to the reporting company for later reimbursement upon the arrival of the invoice, and the cashless exercise of stock options.

The Sarbanes-Oxley Act also shortened the time allowed to file reports concerning changes in securities holdings of directors, officers, and princi-

149. Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements SEC Release No. 34-46767, 2002 WL 31453995 (Nov. 8, 2002).

150. Conditions for Use of Non-GAAP Financial Measures, SEC Release No. 34-46788, 2002 WL 31455599 (Nov. 4, 2002).

151. Sarbanes-Oxley Act of 2002 §§ 404, 405, 407.

152. Disclosure Required by §§ 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, SEC Release No. 34-46701, 2002 WL 31370458 (Oct. 22, 2002).

153. Sarbanes-Oxley Act of 2002 § 409 (adding a new § 13(l), 15 U.S.C. § 78m (l) (Supp. 2003), to the Exchange Act).

154. *Id.* § 402 (adding a new § 13(k), 15 U.S.C. § 78m (k) (Supp. 2003), to the Exchange Act).

pal shareholders from ten days to two days.¹⁵⁵

The Sarbanes-Oxley Act makes it unlawful for directors and executive officers of reporting companies to acquire or transfer equity securities during any blackout period, when ordinary beneficiaries of pension plans may not trade the reporting company's securities.¹⁵⁶ This provision also specifies a notice requirement to plan beneficiaries concerning the reasons for and duration of the blackout period.¹⁵⁷ A disgorgement provision allowing shareholders to sue for the benefit of the reporting company in specified circumstances enforces the provision similar to the short-swing profit section of the Exchange Act.¹⁵⁸ Since the provision makes trading unlawful during blackout periods, unlike the Exchange Act's short-swing provision, the SEC may seek criminal penalties in addition to the disgorgement.

C. ENFORCEMENT

The Sarbanes-Oxley Act expands the authority and enforcement powers of the SEC. The SEC may now seek and obtain equitable relief under any provision of the federal securities laws.¹⁵⁹ Where the SEC obtains both an order or settlement requiring disgorgement of ill-gotten profits and a civil penalty against the same perpetrator, the SEC may add the civil penalty to the disgorgement fund for the benefit of victims.¹⁶⁰

The SEC has authority to bar persons, temporarily or permanently, conditionally or unconditionally, from participating in penny stock offerings if their alleged misconduct related to an offering of penny stock.¹⁶¹ Similarly, the SEC now has authority to bar officers and directors who have violated the securities fraud provisions from service with reporting companies.¹⁶²

The Sarbanes-Oxley Act has also expanded criminal penalties. Violations committed after the Act carry an increased criminal penalty of up to \$5 million (\$25 million for other than natural persons) or 20 years imprisonment or both.¹⁶³

155. *Id.* § 403 (amending § 16(a), 15 U.S.C. § 78p(a) (1997), of the Exchange Act).

156. *Id.* § 306.

157. *Id.* § 306 (adding a new § 101(i), 29 U.S.C. § 1021(i) (Supp. 2003), to the Employee Retirement Income Security Act of 1974).

158. 15 U.S.C. § 78p(b) (1997).

159. Sarbanes-Oxley Act of 2002 § 305 (adding a new subsection, § 21(d)(5), 15 U.S.C. § 78u (Supp. 2003), to the Exchange Act).

160. *Id.* § 308.

161. *Id.* § 603 (adding a new subsection, § 20(g), 15 U.S.C. § 77t (Supp. 2003), to the Securities Act and adding a new subsection, § 21(d)(6), 15 U.S.C. § 78u (Supp. 2003), to the Exchange Act).

162. *Id.* § 1105 (adding a new subsection, § 8A(f), 15 U.S.C. § 77h-1 (Supp. 2003), to the Securities Act and adding a new subsection, § 21C(f), 15 U.S.C. § 78u-3 (Supp. 2003), to the Exchange Act).

163. *Id.* § 1106 (amending § 32(a), 15 U.S.C. § 78ff (1997), of the Exchange Act, increasing the penalty from \$1 million (\$2.5 million for other than natural persons) or 10 years imprisonment).

D. REGULATION OF SECURITIES LAWYERS

The Sarbanes-Oxley Act codified the main part of Rule 102(e)¹⁶⁴ concerning improper and unethical conduct in the context of all federal securities laws, and directed the SEC to adopt rules requiring minimum standards of professional conduct for securities lawyers representing issuers.¹⁶⁵ The SEC's proposed rules go beyond the Act's mandate.¹⁶⁶ The proposed rules impose reporting and record-keeping obligations on both in-house and outside counsel in the case of material violations of the securities laws or fiduciary duties.¹⁶⁷ Proposed Rule 3 requires a securities lawyer to report to the reporting company's chief legal officer evidence of a material violation that the reporting lawyer reasonably believes has occurred, is occurring, or is about to occur, and to make a record of the report.¹⁶⁸ The rule requires the reporting company's chief legal officer to determine whether the incident requires an inquiry.¹⁶⁹ If not, the chief legal officer reports a negative finding to the reporting lawyer.¹⁷⁰ If an inquiry is required, the chief legal officer must take reasonable steps to insure that the reporting company takes appropriate action, including public disclosure, and reports to both the chief executive officer and the reporting lawyer.¹⁷¹ If the reporting lawyer does not receive an appropriate response within a reasonable time, the reporting lawyer must report the violation to the audit committee or the full board.¹⁷² If the reporting lawyer believes the reporting company did not take the appropriate action, the reporting lawyer must document the matter. If an outside counsel, the lawyer must make a noisy withdrawal of representation with a disaffirmation of tainted submissions to the SEC.¹⁷³ Proposed Rules 4 and 5 deal with subordinate lawyers and those that supervise them.¹⁷⁴ Proposed Rule 6 spells out the manner of the SEC's prosecution of violating lawyers.¹⁷⁵ Proposed Rule 3 makes a violation of any of the proposed rules a violation of the Exchange Act, thereby subjecting securities lawyers to the usual Exchange Act penalties.¹⁷⁶

164. *Id.* § 602 (adding a new § 4C, 15 U.S.C. § 78d-3 (2002), to the Exchange Act); 17 C.F.R. § 210.102(e)(2002).

165. *Id.* § 307.

166. Implementation of Standards of Professional Conduct for Attorneys, SEC Release No. 34-46868, 2002 WL 31627090 (Nov. 21, 2002).

167. *Id.*

168. *Id.*

169. *Id.*

170. *Id.*

171. *Id.*

172. *Id.*

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.*

VI. SECURITIES FRAUD

One of the major reasons legislatures passed securities acts was to facilitate actions by investors to recover their moneys through a simplified fraud action that removed the most difficult elements that had to be proved in a common law fraud action, namely scienter and privity.

A. COURT DECISIONS UNDER THE TEXAS ACTS

Five courts considered securities fraud lawsuits under the Texas Securities Act during the Survey period. One dealt with whether a promise to act in the future was actionable under the Texas Securities Act. Another addressed fraud committed by a prior owner. The other three cases floundered on procedural missteps.

In *Herrman Holdings Ltd. v. Lucent Technologies, Inc.*,¹⁷⁷ the court confronted the sale of a company in return for restricted stock of a public company. The public company represented representation to use its reasonable best efforts to file and make effective a registration statement covering the shares and the subsequent failure to obtain an effective registration until after announcing quarterly results caused the stock price to plummet twenty-five percent.¹⁷⁸ As an aid to understanding the result in the cases, note that the investors sued the issuer for refusing to commit securities fraud on the public by filing knowingly misleading registration statements with the SEC to enable the investors to sell to an unsuspecting public.

The first issue in *Herrman Holdings Ltd.* was whether the fraud provision of the Texas Securities Act for “untrue statement of material fact” included an untrue promise of future action.¹⁷⁹ There was no Texas case on point. But the court noted that for common law securities fraud and non-securities fraud, Texas courts allow liability on future promises, provided the future promise is made with no intention of performing it.¹⁸⁰ Moreover, Texas courts look to federal decisions to aid in interpreting the Texas Securities Act.¹⁸¹ The federal courts have held under the federal securities laws that predictive statements are actionable only if they are

177. *Herrman Holdings Ltd. v. Lucent Techs., Inc.*, 302 F.3d 552 (5th Cir. 2002).

178. *Id.* at 556. This article does not cover the breach of contract issues on which the investors won.

179. *Id.* at 563-64; see TEX. REV. CIV. STAT. ANN. art. 581-33 (Vernon Supp. 2002). The investor also argued for a present omitted fact that there were existing circumstances making it probable that a delay would occur. Since this was not raised until the reply brief, the court considered this waived.

180. *Herrman Holdings Ltd.*, 302 F.3d at 563-64 (citing *Ferguson v. Williams*, 670 S.W.2d 327, 331-32 (Tex. App.—Austin 1984, writ ref’d n.r.e.) (rule applies to securities common law fraud, and is so not applicable to the Texas Securities Act); *Formosa Plastics Corp. USA v. Presidio Eng’rs & Contractors, Inc.*, 960 S.W.2d 41, 48 (Tex. 1998) (non-securities common law fraud).

181. *Herrman Holdings Ltd.*, 302 F.3d at 563-64 (citing *Quest Med, Inc. v. Apprill*, 90 F.3d 1080, 1091 n.16 (5th Cir. 1996) (for Texas Securities Act fraud provision, TEX. CIV. STAT. ANN. art. 581-33 (Vernon 2003))).

false when made.¹⁸² The Fifth Circuit decided to follow the federal rule. The effect of this rule is to interject scienter back into a securities fraud claim under the Texas Securities Act. Since the investor had expressly disavowed fraudulent intent for purposes of the Texas Securities Act only, believing the Texas Securities Act did not require scienter, the dismissal of the investor's claim under the Texas Securities Act was proper.

The second issue in *Herrman Holdings Ltd.* was whether under the Texas Stock Fraud Act¹⁸³ fraudulent intent had been adequately pled under the federal rules.¹⁸⁴ Federal rule 9(b) requires the circumstances constituting fraud to be stated with particularity, and only the condition of the mind averred generally.¹⁸⁵ This rule is an exception to the usual federal notice pleading, which is similar to the Texas pleading.¹⁸⁶ The Fifth Circuit requires pleading of the specific fraudulent statement, the identity of the speaker, the location where the statement was made, and an explanation of why the statement is fraudulent.¹⁸⁷ To adequately plead intent, the plaintiff must set forth facts to support an inference of fraud by (1) showing defendant's motive or (2) circumstances that indicate conscious behavior on the part of defendant.¹⁸⁸ On the first point, the court found the allegations that the delay was motivated to avoid double registration costs (delayed to include a second acquisition), to avoid repeatedly updating negative statements in registration statements, and to prevent disclosure of bad financial news until after the second acquisition did not show a fraudulent motive.¹⁸⁹ On the second point, the breach of the contract alone was inadequate to prove intent.¹⁹⁰ Dismissal, therefore, was proper.¹⁹¹ The court also found no abuse of discretion in refusing to allow leave to amend, since it had been given twice before.¹⁹²

In *Texas True Choice, Inc. v. Aetna, Inc.*,¹⁹³ the court dealt with the purchase of stock of a company from a seller who had recently purchased the company, where the buyer relied on incorrect financial information

182. *Id.* (citing *Sushany v. Allwaste, Inc.*, 992 F.2d 517, 524 (5th Cir. 1993) (Rule 10b-5, 17 C.F.R. § 240.10b-5 (2002))).

183. TEX. BUS. & COM. CODE ANN. § 27.01 (Vernon 2002).

184. *Herrman Holdings Ltd.*, 302 F.3d at 564-66. The court similarly dismissed the present promise allegation under the Texas Stock Fraud Act as waived.

185. *Id.* at 564-65; see FED. R. CIV. P. 9(b).

186. See *supra* note 64 and accompanying text; see also *Schultes v. Wood*, 47 F.3d 1427, 1430 (5th Cir. 1995) (describing the particularity of Rule 9(b) as an exception to notice pleading); Robert L. Markus, *The Revival of Fact Pleading Under the Federal Rules of Civil Procedure*, 86 COLUM. L. REV. 433, 447-51 (1986) (asserting that lower courts most often insist on fact pleading in securities fraud, civil rights, and conspiracy cases).

187. *Herrman Holdings Ltd.*, 302 F.3d at 565 (citing *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 412 (5th Cir. 2001) (securities fraud case under rule 10b-5, 17 C.F.R. § 240.10b-5 (2002))).

188. *Id.* (citing *Lovelace v. Software Spectrum Inc.*, 78 F.3d 1015, 1018 (5th Cir. 1996) (securities case under rule 10b-5, 17 C.F.R. § 240.10b-5 (2002))).

189. *Id.* at 565.

190. *Id.* at 566.

191. *Id.*

192. *Id.* at 567.

193. *Tex. True Choice, Inc. v. Aetna, Inc.*, 2002 WL 1268038 (N.D. Tex. 2002).

supplied by the seller's prior seller.¹⁹⁴ These financials reflected grossly overstated account receivables and income from operational fees, and hid a substantial contingent liability owed to customers relating to those overpayments.¹⁹⁵ The issue of whether the court could hold liable under the Texas Stock Fraud Act a prior seller who was not a party to the sale, who did not participate in the sale negotiations, and who did not directly prepare and disseminate the financial information, arose in the context of a removal action from state court.¹⁹⁶ To defeat the allegation of fraudulent joinder (the prior seller resided in the same state as the buyer), the buyer provided the deposition of its former vice-president, stating that negotiators of the company bought and the seller had told him the information came from the prior seller and how the information was incorrect.¹⁹⁷ The petition alleged that the prior seller knew that the current seller would supply this information to a buyer who would rely on it.¹⁹⁸ Since the elements of the fraud under the Texas Stock Fraud Act¹⁹⁹ require a material misrepresentation that is false (the Texas common law interprets this to include either "known to be false when made" or "asserted without knowledge of its truth"), that is intended to be acted upon, that is relied upon, and that causes injury, the court determined it was possible to establish a state cause of action against the prior seller.²⁰⁰ This situation defeated a fraudulent joinder.²⁰¹

The procedural decisions all involved the Texas Stock Fraud Act.²⁰² *Merchandise Center, Inc. v. WNS, Inc.*,²⁰³ dealt with an unusual method of acquiring a company.²⁰⁴ The purchaser formed one corporation to purchase the company's assets, and another to purchase its stock.²⁰⁵ The company's financial condition turned out not to be as believed by the buyers.²⁰⁶ The lower court wrongfully dismissed the action of the asset

194. *Tex. True Choice*, 2002 WL 1268038, at *1.

195. *Id.* at *2.

196. *Id.*

197. *Id.* at *3.

198. *Id.*

199. TEX. BUS. & COM. CODE ANN. § 27.01 (Vernon 2002).

200. *Texas True Choice*, 2002 WL 1268038 at *3 (citing *Trinity Indus., Inc. v. Ashland, Inc.*, 53 S.W.3d 852, 867 (Tex. App.—Austin 2001, pet. denied) (non-securities seller fraud); *Formosa Plastics Corp. USA v. Presidio Eng'rs & Contractors, Inc.*, 960 S.W.2d 41, 47 (Tex. 1998) (common law non-securities owner fraud); *Sears, Roebuck & Co. v. Meadows*, 877 S.W.2d 281, 282 (Tex. 1994) (non-securities employer fraud)). The cited cases did not deal with third-party fraud.

201. *Texas True Choice*, 2002 WL 1268038, at *3. The alternative of aider and abettor liability under TEX. REV. CIV. STAT. ANN. art. 581-33F (Vernon Supp. 2002) would have required additional proof of scienter. *See, e.g.*, *Frank v. Bear, Stearns & Co.*, 11 S.W.3d 380 (Tex. App.—Houston [14th] 2002, pet. denied) (cause of action for aider and abettor liability consists of (1) a violation by the primary person, (2) aider's general awareness of its role in the violation, (3) aider rendered substantial assistance in the violation, and (4) aider either intended to deceive the investor or acted with reckless disregard for the truth of the representation made by the primary person).

202. TEX. BUS. & COM. CODE ANN. § 27.01 (Vernon 2002).

203. *Merch. Ctr., Inc. v. WNS, Inc.*, 85 S.W.3d 389 (Tex. App.—Texarkana 2002, pet.).

204. *Id.*

205. *Id.* at 391-92.

206. *Id.* at 391.

buyer under the Texas Securities Act and Texas Stock Fraud Act without the opportunity to amend to state a cause of action.²⁰⁷ But the no evidence summary judgment granted against the stock buyer under the Texas Securities Act and Texas Stock Fraud Act was proper due to the absence of evidence.²⁰⁸ *Restaurant Teams International, Inc. v. MG Securities Corporation*²⁰⁹ dealt with another no evidence summary judgment properly granted against a Texas Stock Fraud Act action for a stock transaction even though discovery was yet to be completed.²¹⁰ *Elbaor, MD PA v. Tripath Imaging, Inc.*²¹¹ involved a claim under the Texas Deceptive Trade Practices Act²¹² and the Texas Stock Fraud Act²¹³ against an individual hired to invest trust moneys. The trust money was placed with a company, whose president later assured the investor that the investment was sound.²¹⁴ To defeat a removal action, the investor sought a dismissal without prejudice.²¹⁵ The court erroneously granted dismissal with prejudice.²¹⁶ The Fifth Circuit remanded the case to apply reasonable conditions on the dismissal to protect the defendants against prejudice, from such things as differing statutes of limitation.²¹⁷

B. ARBITRATIONS UNDER THE TEXAS ACTS

Securities fraud is also a method for investors to reach their own brokers; however, these actions usually are subject to arbitration.²¹⁸ There were several arbitrations against brokers conducted by the NASD involving the Texas securities acts. Arbiters seldom explain their decisions as

207. *Id.* at 394.

208. *Merch. Cir., Inc.*, 85 S.W.3d at 396.

209. *Rest. Teams Int'l, Inc. v. MG Secs. Corp.*, No. 05-01-00898-CV, 2002 WL 1315913 (Tex. App.—Dallas 2002, no pet.).

210. *Id.* at *1.

211. *Elbaor, MD PA v. Tripath Imaging, Inc.*, 279 F.3d 314 (5th Cir. 2002).

212. TEX. BUS. & COM. CODE § 17.41 (Vernon 2002); *see supra* notes 15-16 and accompanying text for the availability of the Texas Deceptive Trade Practices Act in a securities fraud action.

213. TEX. BUS. & COM. CODE § 27.01 (2002).

214. *Elbaor*, 279 F.3d at 315.

215. *Id.* at 316.

216. *Id.* at 320.

217. *Id.*

218. Brokerage agreements commonly provide for arbitration of all disputes between broker and customer. Since securities transactions are “transactions involving commerce,” the Federal Arbitration Act, 9 U.S.C. § 1 (1999), governs, not the Texas Arbitration Act, TEX. CIV. PRAC. & REM. CODE ANN. § 171.001 (Vernon Supp. 2002). *See, e.g., In re Mony Securities Corp.*, 83 S.W.3d 279, 282 (Tex. App.—Corpus Christi 2002, no pet.). Since 1989 the Supreme Court has permitted arbitration of securities fraud actions under the federal act. *See, e.g., Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 484 (1989) (reversing *Wilko v. Swann*, 346 U.S. 427 (1953), for claims under the Securities Act of 1933); *Shearson/American Express v. McMahon*, 482 U.S. 220 (1987) (reversing *Wilko v. Swann*, 346 U.S. 427 (1953), ban of securities arbitration for claims under the Exchange Act of 1934).

do appellate courts²¹⁹ and need not follow the rules of law.²²⁰ Yet, some trends are ascertainable.

Most of the arbitrations involved investment advice that led to a serious decline in value, typically \$100,000,²²¹ an amount that makes the effort worthwhile. Since the cases dealt with investment advice, the investor generally also included violation of the Texas Deceptive Trade Practices Act.²²² The defense of the broker generally was a version of the claim that the investor had consented to the trades.²²³ The brokers won four of the five arbitrations.²²⁴

219. See, e.g., *Wilko v. Swan*, 346 U.S. 427, 435-37 (1953) (arbiters are not required to explain their reasons); *O.R. Sec., Inc. v. Prof'l Planning Assoc., Inc.*, 857 F.2d 742, 747 (11th Cir. 1988) (same for securities arbitration).

220. See, e.g., *Wilko*, 346 U.S. at 435-37 (arbiters are reversed only for manifest disregard of the law); *Miller v. Prudential Bache Sec., Inc.*, 884 F.2d 128, 130 (4th Cir. 1989) (for securities arbitration to reverse the arbiters it is not enough to show they misinterpreted the law or misapplied the law).

221. See *Rhoden v. Ameri-First Sec. Corp.*, No. 01-02707, 2002 WL 1944451, at *1 (NASD arb. July 10, 2002) (co-worker at securities firm traded claimant's account without permission, purchased risky penny stock without disclosing the risk and large volumes of the employer stock without disclosing any conflict of interest; claimant awarded \$236,714 as compensatory damages, \$25,000 legal fees, \$49,243 pre-judgment interest, \$3000 witness fees, and \$85,000 intentional infliction of emotional distress for sexual harassment); *Strickland v. A.G. Edwards & Sons, Inc.*, No. 00-00864, 2002 WL 497269 (NASD arb. Feb. 8, 2002) (claimant sought \$95,000 for an improperly handled IRA where the broker convinced him to sell his large capitalized stock portfolio to buy lower quality stock contrary to his primary investment objective of income and growth); *Smith v. Merrill Lynch Pierce Fenner & Smith, Inc.*, No. 00-05667, 2002 WL 31058217 (NASD arb. Aug. 15, 2002) (claimant sought \$95,000 for the purchase of a "single premium life policy" when she had specifically asked not to be invested in life insurance); *Green v. A.G. Edwards & Sons, Inc.*, No. 01-01836, 2002 WL 1948222 (NASD arb. Aug. 5, 2002) (claimant sought \$90,000 for the purchase and sale of common stock); *Burden v. Flexvest Securities Group, Inc.*, No. 01-05546, 2002 WL 1948254 (NASD arb. July 29, 2002) (claimant sought \$422,000 for unsuitable investment advice for investments in technology stocks and a limited partnership; awarded her \$164,000 against the investment advisor and \$54,000 against the brokerage as compensatory damages, and \$20,000 attorney's fees.); *Burnett v. Painewebber, Inc.*, No. 00-01593, 2001 WL 34028766 (NASD arb. Feb. 4, 2002) (claimant sought \$83,000 for violations of NASD rule 2310 and NYSE Rule 405 for transactions with respect to a rollover IRA).

222. See *Rhoden*, 2002 WL 1944451, at *3 (violations of the Texas securities laws and the Texas Deceptive Trade Practices Act); *Smith*, 2002 WL 31058217, at *1 (under the Texas Deceptive Trade Practices Act); *Green*, 2002 WL 1948222, at *1 (under the Texas Securities Act and the Texas Deceptive Trade Practices Act); *Burden*, 2002 WL 1948254, at *1 (under the Texas Deceptive Trade Practices Act); but see *Strickland*, 2002 WL 497269, at *1 (under the Texas Securities Act); *Burnett*, 2001 WL 34028766, at *1 (under the Texas securities laws).

223. See *Rhoden*, 2002 WL 1944451, at *2 (defense of investor awareness of the trades since she worked there, and knew of the risks in one company since she dated the president); *Strickland*, 2002 WL 497269, at *1 (defense of failure to notify the brokerage company after receipt of written confirmations and account statements); *Smith*, 2002 WL 31058217, at *1 (defense of consent and ratification of the investment, and claimant's control of the investment decisions); *Green*, 2002 WL 1948222, at *1 (defense was ratification, estoppel, assumption of the risk, and a provision in the client agreement); *Burden*, 2002 WL 1948254, at *1 (defense of assumption of the risk, failure to mitigate, ratification of the trades, awareness of the risks, and market forces caused the losses); *Burnett*, 2001 WL 34028766, at *1 (defense of no causal connection with any act of defendants, ratification, waiver, estoppel, and proper supervision).

224. See *Strickland*, 2002 WL 497269, at *2 (settlement dismissed the claim and expunged the claim from the broker's record); *Smith*, 2002 WL 31058217, at *2 (arbiters

C. COURT DECISIONS UNDER THE FEDERAL ACTS

The fraud provisions of the Texas Securities Act are modeled on the federal statutes.²²⁵ As a result, Texas courts interpreting the Texas Securities Act frequently look to the federal decisions. During the Survey period, the Fifth Circuit decided two cases concerning securities fraud, both involving the Private Securities Litigation Reform Act of 1995 (PSLRA).²²⁶ Congress designed the PSLRA to create procedural hurdles to weed out frivolous class action lawsuits against established companies for extortion purposes.²²⁷ As a result, these cases dealt with fact pleading matters irrelevant to Texas law.²²⁸ They do, however, indicate what is necessary to successfully prove fraud, which Texas courts use as a guide.²²⁹

In *Abrams v. Baker Hughes, Inc.*,²³⁰ investors in a class action suffered a summary judgment against them in a suit for misleading statements regarding a stock price collapse.²³¹ Under the PSLRA, the investors need to allege particular facts that give rise to a strong inference that the defendant acted with the required state of mind.²³² The issue in *Abrams* was whether the investors had sufficiently alleged scienter.²³³ The investors alleged that the company's press releases and SEC filings contained false and misleading information regarding the adequacy of the company's internal accounting controls, the company's fiscal discipline, and the company's financial condition.²³⁴ The Fifth Circuit recognized that severe recklessness, namely "highly unreasonable omissions or misrepresentations that involve not merely simple or even inexcusable negligence, but an extreme departure from the standard of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it," can establish scienter.²³⁵ The investors submitted three sets of allegations from which one could infer scienter. First, top-level executives claimed the company had no accounting issues when two top financial

dismissed the claim); *Green*, 2002 WL 1948222, at *2 (arbiters dismissed the claim); *Burnett*, 2001 WL 34028766, at *2 (arbiters dismissed the claims and expunged the broker's record); *but see Rhoden*, 2002 WL 1944451, at *3 (claimant awarded \$236,714 as compensatory damages, \$25,000 legal fees, \$49,243 pre-judgment interest, \$3000 witness fees, and \$85,000 intentional infliction of emotional distress for sexual harassment); *Burden*, 2002 WL 1948254, at *3 (awarded \$164,000 against the investment advisor and \$54,000 against the brokerage as compensatory damages, and \$20,000 attorney's fees).

225. See *supra*, notes 4-5 and accompanying text.

226. 15 U.S.C. § 78u-4(b)(2) (1997).

227. See Sen. R. No. 98, 104th Cong., 1st Sess., 4 (strike lawsuits) & 14-15 (stay discovery until investors satisfy stringent pleading requirements).

228. See *supra* note 64 and accompanying text.

229. See, e.g., *supra* notes 4-5 and accompanying text.

230. *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424 (5th Cir. 2002).

231. *Abrams*, 292 F.3d at 427.

232. *Id.* at 430; see 15 U.S.C. § 78u-4(b)(2).

233. *Abrams*, 292 F.3d at 429.

234. *Id.* at 427.

235. *Id.* at 430 (citing *Nathenson v. Zonagen, Inc.*, 267 F.3d 400 (5th Cir. 2001)).

officers resigned.²³⁶ Yet, they received unidentified daily financial reports that apprised them of the company's true financial status.²³⁷ The executives instituted a new accounting system indicating that they knew the company lacked internal controls.²³⁸ They violated GAAP rules.²³⁹ The Fifth Circuit stated investors cannot base scienter on status alone.²⁴⁰ Likewise, allegations of non-specific reports without authors, recipients, and information contrary to the report are insufficient.²⁴¹ Similarly, violating GAAP is not enough without the knowledge they were publishing materially false information.²⁴² Second, the perpetrators were motivated by the need to raise capital, the desire for enhanced incentive compensation, and the desire to sell stock at inflated prices. The Fifth Circuit deemed these allegations insufficient to show scienter without an allegation that the perpetrators profited from the inflated stock values.²⁴³ Third, one perpetrator exercised twenty percent of his options and sold the stock.²⁴⁴ The Fifth Circuit rejected this allegation since there was no evidence that this was out of line with prior trading practices.²⁴⁵ Moreover, action by one perpetrator does not give rise to the inference of scienter in the other perpetrators.²⁴⁶

In *ABC Arbitrage Plaintiffs Group v. Tchuruk*,²⁴⁷ the court dealt with a class action involving failures to disclose by a foreign company propping up its stock price to avoid compromising a stock-for-stock acquisition of a Texas company.²⁴⁸ The summary judgment against the investors depends on whether the investors have sufficiently plead a fraud claim under rule 10b-5, in particular (1) the misstatement under the PSLRA, which requires specification of the statement, why it is misleading, and if based on belief the facts on which the belief is based, and (2) materiality.²⁴⁹ The PSLRA requires that for securities fraud, "who," "what," "where," "when," and "how" must be properly alleged *before* access to the discovery process is granted.²⁵⁰ The "who," "what," "where," and "when" are relatively simple to allege—one need only find documentation of the misstatement.²⁵¹ The misstatements in the case numbered four: (1) the

236. *Id.* at 431.

237. *Id.*

238. *Id.* at 432.

239. *Id.*

240. *Id.* (citing *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 539 (3d Cir. 1999)).

241. *Id.* (citing *Janas v. McCracken*, 183 F.3d 970, 985 (9th Cir. 1999)).

242. *Id.* (citing *Fine v. American Solar King Corp.*, 919 F.2d 290 (5th Cir. 1990)). The author took *American Solar King Corp.* public in 1983.

243. *Abrams*, 292 F.3d at 434 (citing *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1068 (5th Cir. 1994)).

244. *Id.* at 435.

245. *Id.* (citing *Janas v. McCracken*, 183 F.3d 970, 987 (9th Cir. 1999)).

246. *Id.* (citing *San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos.*, 75 F.3d 801, 814 (2d Cir. 1996)).

247. *ABC Arbitrage Plaintiffs Group v. Tchuruk*, 291 F.3d 336 (5th Cir. 2002).

248. *Id.* at 340.

249. *Id.* at 348, 359; *see* 15 U.S.C. § 78u-4(b)(1) (2002).

250. *Tchuruk*, 291 F.3d at 349.

251. *Id.* at 347.

CEO's statements that earnings would grow by ten percent, (2) the annual report's statement that the company had sufficient reserves to meet the Asian financial crisis, (3) a press release that the company would continue to have double-digit growth, and (4) a certification in the merger that the company had not experienced, and was not likely to experience, a material adverse affect.²⁵² Alleging "how" these statements are false is more difficult. The investors claimed these statements were misleading because they did not disclose that: (1) a subsidiary was experiencing significant losses, (2) the company had overstated its prior year's financial results, (3) the company had lost major contracts, and (4) the company's earnings were negatively impacted by these developments.²⁵³ The PLSRA requires that the "how" consist of personal knowledge of the investor, or by information and belief supported by all the facts.²⁵⁴ The first issue, of first impression for the Fifth Circuit, was whether specifying *all* the facts upon which the investor based the belief under the PSLRA meant that the investor also had to disclose confidential sources within the company.²⁵⁵ The Fifth Circuit decided to follow the Second Circuit and held that investors need not name confidential sources as long as they plead other facts to support their beliefs and those other facts provided an adequate basis for the belief.²⁵⁶ The second issue for the Fifth Circuit was what information an investor must disclose when the "facts" consist of internal company documents.²⁵⁷ The Fifth Circuit again followed the Second Circuit and required the investor to disclose who prepared the report, when the report was prepared, how firm the numbers were, and which company officers reviewed them.²⁵⁸ Under this standard, the "how" allegations based on an internal newsletter with the date and name of author, on monthly management reports with identification as prepared monthly by each subsidiary's controller's office and transmitted to the CEO, and on a conversation between a high ranking subsidiary official and the executive of the same subsidiary satisfied the PSLRA requirement.²⁵⁹ "How" allegations based on references to regular reports without identification of who prepared them or how frequently they were prepared did not satisfy the PSLRA requirement.²⁶⁰ Consequently, only the first two "how" allegations, concerning the subsidiary's losses and the financial impact on the parent, survived.²⁶¹ Courts ordinarily leave materiality to the jury as a mixed question of law and fact. However, a court

252. *Id.*

253. *Id.*

254. *Id.* at 351 (citing 5 CHARLES ALAN WRIGHT & ARTHUR R. MILLER, *FEDERAL PRACTICE & PROCEDURE* § 1224 at 205-06 (2d ed. 1990)).

255. *Id.* at 350-51.

256. *Id.* at 352-53 (citing *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000), *cert. denied*, 531 U.S. 1012 (2000)).

257. *Id.* at 355.

258. *Id.* (citing *In re Scholastic Corp. Securities Litigation*, 252 F.3d 63 (2d Cir. 2001), *cert. denied sub. nom.*, *Scholastic Corp. v. Truncellito*, 122 S. Ct. 678 (2001)).

259. *Id.* at 357-58.

260. *Id.* at 358.

261. *Id.* at 359-60.

can determine immateriality as a matter of law.²⁶² The Fifth Circuit followed its prior conclusion that subsidiary financial skullduggery is insufficient to materially affect a parent's financial statements on a consolidated basis.²⁶³ Even using the market price drop as a measure of materiality, the disclosure that caused the price drop did not include the subsidiary's financial problems.²⁶⁴ Materiality disposed of the case, so the court did not need to address scienter.²⁶⁵

D. FEDERAL EFFORTS TO CURTAIL SECURITIES FRAUD

The Sarbanes-Oxley Act increased the existing statute of limitations under the federal securities laws for a private cause of action involving a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws from one year after discovery but no more than three years, to two years after discovery but no more than five years.²⁶⁶

The Sarbanes-Oxley Act added several provisions concerning penalties for fraud. Most importantly, the act created a new securities fraud provision, not in the securities laws, but in the criminal laws. Those who knowingly execute, or attempt to execute, a scheme or artifice to defraud any person in connection with any security of a reporting company, or obtain by means of false fraudulent representations any property in connection with the purchase or sale of a security of a reporting company shall be fined or imprisoned for not more than twenty-five years.²⁶⁷ This provision equates committing the offense with attempting to commit the offense. Since the provision is analogous to Rule 10b-5 of the Exchange Act²⁶⁸ for which courts have long recognized a private right of action, and since this new criminal provision lacks the private cause of action bar of other portions of the Sarbanes-Oxley Act,²⁶⁹ courts should recognize a private cause of action for these attempted offenses. Since recklessness suffices for scienter under Rule 10b-5,²⁷⁰ it is likely that courts will similarly find that recklessness satisfies the scienter required by the term "knowingly." Due to the different language used in Rule 10b-5, courts will also struggle with whether any fraud relating to an issuer constitutes "in connection with" a security and whether it covers broader conduct than Rule 10b-5.

Similarly, the Act elevated attempts and conspiracies with respect to certain white collar crimes to the same level as committing the offense.²⁷¹

262. *Id.* at 359.

263. *Id.* at 360 (citing *Shushany v. Allwaste, Inc.*, 992 F.2d 517 (5th Cir. 1993)).

264. *Id.* at 361.

265. *Id.* at 362.

266. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. §§ 745, 801, 804 (2002).

267. *Id.* § 807 (adding 18 U.S.C. § 1348).

268. 17 C.F.R. § 240.10b-5 (2002).

269. *See supra* note 146 and accompanying text.

270. *See, e.g.*, *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 430 (5th Cir. 2002).

271. Sarbanes-Oxley Act of 2002, § 902 (adding 18 U.S.C. § 1349 (2002)).

The Act also increased criminal penalties for mail and wire fraud from five years to twenty years,²⁷² and increased the Exchange Act criminal penalty to \$5 million (\$25 million for other than natural persons) or twenty years or both.²⁷³

272. *Id.* § 903 (amending 18 U.S.C. §§ 1341, 1343 (1997)).

273. *Id.* § 1106 (amending Exchange Act § 32, 15 U.S.C. § 78ff). The previous penalty was \$1 million (\$2.5 million for other than natural persons) or 10 years or both. 15 U.S.C. § 78ff (2000).

