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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. Although this article includes Fifth Circuit cases under federal law,<sup>1</sup> the author has attempted to limit the material to that involving state law, and only briefly touches federal securities law. The author does not intend this article to be an exhaustive survey of securities regulation, but rather an update regarding developments of interest to the Texas based securities practitioner.

## I. COVERAGE OF THE SECURITY ACTS

The definitions, especially those relating to the issues of what transactions constitute a security and what persons are liable, determine the scope of the securities acts. With respect to what transactions constitute a security, the 78th Texas Legislature removed any requirement for a written document while the courts determined that an investment in a commodity for a commodity exchange constituted an "investment contract," included within the definition of "security." With respect to persons liable, the inability to recover from some judgment-proof fraud perpetrators led to a profusion of cases dealing with various vicarious liability schemes under the securities laws. This included aider and abettor liability and control person liability under the Texas Securities Act, third party awareness liability under the Texas Stock Fraud Act, primary liability of a sec-

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1. In the past, two law reviews included securities law in their surveys of Fifth Circuit decisions. These law reviews have since discontinued these inclusions. For the last such inclusions, see Frank E. Massengale & Marie Breaux Stroud, *Fifth Circuit Symposium: Federal Securities Law*, 36 LOY. L. REV. 821 (1990) (noting dearth of notable opinions); Dan R. Waller & Wayne M. Secore, *Fifth Circuit Survey: Securities Law*, 24 TEXAS TECH. L. REV. 741 (1993) (finding only one significant opinion).

These surveys ceased because of a belief in the lack of worthwhile opinions. See, e.g., Jayne Zanglein & Alison Myhra, *Survey Article: Securities Law*, 23 TEXAS TECH. L. REV. 377 (1992) (commenting on the lack of significant advances). When reading appellate opinions one receives a feeling that the appellate judges think that the losing litigant hired an incompetent lawyer for having raised the issues that the lawyer did or that the litigant's lawyer raised spurious issues to obtain more in legal fees. A survey such as the current one, which examines more than just one jurisdiction's appellate opinions, provides a feeling that many judges, not necessarily the majority, think lawmakers should change certain laws.

ondary party under federal law and third party beneficiary liability under the common law and the Texas Deceptive Trade Practices Act.

### A. THE SECURITY DEFINITION

Based on the recommendation of the State Securities Board and the Attorney General's Office,<sup>2</sup> the Texas Legislature amended the definition of security to insure that the term "security" applies regardless of whether evidenced by a written instrument.<sup>3</sup> This change reflects the long criminal litigation over whether an "evidence of indebtedness," included within the definition of "security," requires a written document.<sup>4</sup> The State lost. This amendment will ensure the State does not lose again for this reason.

For securities lawyers it is axiomatic that the sale of an asset coupled with an exclusive management contract constitutes a security as an investment contract. An attorney for a criminal facing eighteen years in prison and a \$10,000 fine, however, felt obligated to challenge this axiom. In *Caldwell v. State*,<sup>5</sup> a promoter encouraged investors to join an investment club for a \$300 annual fee and contribute money to the club for periods of up to twenty-eight months. The club would invest a minimum of \$25,000 in an international "American rice for African diamonds" exchange, run through the promoter's off-shore company, that would return 100 to 300 percent. This Ponzi scheme ran over nine years by paying the early investors with investment monies paid by later investors, while diverting \$2.4 million into the promoter's Houston bank accounts. The scheme collapsed when the ability to recruit new investors declined, causing substantial losses to the later investors. The district attorney obtained a criminal conviction for selling a security, namely an investment contract, in violation of the Texas Securities Act. Since the Texas Securities Act uses an almost identical definition of "security" as the federal acts,<sup>6</sup> the court applied the federal *Howey*<sup>7</sup> definition of an investment contract. The appeal urged that the evidence did not support the *Howey* requirement that profits be derived "solely from the efforts of others," since the investors had certain powers within the team and because the investors' funds pur-

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2. See HOUSE COMM. ON PENSIONS & INVESTMENTS, BILL ANALYSIS, TEX. S.B. 1060, 78th Leg., R.S. (2003).

3. See Act of May 20, 2003, 78th Leg., R.S., ch. 108, § 1, 2003 Tex. Gen. Laws 147, § 1 (amending TEX. REV. CIV. STAT. ANN. art. 581-4A (Vernon Supp. 2003)).

4. See *Thomas v. State*, 65 S.W.3d 38 (Tex. Crim. App. 2001) (determining the act requires a writing), *aff'g* 3 S.W.3d 89 (Tex. App.—Dallas 1999), *remanded from* 919 S.W.2d 427 (Tex. Crim. App. 1996) (remanded to consider whether the Texas Securities Act requires a writing), *rev'g* No. 05-92-01844, 1994 WL 605946 (Tex. App.—Dallas); see also George Lee Flint, Jr., *Securities Regulation*, 56 SMU L. REV. 1995, 2000-01 (discussing the case).

5. *Caldwell v. State*, 95 S.W.3d 563 (Tex. App.—Houston [1st Dist.] 2002, no pet.).

6. Compare TEX. REV. CIV. STAT. ANN. art. 581-4(A) (Vernon Supp. 2003), with 15 U.S.C. § 77(b)(1) (1997), and 15 U.S.C. § 78(b)(10) (1997).

7. See *Sec. & Exch. Comm'n v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946). The cause of action's four elements are (1) an investment of money; (2) in a common enterprise; (3) with an expectation of profits; and (4) that comes solely from the efforts of others.

chased commodities. With respect to the first point, the promoter's management contract only allowed the investors to conduct meetings, elect leaders, perform tax planning, and pool new monies for investment, while all contractual power to invest, sell, buy, arrange meetings, set goals, select advisors, make deposits, disburse funds, and do all things necessary to manage the affairs of the team laid with the promoter. Testimony of the investors confirmed that the promoter made all investment decisions, while the team required investors to do nothing other than invest money, and many investors did not meet or correspond with other members. The Texas Supreme Court has determined that such a passive investor role satisfies the *Howey* requirement.<sup>8</sup> A court in Texas does not construe "solely" literally. With respect to the second point, the item purchased or not purchased by the enterprise is irrelevant. What matters is the promoter's control over the enterprise. The Fifth Circuit has so held for commodities accounts,<sup>9</sup> and other federal circuits for Ponzi schemes.<sup>10</sup>

## B. PERSONS LIABLE

The ease of becoming judgment proof in Texas with liberal exemptions from execution of judgment makes secondary liability very important. The Texas statutes provide for four such vicarious liability theories: aiding and abetting, control person liability, third party actual awareness liability, and third party beneficiary liability. Federal law adds primary liability for some secondary parties.

### 1. *Aiding and Abetting*

An important method of finding vicarious liability under the securities laws is through the concept of aiding and abetting. In light of the fact that the federal securities law does not allow a private investor to recover against aiders and abettors,<sup>11</sup> aiding and abetting will become a significant aspect of state securities law. This Survey period had two aiding and abetting cases. One of the crucial ideas behind the basic anti-fraud provision of the Texas Securities Act is to shift the burden of proof for the scienter element of the common law fraud cause of action, making it easier for the investor to recover. The investor need not prove scienter, but the seller has a due diligence defense.<sup>12</sup> The Texas Securities Act, however, does not make this shift in burden for aiding and abetting liability. Both courts investigated what scienter is required for aiding and abetting liability.

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8. *Caldwell*, 95 S.W.3d at 568 (citing *Sears v. Commercial Trading Corp.*, 560 S.W.2d 637, 641 (Tex. 1977)).

9. *Id.* (citing *Long v. Shultz Cattle Co.*, 881 F.2d 129, 138 n.8 (5th Cir. 1989); *Sec. & Exch. Comm'n v. Cont'l Commodities Corp.*, 497 F.2d 516, 522 (5th Cir. 1974)).

10. *Id.* at 565-68.

11. See *infra* note 37 and accompanying text.

12. See TEX. REV. CIV. STAT. ANN. art. 581-33A(2) (Vernon Supp. 2003).

In *Sterling Trust Co. v. Adderly*,<sup>13</sup> an investment advisor and broker operated an illegal Ponzi scheme by convincing elderly investors to invest their retirement savings in companies owned by the investment advisor. To hold the qualified funds required a third-party trustee that specialized in holding nonstandard and unregulated securities. The third-party trustee approved the investments, despite knowing that the investment advisor was on both sides of the investment, and the investment advisor was segregating retirement monies (a classic warning of a Ponzi scheme). Moreover, he failed to follow its own safeguards by taking unauthorized instructions from the investment advisor, failing to obtain the original securities documents, allowing the investment advisor to hold the original securities documents, failing to obtain valuations of the securities, and accepting investments in known defaulted notes. After the Federal Securities and Exchange Commission (SEC) shut down the Ponzi scheme, rendering the investors' investments worthless, the investors sued the third-party trustee as an aider and abettor. The trial court found for the investors, awarding them \$6 million in actual damages and \$250,000 punitive damages for breach of fiduciary duty. On appeal the third-party trustee contented that aiding and abetting should have the same due diligence defense provided to a primary violator since the Texas Securities Act makes aiders and abettors liable to the same extent as sellers and since the aiding and abetting scienter should at least include a general awareness of the primary violation. The court noted that the elements of the two causes of action are different. The Texas Securities Act makes primary violators strictly liable, without any scienter, reliance or causation elements for the investor to prove, and consequently provides primary violators with the due diligence defense.<sup>14</sup> In contrast, the Texas Securities Act does not make aiders strictly liable, and investors must prove scienter for aider liability.<sup>15</sup> The "extent" language of the statute merely refers to the consequences of their liability. The court also determined that the language of the Texas Securities Act specifically contains no requirement that the aider be generally aware of the primary violation. The court noted that this result conflicts with two other Texas Courts of Appeal, but those courts based their opinions on federal law that differs significantly from the Texas Securities Act by not providing for a private cause of action for aiding and abetting and by providing for the general awareness language for aider liability pursued by the SEC.<sup>16</sup>

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13. *Sterling Trust Co. v. Adderly*, 119 S.W.3d 312 (Tex. App.—Fort Worth 2003, pet. filed).

14. *Id.* at 313. See *infra* notes 116-138 and accompanying text for the Texas Securities Act position on reliance and causation.

15. *Id.* at 317 (citing TEX. REV. CIV. STAT. ANN. art. 581-33 comment on § F(2) (Vernon Supp. 2003); Alan R. Bromberg, *Civil Liability Under Texas Securities Act § 33 (1977) and Related Claims*, 32 Sw. L.J. 867, 891 (1978)). Compare TEX. REV. CIV. STAT. ANN. art. 581-33A(2), B (Vernon Supp. 2003) (primary liability), with TEX. REV. CIV. STAT. ANN. art. 581-33F(2) (Vernon Supp. 2003) (aider and abettor liability).

16. *Sterling Trust Co.*, 119 S.W.3d at 319. For the two conflicting Texas Courts of Appeal cases see *Crescendo Inv., Inc. v. Brice*, 61 S.W.3d 465, 472 (Tex. App.—San Antonio

Although the trial court correctly found liability, the trial court awarded punitive damages erroneously. The punitive damages related to a non-securities cause of action, breach of fiduciary duty. Although the Texas Securities Act remedies are cumulative of other causes of action, the successful plaintiff must rely on a single theory for both actual and punitive damages. So the court reversed in part, affirmed in part.<sup>17</sup>

In *Goldstein v. Mortenson*<sup>18</sup> the defrauder, through his subsidiary companies, engaged in a Ponzi scheme to trade in the foreign currency markets. The subsidiary companies pooled client funds while the sole authority to make investment decisions remained with the defrauder. His trading resulted in serious losses that the subsidiary companies did not disclose on their client statements. The defrauder originally made the trades over the phone, but to prevent losses from rapidly fluctuating markets, the subsidiary companies contracted with a broker for brokerage services enabling real time trades. After the Texas State Securities Board (Board) began investigating to determine whether the subsidiary companies were selling unregistered securities, and when the difference between the client statements and the amount held by the broker became \$8.6 million, the subsidiary companies obtained a loan through the broker without making an application, submitting financial statements, or providing security. The Board lawsuit against the subsidiary companies forced them into receivership. The receiver brought an action against the broker and various middle persons and obtained a judgment against the loan arranger for aiding and abetting the defrauder, directly committing fraud, and conspiring to commit fraud with actual damages of \$36 million and a total judgment of \$264 million. The loan arranger challenged the aiding and abetting judgment contending there was insufficient evidence for an aiding and abetting finding, focusing on the general awareness element. The court blindly accepted that general awareness is the standard for liability, but found ample evidence of it in the record.<sup>19</sup> The court reasoned that the subsidiary companies' officials had told the loan arranger that the loan amount was to cover the difference between what the companies had and what they had told the investors they had. By then arranging the loan, the loan arranger provided substantial assistance, enabling the subsidiary companies to continue operations and hinder the Board's investigation. When given information of possible illegal activity

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2001, pet. denied); *Frank v. Bear, Stearns & Co.*, 11 S.W.3d 380, 384 (Tex. App.—Houston [14th Dist.] 2000, pet. denied) (citing Keith A. Rowley, *The Sky is Still Blue in Texas: State Law Alternatives to Federal Securities Remedies*, 50 BAYLOR L. REV. 99, 182 (1998) (citing *Abbott v. Equity Group, Inc.*, 2 F.3d 613, 621 (5th Cir. 1993))). For the federal law, see *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 177 (1994); 15 U.S.C.A. § 78j (1997); 17 C.F.R. § 240.10b-5 (2003).

17. *Sterling Trust Co.*, 119 S.W.3d at 312-25.

18. *Goldstein v. Mortenson*, 113 S.W.3d 769 (Tex. App.—Austin 2003, no pet.).

19. *Id.* at 776 (citing *Frank v. Bear, Stearns & Co.*, 11 S.W.3d 380, 384 (Tex. App.—Houston [14th Dist.] 2000, pet. denied); Keith Rowley, *The Sky is Still Blue in Texas: State Law Alternatives to Federal Securities Remedies*, 50 BAYLOR L. REV. 99, 182 (1998)). For a contrary view, see *supra* note 16 and accompanying text.

and failing to conduct a minimal investigation before, the loan arranger showed a reckless disregard for the truth. The judgment for direct fraud failed since the broker's employees, not the loan arranger, made the representations relied upon by the receiver. The loan arranger attacked the conspiracy judgment contending there was insufficient evidence for civil conspiracy, focusing on the meeting of the mind element.<sup>20</sup> The court found ample evidence of the meeting of the minds between the loan arranger and the defender. The object of the subsidiary companies was to keep the losses secret in an attempt to turn things around while avoiding investor panic. Documentation showed the loan arranger knew the subsidiary companies were not disclosing the losses to the investors, arranged for a loan in the same amount, was aware of both the Board's investigation and the defrauder's delay in responding to a subpoena. The court, however, reformed the judgment since the exemplary damages exceeded the statutory amount.<sup>21</sup>

## 2. Control Person Liability

Another method of obtaining vicarious liability for securities fraud is the liability of control persons. The Texas Securities Act provides joint and several liability for control persons, but does not define "control person."<sup>22</sup> The State Bar Comments to that liability section indicate federal law determines the meaning.<sup>23</sup> The Fifth Circuit determines control person liability under a two-pronged test: (1) exercise of control over operations of the primary violator in general and (2) the power to control the specific action on which the primary violation is based.<sup>24</sup> During the last Survey period, the Texarkana Court of Appeals added a third element of direct participation in the offending act by the control person.<sup>25</sup> During the present Survey period, the Dallas Court of Appeals adopted the Fifth Circuit's test, without the participation requirement, following the Houston Fourteenth District Court of Appeals.

In *Barnes v. SWS Financial Services, Inc.*,<sup>26</sup> a registered agent was licensed with two broker-dealers. One of the broker-dealers specialized in

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20. *Id.* at 770. "The elements of conspiracy are: (1) two or more persons; (2) an object to be accomplished; (3) a meeting of the minds on the object or course of action; (4) one or more unlawful, overt acts; and (5) damages as the proximate result." *Massey v. Armco Steel Co.*, 652 S.W.2d 932, 934 (Tex. 1983).

21. *Goldstein*, 113 S.W.3d at 769-80, 783 (holding that the ratio of exemplary to actual damages is not to exceed 2 to 1 of actual damages); TEX. CIV. PRAC. & REM. CODE § 41.008(b) (Vernon 2003).

22. See TEX. REV. CIV. STAT. ANN. art. 581-33F (Vernon Supp. 2003).

23. See TEX. REV. CIV. STAT. ANN. art. 581-33F cmt. (Vernon Supp. 2003); see also 15 U.S.C. § 78t(a) (1997); 15 U.S.C. § 77o (1997).

24. See, e.g., *Abbott v. Equity Group, Inc.*, 2 F.3d 613, 620 (5th Cir. 1993).

25. See *Tex. Capital Sec. Mgmt., Inc. v. Sandefer*, 80 S.W.3d 260, 268 (Tex. App.—Texarkana, 2003, pet. struck); see also *Flint*, *supra* note 4, at 1998 (discussing the case).

26. *Barnes v. SWS Fin. Servs., Inc.*, 97 S.W.3d 759, 763 (Tex. App.—Dallas, 2003, no pet.) (following and citing *Frank v. Bear, Stearns & Co.*, 11 S.W.3d 380, 384 (Tex. App.—Houston [14th Dist.] 2000, pet. denied)). The registered agent also was licensed with another broker-dealer that sold the investment accounts of the plaintiff investors to the defendant broker-dealer. Most of the offending transactions occurred before the sale.

church-related securities. Since the early 1990s this registered agent had sold interests in a purported interim church loan fund through the church-related broker-dealer and continued to do so after becoming a registered agent of the defendant broker-dealer. There was no interim church loan fund. The registered agent had deposited the investors' monies in his checking account and used them for personal expenses, defrauding the investors of \$1.7 million. The investors, unable to recover from the defalcating registered agent and the church-related broker-dealer, sued the defendant broker-dealer company under the Texas Securities Act. The broker-dealer obtained a summary judgment. The investors challenged the sufficiency of the evidence that the broker-dealer was not a control person with respect to the defalcating registered agent's fraudulent sales of the interim church loan fund. Following a Ninth Circuit example, the court determined that the power to control the specific action was absent because the registered agent did not use the broker-dealer's access to the markets, the broker-dealer had no knowledge of the complained-of transactions, the offending securities were unrelated to any securities offered by the broker-dealer, and the investors did not rely on the broker-dealer in deciding to invest.<sup>27</sup> This broker-dealer did not sell church securities, did not receive commissions with respect to the offending transactions, and did not include the offending transactions on its statements to the investors. The court affirmed the summary judgment in favor of the broker-dealer.<sup>28</sup>

### 3. *Third Party Actual Awareness Liability*

The Texas Stock Fraud Act also has a vicarious liability provision for a person who knows of another's misrepresentations and receives an economic benefit by keeping silent.<sup>29</sup> In *Glazener v. Jansing*,<sup>30</sup> co-owners of a day-trading company, not licensed as securities dealers, knew of, and allowed, the company's manager, a licensed securities dealer, to present himself and conduct business as the sole owner. The manager obtained loans of \$100,000 from the investor under the representation that the notes providing margin funds to day-traders were low risk, had a guaranteed return between nine and eighteen percent, and provided a twenty-five percent interest in the company. The investor recovered a judgment against the manager, then learned about the two co-owners and recovered an additional default judgment with punitive damages and attorney's fees. The co-owners challenged the judgment contending: (1) that mere awareness was insufficient scienter; (2) there was no allegation of "stock" as required by the Texas Stock Fraud Act; (3) the pleadings did not sup-

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27. *Id.* at 764-65 (citing *Hauser v. Furrell*, 14 F.3d 1338, 1341 (9th Cir. 1994), *rev'd on other grounds by Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994)).

28. *Id.* at 761-65.

29. TEX. BUS. & COM. CODE § 27.01(d) (Vernon 2002).

30. *Glazener v. Jansing*, No. 03-02-00796-CV, 2003 WL 22207226 (Tex. App.—Austin Sept. 25, 2003, no pet.) (memorandum opinion).



port a fraud finding; and (4) the Texas Stock Fraud Act does not provide for actual damages for those vicariously liable. The court disagreed finding that the petition alleged the co-owners not only were aware of the misrepresentations, but did not correct them, approved them, and made them their own. The court also found that, since the Texas Stock Fraud Act does not define "stock", the word "share" in the petition was sufficient.<sup>31</sup> The court also found that, although not all statements made by the manager were false, the allegation of the ownership misrepresentation, coupled with reliance and causation allegations, was sufficient to support the fraud. The court also noted that the liability for actual damages was for committing the fraud, and that vicarious liability persons were deemed to have committed the fraud by the Texas Stock Fraud Act.<sup>32</sup>

#### 4. *Third Party Beneficiary of a Service Contract*

The Texas Deceptive Trade Practices Act provides a remedy for consumers who purchase or lease goods or services resulting in damages caused by a false, misleading or deceptive act.<sup>33</sup> A group of investors, as third party beneficiaries of a contract with the issuer, attempted to hold a service provider to the issuer liable under this provision.

In *Great Plains Trust Co. v. Morgan Stanley Dean Witter & Co.*,<sup>34</sup> debenture holders tried to hold a securities firm liable for failing to conduct adequate due diligence in preparation of a fairness opinion with respect to a merger. In the merger, the debenture holders had opted not to take cash in redemption. So when the acquirer later announced inaccurate financial statements before the merger, the price of the debentures declined. The securities firm had a letter agreement with the target to provide the fairness opinion for the corporation, with restrictions not to disclose the opinion without the consent of the securities firm. The debenture holders based their claims on various common law tort theories as well as the Texas Deceptive Trade Practice Act,<sup>35</sup> all grounds sometimes used by security holders against their sellers in addition to the securities acts. These actions failed primarily due to the failure to allege facts showing that the securities firm undertook the engagement contract with the issuer with the intent to benefit the debenture holders.<sup>36</sup>

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31. *Id.* at \*4 (observing the one Texas Miscellaneous Business Corporation Act that uses the terms interchangeably, citing TEX. REV. CIV. STAT. ANN. art. 1302-1.02(A)(3), (6) (Vernon 2003)).

32. *Id.* at \*1-5.

33. TEX. BUS. & COM. CODE ANN. § 17.45 (Vernon Supp. 2003).

34. *Great Plains Trust Co. v. Morgan Stanley Dean Witter & Co.*, 313 F.3d 305 (5th Cir. 2002).

35. *Id.* at 314 (negligence, gross negligence, professional negligence); *id.* at 318 (negligent misrepresentation); *id.* at 320 (breach of fiduciary duty); *id.* at 321 (fraud); *id.* at 327 (deceptive trade practice).

36. *Id.* at 305-14, 316 (for negligence, gross negligence, professional negligence); *id.* at 319 (negligent misrepresentation); *id.* at 320 (to establish a fiduciary relationship); *id.* at 322 (reliance for fraud must be intended, more than foreseeable); *id.* at 327-28 (third party beneficiary of the contract).

### 5. *Primary Liability of a Secondary Party*

Although the Supreme Court has determined that a private action under Rule 10b-5 does not include aiding and abetting liability,<sup>37</sup> litigators have attempted to depict the act of aiding and abetting as one of primary liability. One federal district court in Texas faced such a challenge and decided to follow the SEC's proposed test rather than the circuits that use the "substantial participation" test or the circuit that follows the "bright line" test.

In *In re Enron Corp., Securities, Derivatives & ERISA Litigation*,<sup>38</sup> private litigants sought recovery for a significant decline in the market value of their common shares from the commercial and investment banks, an auditor, and two law firms that had caused the company to present materially misleading statements in its financial statements. While the court granted the motion to dismiss of one bank and one law firm, it denied the motions of the other secondary defendants. The district court noted that the Supreme Court had specifically left open the possibility that a secondary actor, such as a lawyer, accountant, or bank, might be liable as a primary violator, provided all the elements of the cause of action were present, including scienter and reliance.<sup>39</sup> The court also noted that the circuit courts have developed two tests for this liability. The "bright line" test of the Second Circuit requires not only a misrepresentation or omission by the secondary actor, but also an attribution to the specific actor at the time of dissemination and so the secondary party can avoid liability by insuring no attribution.<sup>40</sup> In contrast, the "substantial participation test" of the Ninth and Tenth Circuits finds liability in having a significant role in preparing a false statement actually uttered by another without the attribution, a test that fails to distinguish the liability from aiding and abetting.<sup>41</sup> On the basis of an amicus curiae brief filed by the SEC, the district court adopted a middle course, the secondary person becomes liable if the secondary person writes misrepresentations for inclusion in a document to be given to investors, even if the idea for the misrepresentation came from another.<sup>42</sup>

## II. ORGANIZATION OF THE REGULATORY BODY

The securities laws generally create a regulatory body to handle the registrations required by those laws, as well as serve an enforcement

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37. See *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 175-76 (1994); 17 C.F.R. § 240.10b-5 (2003).

38. *In re Enron Corp. Sec., Derivatives & ERISA Litig.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002).

39. *Id.* at 582 (citing *Cent. Bank of Denver*, 511 U.S. at 191).

40. *Id.* at 583 (citing *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998), *cert. denied*, 525 U.S. 1104 (1999)). A different district court in the Fifth Circuit has followed the "substantial participation" test. See *McNamara v. Bre-X Minerals Ltd.*, 57 F. Supp. 2d 396, 426 (E.D. Tex. 1999).

41. *Id.* at 584-85 (citing *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996), and *In re Software Toolworks, Inc.*, 50 F.3d 615, 628-29 (9th Cir. 1994)).

42. *Id.* at 586-90.

mechanism. The 78th Texas Legislature made two changes geared to reducing the cost to the State of Texas of operating the Board. In like fashion, the Board amended a rule to increase its revenues.

The Texas Legislature removed the requirement for surety bonds for state officers and employees.<sup>43</sup> Surety bonds provide some recovery for thieving state officials. Claimants seldom made claims under the bonds, so the immediately preceding legislature to save the cost of premiums removed the requirement unless required by the state constitution, federal law, regulation, or court order.<sup>44</sup> The current legislative change deletes confusing language in the statutes that formerly required state agencies to purchase surety bonds. The Texas Securities Act was one of those statutes.

The Texas Legislature changed the method of funding of the Board so that it would more closely mirror the funding of similar state agencies.<sup>45</sup> Direct appropriations from the General Revenue Fund funded the Board in the past.<sup>46</sup> Since current appropriations were not sufficient, the legislature amended the Texas Securities Act to allow the Board to fund itself through the filing fees it collects for various service areas, capped at \$100.<sup>47</sup> The service areas include an application, renewal or amendment of a securities registration, and an application or renewal of a dealer, investment advisor, or each of their agents, officers, or investment advisor representative. Those experienced in Blue Sky registrations know that for offerings in many states, some states rely on the Texas Board. They refuse to act on the registration in their state until after the offering has cleared Texas.<sup>48</sup> This action by foreign securities regulators shifts the cost of rejected offerings to Texas. This legislative amendment will reshift the cost to the companies seeking registration of their securities.

The Board changed its fees for certified copies from \$5 to \$10 to bring its fees in line with those of the Secretary of State.<sup>49</sup>

### III. REGISTRATION OF SECURITIES

The basic rule of most securities laws is that securities either need to be registered with the regulatory agency or fall within an exemption to regis-

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43. See Act of May 28, 2003, 78th Leg., R.S., ch. 285, § 31(48), 2003 Tex. Gen. Laws 1247 (repealing TEX. REV. CIV. STAT. ANN. art. 581-21).

44. See Act of May 21, 2001, 77th Leg., R.S., ch. 1017, 2001 Tex. Gen. Law 2226 (amending TEX. GOV'T CODE ANN. § 653 (Vernon 1994)); see also HOUSE COMM. ON STATE AFFAIRS, BILL ANALYSIS, TEX. H.B. 2376, 78th Leg., R.S. (2003) (eliminating surety requirements saves Board \$250,000 each biennium).

45. See Texas Senate Report, 78th Leg., H.B. 1840 (2003).

46. *Id.*

47. See 2003 Tex. Sess. Law Serv. Ch. 1077 (H.B. 1840) (amending TEX. REV. CIV. STAT. ANN. arts. 581-35, 581-35-1 & 581-35-2 (Vernon Supp. 2003)).

48. Personal experience of the author.

49. See 28 Tex. Reg. 2830 (2003), adopted 28 Tex. Reg. 5991 (codified at 7 TEX. ADMIN. CODE §§ 101.1, 101.5, 101.6). The amendment also made grammatical corrections to 7 TEX. ADMIN. CODE § 101.1, and changed the original reference to the General Services Commission to its successor, the Texas Building and Procurement Commission in 7 TEX. ADMIN. CODE §§ 101.5 & 101.6.

tration. The Board made several cosmetic changes to its securities registration rules to reflect current developments. Board enforcement actions against unregistered securities, mostly through emergency cease and desist orders to prevent the rapid spread of offers through the internet, focused on numerous offers of oil and gas interests as well as con-artist schemes using a securities setting.

The Board made several non-substantive changes to its registration rules. One batch of amendments reflect the Board's recent internal reorganization into one Registration Division, rather than two registrations divisions with one for securities and the other for dealers, and recognize registration for the investment advisors through a central depository.<sup>50</sup> The Board also conformed four rules to the recent statutory amendment removing the requirement to file a resolution with a consent to service of process.<sup>51</sup>

The Board had numerous enforcement actions against issuers who did not register their securities. Most of these offers and sales involved the internet, and hence prompted emergency cease and desist orders.<sup>52</sup> A considerable portion dealt with sale of oil and gas interests,<sup>53</sup> where some

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50. See 28 Tex. Reg. 2831 (2003), adopted 28 Tex. Reg. 5991 (amendments codified at 7 TEX. ADMIN. CODE §§ 104.1, 104.2, 104.4-104.6). The amendment also eliminated an outdated reference from 7 TEX. ADMIN. CODE § 104.1 and updated a statutory reference in 7 TEX. ADMIN. CODE § 104.2. For the recent requirement of investment advisor registration, see Flint, *supra* note 4, at 2011.

51. See 28 Tex. Reg. 2832 (2003), adopted 28 Tex. Reg. 5991 (2003) (amendment codified at 7 TEX. ADMIN. CODE § 113.4); see also 28 Tex. Reg. 2833 (2003), adopted 28 Tex. Reg. 5992 (2003) (amendment codified at 7 TEX. ADMIN. CODE §§ 114.3); see also 28 Tex. Reg. 2833 (2003), adopted 28 Tex. Reg. 5992 (2003) (repealing 7 TEX. ADMIN. CODE § 133.8, a rule concerning power of attorney); see also 28 Tex. Reg. 2848 (2003), adopted 28 Tex. Reg. 5992 (2003) (new rule codified at 7 TEX. ADMIN. CODE § 133.8); see also 28 Tex. Reg. 2834 (2003), adopted 28 Tex. Reg. 5992 (2003) (amendment eliminating uniform corporate resolution form codified at 7 TEX. ADMIN. CODE § 133.33).

52. See *infra* notes 53-58.

53. See *In re* Northstar Energy, Inc., No. 03-036, 2003 WL 22122986 (Tex. St. Sec. Bd. Sept. 2, 2003) (finding oil and gas company \$75,000 and ordering it to cease and desist after its unregistered agents sold unregistered working interests in its drilling programs); *In re* Chesnut Petroleum, Inc., No. 03-034, 2003 WL 22036389 (Tex. St. Sec. Bd. Aug. 18, 2003) (ordering unregistered corporation to cease and desist after it made an offering through mail for unregistered Louisiana oil and gas projects in units with fractional portions of working interest and revenues); see also *In re* Mid-Continent Oil & Gas, Inc., No. 03-008, 2003 WL 14441648 (Tex. St. Sec. Bd. Mar. 7, 2003) (issuing emergency cease and desist to company that failed to disclose Pennsylvania cease and desist order while it offered, through the internet, units in oil and gas interest and claimed that the investment was risk-free as it involved drilling in proven fields, the entire investment was tax deductible and 15 % of the return was tax free; made the offeree represent he was given no representations about tax matters); see also *In re* Diamond "S" Oil, LLC, No. 03-007, 2003 WL 576904 (Tex. St. Sec. Bd. Feb. 14, 2003) (ordering emergency cease and desist after non-existent limited liability company: (1) offered interests in drilling prospects in Mississippi and Texas over the internet; (2) later told the offeree that the language in the subscription agreement was just boiler-plate, and the \$250,000 net worth accreditation requirement set forth on the agreement was meaningless as the offer was private and not regulated; and (3) failed to disclose prior Pennsylvania cease and desist order); see also *In re* Hobbs Oil Co., No. 02-42, 2002 WL 31869359 (Tex. St. Sec. Bd. Dec. 18, 2002) (ordering emergency cease and desist order after respondents failed to disclose to forfeiture clause in the participation agreement to offeree).

operators either are unaware of the securities laws aspects of oil and gas interests, or felt that the penalty, usually refunding the investment of the complaining purchaser, was not a sufficient deterrent warranting registration. Several actions, however, dealt with significant non-disclosures. Another significant portion of the actions involved con-artist schemes in the securities setting, with chain letters, ridiculous returns promised, deposits to sell stock, and non-existent accounts.<sup>54</sup> Others involved botched attempts at exemptions from registration,<sup>55</sup> possible unawareness of security status,<sup>56</sup> non-disclosures of material informa-

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54. See *In re Global One Found. (G.O.F.-U.S.A.), Inc.*, No. 03-22, 2003 WL 21355949 (Tex. St. Sec. Bd. May 12, 2003) (granting an emergency cease and desist order after respondents offered a private placement deal to make European commercial paper transactions and securities available to a Minnesotan and requesting that he provide copies of his current bank statements and passport—a request that has prompted similar prosecutions of others by the Board and warnings from the SEC); see also *In re David L. Reid, Jr. (CashExchange)*, No. 3-020, 2003 WL 21027727 (Tex. St. Sec. Bd. May 1, 2003) (ordering an emergency cease and desist after individual offered an investment plan through an internet advertisement which promised that 500% returns were guaranteed for those who invested at least \$10 per week and claimed that scheme was legal since it involved a service of promotional advertisements resembling chain letters); see also *In re Ronald Yeasley (Blue Sky Inv. Strategies)*, No. 03-010, 2003 WL 1595249 (Tex. St. Sec. Bd. March 18, 2003) (issuing an emergency cease and desist order to individual who offered a stock trading program in a newspaper advertisement and guaranteed 100 % tax-free returns, through unincorporated corporation and non-existent accounts at brokerages); see also *In re Innovative Consulting Inc. aka Innovative consulting USA aka Innovative Consulting; Whitman & Assocs. and James Bradley*, No. 03-013, 2003 WL 1854652 (Tex. St. Sec. Bd. March 31, 2003) (London Company from Texas used internet ads to find foreign victims of a scheme to purchase stocks they hold at multiples of the FMV; (2) told the victims to send deposits for 25 % of the price; and (3) failed to disclose use of phony phone numbers, deceptive names of government agencies, and non-incorporation); see also *In re Omega Fin. Group*, No. 03-005, 2003 WL 394743 (Tex. St. Sec. Bd. Feb. 12, 2003) (offering, by fax and through the internet, an investment of \$650 that would return \$2350 every 30 days for fax shares prompts court to order an emergency cease and desist).

55. See *In re E. Coast Imaging of Fla., Inc.*, No. 03-017, 2003 WL 1950127 (Tex. St. Sec. Bd. Apr. 16, 2003) (issuing an emergency cease and desist to a Nevada corporation and Florida limited liability company that: (1) offered the purchase of shares in a body scanning company through cold calls, the internet, and private placement memorandum; (2) failed to disclose principal and permanent injunction of SEC; and (3) withheld cease and desist orders in South Dakota, Missouri, Pennsylvania, Wisconsin, and Iowa); see also *In re Southwest Earth Res., Inc.*, No. 02-45, 2002 WL 31926888 (Tex. St. Sec. Bd. Dec. 31, 2002) (ordering respondents to cease and desist after selling shares in a company to more than 35 investors—more than 15 in one year—in violation of the non-public offering exemption); see also *In re A.B.B. Sanitec W., Inc.*, No. 02-44, 2002 WL 31906375 (Tex. St. Sec. Bd. Dec. 30, 2002) (ordering an emergency cease and desist to respondents who offered by cold calls a promissory note and warrants for common in a medical waste treatment company and then claimed that accredited investor requirements and high risk in private placement memorandum were untrue).

56. The following cases involve investment contracts: *In re Thell G. Prueitt DBA Fresh Start Funding Group*, No. 03-041, 2003 WL 22284602 (Tex. St. Sec. Bd. Sept. 22, 2003) (ordering an emergency cease and desist to respondent who held a seminar to sell ATM equipment coupled with an ATM equipment lease, with ability to convert to pre-IPO stock); *In re Paymentworks, Inc.*, No. 03-032, 2003 WL 21953084 (Tex. St. Sec. Bd. Aug. 4, 2003) (issuing emergency cease and desist after companies offered unregistered ATM program for equipment with a servicing contract through a magazine and a website without disclosing the finder fee offer would require dealer registration and that one company was actually not incorporated desist); *In re David Henry Disraeli DBA Disraeli & Assoc.*, No. 02-38, 2003 WL 1902986 (Tex. St. Sec. Bd. Apr. 2, 2003) (ordering individual—who used the newspaper and internet to offer unregistered investment in senior housing communi-

tion,<sup>57</sup> and sales to the public without proper registration.<sup>58</sup>

#### IV. REGISTRATION OF MARKET OPERATORS

One of the underpinnings of the state's 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 and those rendering investment advice.<sup>59</sup>

Registration infractions generally surface when applying or reapplying for registration. The Board disciplined several selling agents and dealers for various infractions of the registration rules and Board orders, but a few infractions involved agents' relationship to investors. One court determined that the Texas Securities Act has extra-territorial application to prevent fraudulently selling securities from Texas to non-residents. Since

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ties managed by another to get like-kind tax treatment, and failed to disclose a tax lien against himself—to cease and desist); and *In re* David Henry Disraeli DBA Disraeli & Assoc., No. 02-38, 2002 WL 31500561 (Tex. St. Sec. Bd. Nov. 10, 2002) (emergency cease and desist).

57. See *In re* NSI Dev. Corp., No. 03-044, 2003 WL 22395432 (Tex. St. Sec. Bd. Oct. 10, 2003) (running newspaper advertisement and website for purpose of offering sale of notes returning 25% without disclosing unincorporated status and SEC cease and desist order prompts court to issue emergency cease and desist order); see also *In re* Nat'l CD Brokers, No. 03-043, 2003 WL 22279544 (Tex. St. Sec. Bd. Sept. 23, 2003) (issuing emergency cease and desist order after respondents: (1) ran newspaper advertisement to sell certificate of deposits; and (2) failed to disclose bankruptcy filing and Consent Judgment pursuant to Iowa Consumer Fraud Act); see also *In re* Softnet Communications Caribbean Ltd., No. 03-035, 2003 WL 22063321 (Tex. St. Sec. Bd. Aug. 26, 2003) (holding that emergency cease and desist appropriate for company that offered by fax and telephone call, a block of stock in an Antigua internet gaming company through puffery and refused to disclose information requested); *In re* European Inv. Trust, No. 03-033, 2003 WL 21953085 (Tex. St. Sec. Bd. Aug. 8, 2003) (ordering emergency cease and desist to Swiss investment trust that offered safe and locked-in investment return by electronic mail and website, without defining terms "safe" or "locked-in," while failing to disclose how money would be used); see also *In re* U.S. Global Inv., Inc., No. 03-030, 2003 WL 21908941 (Tex. St. Sec. Bd. July 29, 2003) (ordering an emergency cease and desist to a purported Nevada corporation that offered, through newspaper advertisements, investments in certificates of investment even though it was not really incorporated in Nevada or, authorized in Texas, and failed to disclose its capitalization structure); see also *In re* Ameri-Q Energy, Inc., No. 03-025, 2003 WL 21291880 (Tex. St. Sec. Bd. May 28, 2003) (issuing emergency cease and desist to respondents who offered and sent documents to Pennsylvanian and Arizonian without disclosing cease and desist orders in Pennsylvania, Montana, Iowa, Nevada, and Kansas); see also *In re* Strike Challenge, Inc., No. 03-003, 2003 WL 328572 (Tex. St. Sec. Bd. Feb. 3, 2003) (ordering an emergency cease and desist after company offered, by newspaper advertisement, a promissory note supposedly secured by equipment when it really was not); see also *In re* Pension Plans of Am., No. 03-001, 2003 WL 131520 (Tex. St. Sec. Bd. Jan. 10, 2003) (ordering an emergency cease and desist to company that: (1) offered, through the internet, an investment in a limited partnership for growing paulownia trees to harvest six years later; and (2) claimed the investment was low risk when documents described it as high risk).

58. See *In re* Woodlands S.A. Fin. Servs., Inc., No. 03-024, 2003 WL 21250257 (Tex. St. Sec. Bd. May 20, 2003) (ordering respondent to cease and desist because it offered, by website and newspaper advertisements, unregistered promissory notes); see also *In re* ESS Env't'l, Inc., No. 03-009, 2003 WL 1595243 (Tex. St. Sec. Bd. Mar. 17, 2003) (issuing a cease and desist order and a \$2,500 administrative fine when respondent offered by telephone and internet shares in a company to resolve problems of hazardous and non-hazardous waste management without registering the securities or dealers).

59. See TEX. REV. CIV. STAT. ANN. art. 581-13 (Vernon Supp. 2003).

the Board's registration of investment advisors is new,<sup>60</sup> some investment advisors' enforcement actions suggest unawareness of the new rules.

#### A. DEALERS

The Board pursued numerous enforcement actions against selling agents and dealers. The most common infraction against selling agents dealt with prior employment efforts to sell securities while unregistered.<sup>61</sup> Other selling agent infractions concerned failure to disclose information on forms submitted to the Board,<sup>62</sup> violation of client suitability requirements,<sup>63</sup> and withdrawing client funds without consent, a fraudulent prac-

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60. See Flint, *supra* note 4, at 2011.

61. See *In re* Application for Agent Registration of Stephen Christopher Plunkett, No. 03-036, 2003 WL 22122957 (Tex. St. Sec. Bd. Sept. 2, 2003) (reprimanding, suspending for five days, and fining \$5000 vice presidents of oil and gas company who sold unregistered working interests in its drilling programs when unregistered as agents and registered with another company); see also *In re* Application for Agent Registration of William Paul Hudson, No. 03-036, 2003 WL 22122965 (Tex. St. Sec. Bd. Sept. 2, 2003) (same as No. 03-036); see also *In re* Application for Agent Registration of Tony Eugene Morrison, No. 03-036, 2003 WL 22122965 (Tex. St. Sec. Bd. Sept. 2, 2003) (same as No. 03-036); see also *In re* Application for Agent Registration of Kenneth Paul Lawrence, No. 03-036, 2003 WL 22122974 (Tex. St. Sec. Bd. Sept. 2, 2003) (same as No. 03-036); see also *In re* Application for Agent Registration of Christopher Rene Madrid, No. 03-036, 2003 WL 22122979 (Tex. St. Sec. Bd. Sept. 2, 2003) (same as No. 03-036); see also *In re* Application for Agent Registration of Jerry Glenn Griggs, Jr., No. 03-028, 2003 WL 21468204 (Tex. St. Sec. Bd. June 17, 2003) (granting application while reprimanding, suspending for 10 days, and fining \$1,500 an agent who sought registration with old company and in the interim sold unregistered working interests in oil and gas projects without registration as dealer); see also *In re* Application for Agent Registration of Todd William Cowle, No. 03-018, 2003 WL 1950128 (Tex. St. Sec. Bd. Apr. 16, 2003) (granting the individual's application while reprimanding him, fining him \$250, and ordering him to reimburse half of the money and to make arrangements to refund the other half because he previously sold securities without being registered); see also *In re* Agent Registration of Alonso Martin Martinez, No. 3-004, 2003 WL 346264 (Tex. St. Sec. Bd. Jan. 6, 2003) (reprimanding and suspending applicant for 65 days because, in prior employment sold unregistered coin-operated, customer-owned telephone programs while unregistered); see also *In re* Application for the Agent Registration of Harrel B. Hansen, No. 02-39, 2002 WL 31526551 (Tex. St. Sec. Bd. Nov. 7, 2002) (granting application while reprimanding and fining \$5,000 an applicant who: (1) sold securities as an agent when he was not registered; (2) failed to list problem on Form U-4; (3) undertook to file amended Form U-4; (4) cooperated with investigation; and (5) for two years, promptly notified Board of any customer complaints).

62. See *In re* Agent Registration of Christopher Noel Williams, No. 03-011, 2003 WL 1595253 (Tex. St. Sec. Bd. March 19, 2003) (reprimanding agent, suspending him for three days, and fining him \$2,500 because he received complaints against himself, did not disclose on his Form U-4, and denied their existence during an inspection).

63. See *In re* Agent Registration of Robert Michael Graves, Jr., No. 3-016, 2003 WL 1950126 (Tex. St. Sec. Bd. Apr. 16, 2003) (granting new application and suspending applicant for 150 days because registered agent applied with new company after selling unsuitable and unregistered promissory note to a prior client and later reimbursed client and repaid company commissions).

tice.<sup>64</sup> Dealer infractions concerned failure to register,<sup>65</sup> non-disclosure,<sup>66</sup> operating branch offices before Board approval,<sup>67</sup> violating various Board orders,<sup>68</sup> and failure to supervise brokers.<sup>69</sup>

One case raised the issue of extra-territorial application of the registration requirements of the Texas Securities Act. In *Citizens Insurance Co. of America v. Hakim*,<sup>70</sup> an insurance company sold life insurance policies to non-residents and non-citizens of the United States. The policies allowed policyholders to assign policy dividends to offshore trusts that would use the funds to purchase common stock of the insurance company. One policyholder obtained a class certification for an action against the insurance company for selling securities from Texas without complying with the registration requirements. On the appeal of the certi-

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64. See *In re* Agent Registration of Douglas Wayne Blackenship, No. 03-002, 2003 WL 193495 (Tex. St. Sec. Bd. Jan. 16, 2003) (granting registration and ordering a reprimand and administrative fine of \$15,000 because the formerly registered agent withdrew funds from a client's account without permission during previous employment); see also *In re* Agent Registration of Letricia Elayne Preston, No. 02-40, 2002 WL 31627994 (Tex. St. Sec. Bd. Nov. 18, 2002) (granting registration and reprimanding applicant who, in pending application for a prior employer, obtained loan from client in violation of her employer's policies).

65. See *In re* Strategic Fin. Advisors, Inc., No. 03-044, 2003 WL 22279545 (Tex. St. Sec. Bd. Sept. 23, 2003) (fining respondents \$5,000 and ordering them to cease and desist until an exemption is established or the salesmen are registered because they cold called a Texas resident for private placement of unit promissory note and warrants without registering to sell or render investment advice).

66. See *In re* Dealer Registration of Ameritas Inv. Corp., No. 03-039, 2003 WL 22284604 (Tex. St. Sec. Bd. Sept. 17, 2003) (reprimanding to complete forms and ordering administrative fine of \$25,000 because dealer: (1) failed to disclose through required amendments to Forms U-4 and U-5 information with respect to the termination and rehire of an employee for violating dealer's compliance rules for selling viatical settlement contracts and medium term notes; and (2) operated branch office before receiving Board approval); see also *In re* Agent Registration of Robert Kurtis Mauss, No. 03-027, 2003 WL 21433089 (Tex. St. Sec. Bd. June 12, 2003) (revoking agent's registration and ordering him to cease and desist as an agent).

67. See *In re* Dealer Registration of Laradorbecker Sec. Corp., No. 03-21, 2003 WL 21133561 (Tex. St. Sec. Bd. May 8, 2003) (reprimanding company and fining it \$5,000 for selling securities through an unregistered agent at an unapproved branch office).

68. See *In re* Dealer Registration of Premier Group, Inc., No. 03-023, 2003 WL 21250256 (Tex. St. Sec. Bd. May 19, 2003) (reprimanding company and suspending it for three days, as well as fining it \$5,000 after it used unregistered agents for a telephone script for oil and gas investments while it was under a Consent Order not use unregistered agents when engaging in unregistered securities activity); see also *In re* Dealer Registration of Lone Star Sec., Inc., No. 03-012, 2003 WL 1787580 (Tex. St. Sec. Bd. March 24, 2003) (ordering a reprimand and administrative fine of \$10,000 for a company that, in prior inspection entered into an Undertaking not to engage in public solicitation of the sale of securities and to provide copies of the Undertaking to agents, did not maintain records as required by the Undertaking, prompting California to issue cease and desist order).

69. See *In re* Dealer Registration of James Wheeler & Co. Inv., Inc., No. 03-015, 2003 WL 19358338 (Tex. St. Sec. Bd. Apr. 14, 2003) (ordering reprimand, 365 day suspension, and an Undertaking to cooperate with Board investigations of employees because brokerage: (1) failed to report it moved its branch office of Form BD; (2) failed to verify investment advisor status for individuals on Form U-4, which also violates NASD rule 3010; (3) failed to record fifteen individuals' investments that totaled \$400,000 which violates NASD rule 3040; and (4) failed to get these customers' information, which violates NASD rule 2310).

70. *Citizens Ins. Co. of Am. v. Hakim*, 105 S.W.3d 712 (Tex. App.—Austin 2003, pet. filed).



fication, the insurance company urged that the choice of law rules would differ for each member of the class, destroying the commonality of issues. The court noted that Texas choice of law analysis follows a statutory directive, if present, rather than looking at the number of factors that might differ among class members. The Texas Securities Act contains such a directive, prohibiting unregistered sellers from selling from Texas, even to non-resident purchasers.<sup>71</sup> The court similarly rejected other Texas Securities Act objections to the certification.<sup>72</sup>

## B. INVESTMENT ADVISORS

The Board had several enforcement actions against investment advisors. These actions involved non-disclosure on forms submitted to the Board;<sup>73</sup> possible unawareness of investment advisor status;<sup>74</sup> and rendering service before registration,<sup>75</sup> while registration was pending,<sup>76</sup> or after registration terminated.<sup>77</sup>

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71. *Id.* at 723-24 (citing TEX. REV. CIV. STAT. ANN. art. 581-12, 33A(1) (Vernon Supp. 2003), with support from rules, *see* 7 TEX. ADMIN. CODE § 139.7 (2003), and the old Regulation B cases, *Enntex Oil & Gas Co. v. State*, 560 S.W.2d 494, 497 (Tex. Civ. App.—Texarkana 1977, writ ref'd n.r.e.), and *Rio Grande Oil Co. v. State*, 539 S.W.2d 917, 921-22 (Tex. Civ. App.—Houston [1st Dist.] 1976, writ ref'd n.r.e.)).

72. *See id.* at 716-21 (holding the defined class did not require a finding that the policies were securities, or were in fact sold from Texas, so the court did not impermissibly reach the merits); *see also id.* at 722-26 (noting that the granting of attorney's fees based on conduct of each party to the underlying transaction does not destroy commonality of issues, since the transaction is not the registration, and does not involve unique misrepresentations, reliances, or policyholders' knowledge).

73. *See In re Inv. Advisor Representative and Agent Registration of Russell Kent Childs*, No. 03-031, 2003 WL 21953082 (Tex. St. Sec. Bd. Aug. 1, 2003) (reprimanding advisor and fining him \$5,000 because (1) the advisor recommended that client sell municipal bonds and certificates of deposits for variable annuities; (2) clients later complained of damages of \$58,000; (3) the advisor settled and later made additional payments to client; and (4) advisor failed to disclose on Form U-4); *see also In re Inv. Advisor Representative and Agent Registration of Russell Kent Childs*, 2003 WL 21953083 (Tex. St. Sec. Bd. July 20, 2003) (the Undertaking); *In re Application for Inv. Advisor Representative of Alan Ken Flake*, No. 03-029, 2003 WL 21666147 (Tex. St. Sec. Bd. July 9, 2003) (granting investment advisor representative's application, while reprimanding him, suspending him for 15 days, and fining him \$3,000 because he, while seeking representation with another company, failed to disclose own bankruptcy on Form U-4); *see also Application for Inv. Advisor Representative of Alan Ken Flake*, 2003 WL 21666148 (Tex. St. Sec. Bd. July 9, 2003) (revoking registration with other company).

74. *See In re Kenneth R. Golightly*, No. 03-014, 2003 WL 1905634 (Tex. St. Sec. Bd. April 10, 2003) (ordering individual to cease and desist and to take an undertaking to repay some money to investors after he convinced two investors to invest with him, deposited their money in his Charles Schwab account, and traded through the internet).

75. *See In re Application for Inv. Advisor Registration of Kleinheinz Capital Partners, Inc. and the Inv. Adviser Representative Registration of John Burke Keinheinz*, No. 02-43, 2002 WL 31869363 (Tex. St. Sec. Bd. Dec. 19, 2002) (granting application while reprimanding and ordering administrative fine of \$60,000 because it, while filing for investment advisor, rendered such service when not registered).

76. *See In re Application for Inv. Advisor Registration of Murphy Fin. Advisors, Inc.*, No. 03-26, 2003 WL 21433090 (Tex. St. Sec. Bd. June 5, 2003) (granting application and reprimanding for rendering service while application was pending).

77. *See In re Applications for Inv. Adviser Registration of Willingham Asset Mgmt., Inc.*, No. 03-006, 2003 WL 576910 (Tex. St. Sec. Bd. Feb. 14, 2003) (granting application

## V. REGISTRATION OF PUBLIC COMPANIES

The federal approach to the secondary market requires disclosure concerning companies whose securities are publicly traded. The strength of the American capital markets depend on investor confidence in those reports. Congress determined that recent allegations of misdeeds by corporate executives, independent auditors, and underwriters have undermined that confidence. So Congress recently passed the Sarbanes-Oxley Act<sup>78</sup> to correct the perceived deficiencies in that reporting system and to impose certain obligations on public companies, their officers and agents to restore investor confidence. In accordance with the Sarbanes-Oxley Act, the SEC has completed most of the required rule-making mandated by the act.

### A. REPORTING

The SEC's new reporting rules focus on reconciling management's accounting with the accounting expected by investors, professional standards imposed on officers enforced through reporting, and more rapid disclosures commensurate with the information age's capabilities.

To prevent misleading investors through unusual accounting, the Sarbanes-Oxley Act directed the SEC to issue rules requiring that, for pro-forma financial information disclosed or released by a public company, the company reconcile it with the financial condition and results of operations under Generally Accepted Accounting Principles (GAAP).<sup>79</sup> Under this authority, the SEC adopted a new Regulation G that applies whenever a company publicly discloses or releases material information that includes a non-GAAP financial measure. Regulation G requires that disclosures or releases of non-GAAP financial measures include a comparison of the most directly comparable GAAP financial measure and a reconciliation of the disclosed non-GAAP financial measure to the comparable GAAP financial measure.<sup>80</sup>

To end one perceived egregious accounting practice, the Sarbanes-Oxley Act directed the SEC to devise rules for fully disclosing off-balance sheet transactions that may have a current or future material effect on the financial condition of the issuer.<sup>81</sup> The SEC rules require this disclosure in a separately captioned subsection of "Management's Discussion and Analysis" with a tabular overview of certain known contractual obligations. The definition of "off-balance sheet arrangements," is aimed at the methods typically used by issuers to structure transactions that incur risks

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while reprimanding and imposing \$5,000 fine for rendering investment service after registration was terminated for non-renewal).

78. Sarbanes-Oxley Act of 2002, Publ. L. No. 107-204, 116 Stat. 745 (2002).

79. Sarbanes-Oxley Act of 2002, Publ. L. No. 107-204, § 401(b), 116 Stat. 745, 786 (2002).

80. *In re* Conditions for Use of Non-GAAP Fin. Matters, SEC Rel. 33-8176, 2003 WL 161117 (Jan. 22, 2003) (adding Regulation G, 17 C.F.R. § 244.100-102) (2003).

81. Sarbanes-Oxley Act of 2002, § 401(a), 116 Stat. 745, 785 (2002) (15 U.S.C.A. § 78m(i) & (j) (Supp. 2003)).

of loss that are not fully apparent to investors. Therefore, it includes contractual arrangements such as certain guarantee contracts, retained and contingent interests in assets transferred to an unconsolidated entity, derivative instruments that are classified as equity, or material variable interest in unconsolidated entities that conduct certain activities. The rules require disclosure of the off-balance sheet arrangements': (1) business purpose; (2) impact on liquidity, capital resources, credit risk support or other benefits; (3) financial impact; and (4) known events, demands, commitments, trends or uncertainties that impact the issuer's ability to benefit from the off-balance sheet arrangement.<sup>82</sup>

The professional standards enforced through reporting deal with officer ethics, financial experts on audit committees, certifications, and internal controls. The Sarbanes-Oxley Act mandates that public companies must annually disclose whether the company has adopted a code of ethics for its principle officers and make it available to the public or explain why it has not.<sup>83</sup> The SEC has amended its disclosure rules and forms to require: public disclosure of the code of ethics on the internet or as an exhibit to the annual report; and disclosure of amendments to the code of ethics and waivers granted to officers within five business days on Form 8-K or the internet.<sup>84</sup>

The Sarbanes-Oxley Act provides that public companies disclose annually whether the company has at least one "financial expert" on its audit committee or explain why it does not.<sup>85</sup> The SEC has amended its disclosure rules and forms to specify the attributes of the audit committee's financial expert and the manner of acquiring those attributes with a safe harbor provision protecting the financial expert from "expert" status for other aspects of the federal security laws. The amended rules also provide that the designation of financial expert does not impose any additional liability to that imposed without the designation, and that the other directors are not relieved of any of their usual liability by virtue of the designation.<sup>86</sup>

The Sarbanes-Oxley Act directs the SEC to adopt rules requiring each annual report to contain a statement that it is management's responsibility to establish an adequate internal control structure, and an assessment

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82. *In re* Disclosure of Mgmt's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, SEC Rel. 33-8182, 2003 WL 175446 (Jan. 28, 2003) (amending Regulation SB, 17 C.F.R. § 229 (2003), Regulation S-K, 17 C.F.R. § 229 (2003), and the Forms, 17 C.F.R. § 249 (2003)).

83. 15 U.S.C.A. § 7264 (Supp. 2003).

84. *In re* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, SEC Rel. 33-8177, 2003 WL 164269 (Jan. 23, 2003) (amending Regulation SB, 17 C.F.R. § 229, Regulation S-K, 17 C.F.R. § 229, and the Forms, 17 C.F.R. § 249), corrected by *In re* Sarbanes-Oxley Act, SEC Rel. 33-8177A, 2003 WL 1561444 (Mar. 26, 2003).

85. 15 U.S.C.A. § 7265 (Supp. 2003).

86. *In re* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, SEC Rel. 33-8177, 2003 WL 164269 (amending Regulation SB, 17 C.F.R. § 229, Regulation S-K, 17 C.F.R. § 229, and the Forms, 17 C.F.R. § 249), corrected by *In re* Sarbanes-Oxley Act, SEC Rel. 33-8177A, 2003 WL 1561444 (Mar. 26, 2003).

of the effectiveness of the controls for financial reporting.<sup>87</sup> The rule provides that management must disclose any material weaknesses and can not conclude the controls are effective if there is one or more material weakness. The rule requires that the framework used by management to evaluate the control system is based on a recognized control framework established by a body using due process procedures, in particular, public comment. The rule also requires companies to perform quarterly evaluations of changes that have or are likely to materially affect the company's controls over financial reporting.<sup>88</sup>

The Sarbanes-Oxley Act requires the officers to certify certain aspects of the financial statements and to certify compliance with the Exchange Act.<sup>89</sup> Last year the SEC adopted rules with respect to the certifications.<sup>90</sup> This year the SEC amended these rules to provide that the certifications appear as exhibits to the respective reports.<sup>91</sup>

To lessen the impact of insider trading before disclosure is made to the public, the rules provide for a more rapid disclosure. The Sarbanes-Oxley Act requires public companies to disclose material changes in financial condition or operations to the public on a rapid and current basis.<sup>92</sup> The SEC requires this disclosure on Form 8-K, unless made orally, telephonically, by webcast, or by broadcast within forty-eight hours of a related filing on Form 8-K, the presentation is accessible by the public, and the information is also posted on the company's Website.<sup>93</sup>

The Sarbanes-Oxley Act requires electronic filing of beneficial ownership reports of directors, officers, and principal security holders.<sup>94</sup> The SEC rule requires these insiders to file them with the SEC on the EDGAR system and then post them by the end of the business day after filing on the company's website or on a third-party service.<sup>95</sup>

## B. LIMITATIONS ON DIRECTORS AND OFFICERS

Another perceived evil involved Enron Corporation's management disposing of their declining shares when employees with shares in employee

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87. 15 U.S.C.A. § 7262 (Supp. 2003).

88. *In re* Mgmt's Report on Internal Control Over Fin. Reporting and Certification of Disclosure in Exch. Act Periodic Reports, SEC Rel. 33-8238, 2003 WL 21294970 (June 5, 2003) (amending various rules and forms).

89. 15 U.S.C.A. § 7241 & 18 U.S.C. § 1350 (Supp. 2003).

90. Certification of Disclosure in Cos.' Quarterly and Annual Reports, SEC Rel. 33-8124, 2003 WL 31720215 (Sept. 9, 2002) (adopting among others Rules 13a-14, 13a-15, 15d-14, and 15d-15, 17 C.F.R. §§ 240.13a-14, 240.13a-15, 240.15d-14, and 15d-15 (2003)).

91. Certification of Disclosure, SEC Rel. 33-8212, 2003 WL 1447826 (Mar. 21, 2003) (proposed amendment to Rules 13a-14 & 15d-14), *adopted* by SEC Rel. 33-8238 (June 5, 2003).

92. 15 U.S.C.A. § 78m(l) (Supp. 2003).

93. *In re* Conditions for Use of Non-GAAP Financial Matters, SEC Rel. 33-8176, 2003 WL 161117 (Jan. 22, 2003) (amending Form 8-K, 17 C.F.R. § 249.308 (2003)).

94. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 403, 116 Stat. 745, 788 (2002) (amending 15 U.S.C.A. § 78p (West 2003)).

95. *In re* Mandated Electronic Filing and Website Posting for Forms 3, 4, and 5, SEC Rel. 33-8230, 2003 WL 21025853, at \*4 (May 7, 2003) (amending various rules and forms).

benefit plans could not. Sarbanes-Oxley prohibits this practice.<sup>96</sup> The SEC has devised a new Regulation Blackout Trading Restriction (BTR).<sup>97</sup> Regulation BTR adopts concepts from the rules under Section 16 of the Exchange Act, using the same definition for “director” and “officer” for “executive officer.” The regulation also extends to indirect acquisitions and dispositions through family members, partnerships, corporations, and trusts. The regulation sets forth damages in a private action as the difference between the amount paid or received for the equity security on the date of the transaction during the blackout period and the amount that would have been paid or received if the transaction had taken place outside of the blackout period. The regulation also provides for the contents and timing of the notice to directors, executive officers, and to the SEC.

The Sarbanes-Oxley Act directed the SEC to establish rules prohibiting directors and officers of public companies from fraudulently influencing, coercing, manipulating, or misleading any auditor performing the company’s audit.<sup>98</sup> The standard specified in the SEC’s rule finds improper influence when the director or officer knew or should have known that the action, if successful, could result in rendering the company’s financial statements materially misleading. The rule provides examples of conduct that improperly influence an auditor, such as offering or paying financial incentives, providing the auditor with inaccurate legal analysis, threatening to cancel existing non-audit or audit engagements if the auditor objects to the company’s accounting, seeking to remove an audit partner that objects to the company’s accounting, blackmailing, and making physical threats.<sup>99</sup>

### C. REGULATIONS OF LAWYERS AND ACCOUNTANTS

To avoid auditor conflicts of interest, the Sarbanes-Oxley Act prohibits public accounting firms from providing a public company non-audit services at the same time they are providing the company with audit services.<sup>100</sup> The SEC has adopted rules defining the prohibited services, requiring audit partners to rotate after a number of years, destroying auditor independence for those issuers with an officer that was a former employee of the auditor within the last year or the auditor based compensation of procuring engagements with that issuer for non-audit services, requiring the auditor to report certain critical accounting policies to the audit committee, requiring the audit committee to approve all audit and

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96. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 306, 116 Stat. 745, 779 (2002); 15 U.S.C.A. § 7244(a) (West 2003).

97. *In re Insider Trades During Pension Fund Blackout Periods*, SEC Rel. 34-47225, 2003 WL 152486, at \*1 (Jan. 22, 2003) (adding Regulation BTR, 17 C.F.R. § 245.100-104).

98. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 303, 116 Stat. 745, 778 (2002); 15 U.S.C.A. § 7242 (West 2003).

99. *In re Improper Influence on Conduct of Audits*, SEC Rel. 34-47890, 2003 WL 21148349, at \*5-6 (May 20, 2003) (amending 17 C.F.R. § 240.13b2-2 (2003)).

100. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 201, 116 Stat. 745, 771 (2002); 15 U.S.C.A. § 78j-1 (West 2003).

non-audit services provided by the auditor, and requiring disclosure to investors of information about audit and non-audit services and fees.<sup>101</sup>

To prevent destruction of evidence of auditor wrong-doing, the Sarbanes-Oxley Act requires auditor retention of audit records for five years.<sup>102</sup> The SEC has adopted a rule requiring accounting firms to retain records relevant to the audits and reviews of public companies, including work papers, memoranda, correspondence, communications, and records created, sent, or received in connection with the audit or review. Moreover, those records must contain conclusions, opinions, analyses, or financial data related to the audit or review for seven years after conclusion of the audit or review.<sup>103</sup>

The Sarbanes-Oxley Act directed the SEC to adopt rules requiring minimum standards of professional conduct for securities lawyers representing issuers.<sup>104</sup> The SEC has adopted “report up-the-ladder” rules basically as proposed,<sup>105</sup> leaving the controversial issue of “noisy withdrawal” rules open. The final “report-up-the-ladder” rules, however, make it clear that the SEC intends an objective, rather than subjective, standard involving credible evidence triggering the obligation. Namely, it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing or is about to occur.<sup>106</sup>

## VI. SECURITIES FRAUD

One of the major reasons legislatures passed securities acts was to facilitate actions by investors to recover their money through a simplified fraud action that did away with the most difficult elements to prove in a common law fraud action, namely scienter, reliance, and privity.

### A. NEW LEGISLATIVE REMEDIES

The Texas Legislature made three changes with respect to remedies for fraud, all pursuant to the recommendation of the State Securities Board and the Attorney General’s Office. First, the Securities Commissioner may provide assistance to an authorized, requesting securities regulator in a foreign jurisdiction investigating securities violations.<sup>107</sup> In determin-

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101. *In re* Strengthening the Commission’s Requirements Regarding Auditor Independence, SEC Rel. 33-8183, 2003 WL 183801 (Jan. 28, 2003) (amending various rules).

102. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 802, 116 Stat. 745, 800 (2002); 18 U.S.C.A. § 1520 (West 2003).

103. *In re* Retention of Records Relevant to Audits and Reviews, SEC Rel. 33-8180, 2003 WL 164273 (Jan. 24, 2003) (adding Rule 2-06 of Regulation S-X, 17 C.F.R. § 210.2-06).

104. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (2002); 15 U.S.C.A. § 7245 (West 2003).

105. For the proposal, see Flint, *supra* note 4, at 2015.

106. *In re* Implementation of Standards of Professional Conduct for Attorneys, SEC Rel. 33-8185, 2003 WL 193527, at \*2 (Jan. 29, 2003) (adding 17 C.F.R. § 205.1-.7).

107. See Act of Sept. 1, 2003, 78th Leg., R.S., ch. 108 § 2, 2003 Tex. Sess. Law Serv. 147, 148 (Vernon Supp. 2004) (amending TEX. REV. CIV. STAT. ANN. art. 581, § 28).

ing whether to provide such assistance, the Commissioner may consider reciprocal agreements of assistance, whether such assistance would prejudice the public policy of the State of Texas, whether the conduct under investigation would have violated Texas securities laws if committed in Texas, and the availability of resources.<sup>108</sup>

Reflective of the effort to suppress multi-state fraud, the State Securities Board participated in several multi-state prosecutions with the SEC against conflicts of interests in full-service brokerage houses.<sup>109</sup> In order to attract underwriting clients, these firms encouraged their securities analysts through compensation schemes based on underwriting revenues to provide coverage and buy recommendations for both their underwriting clients and potential underwriting clients.<sup>110</sup> Besides the hefty fines, the various states required the brokerage houses to agree to separate their analyst and underwriting functions and to provide notice of this potential conflict of interest.<sup>111</sup>

The second legislative change makes it a crime to render services as an

108. See Act of Sept. 1, 2003, 78th Leg. R.S., ch. 108, § 2, 2003 Tex. Sess. Law Serv. 147 (Vernon Supp. 2004); Comm. on Gov't Org., Bill Analysis, Tex. S.B. 1060, 78th Leg., R.S. (2003) (emphasizing reciprocal assistance).

109. See *In re Dealer Registration of Morgan Stanley & Co., Inc.*, No. 03-045, 2003 WL 22395433, at \*13 (Tex. State Sec. Bd. Oct. 13, 2003) (awarding \$1,606,557 administrative fine to Texas in a multi-state fine of \$25,000,000); *In re Dealer Registration of U.S. Bancorp Piper Jaffray Inc.*, No. 03-042, 2003 WL 22279543, at \*12 (Tex. St. Sec. Bd. Sept. 23, 2003) (awarding \$803,329 administrative fine to Texas of multi-state fine of \$12,500,000); *In re Dealer Registration of Credit Suisse First Boston LLC*, No. 03-040, 2003 WL 22284605, at \*19 (Tex. St. Sec. Bd. Sept. 18, 2003) (awarding \$4,819,970 administrative fine to Texas of multi-state fine of \$200,000,000); *In re Dealer Registrations of UBS Warburg L.L.C.*, No. 03-038, 2003 WL 22284603, at \* 14 (Tex. St. Sec. Bd. Sept. 17, 2003 (Sept. 17, 2003) (awarding \$1,6006,657 administrative fine to Texas of multi-state fine of \$80,000,000); *In re Dealer Registration of Goldman, Sachs & Co.*, No. 03-037, 2003 WL 22122996, at \*19 (Tex. St. Sec. Bd. Sept. 5, 2003) (awarding \$1,606,657 administrative fine to Texas of multi-state fine of \$110,000,000); see also *In re Dealer Registration of J.P. Morgan Securities Inc.* No. 03-019, 2003 WL 21024847, at \*12 (Tex. St. Sec. Bd. Apr. 24, 2003) (reprimanding and fining \$1,606,657); *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 02-41, 2002 WL 31685726, at \*6 (Tex. St. Sec. Bd. Nov. 26, 2002) (using New York investigation to obtain a fine of \$3,473,787).

The New York Attorney General's investigation into Merrill Lynch prompted these cases. See *In re Merrill Lynch & Co., Inc.*, 273 F. Supp. 2d 351 (S.D.N.Y. 2003). These cases spawned a provision in the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 502, 116 Stat. 745, 791 (2002), now § 15D of the Exchange Act, 15 U.S.C. A. § 78o-6 (West Supp. 2003), directing the SEC to promulgate rules governing the independence and objectivity of securities analysts and protecting analysts from retaliation by their firms because of negative research or ratings. The SEC recently adopted such rules. See *In re Regulation Analyst Certification*, SEC Rel. 33-8193, 2003 WL 397879, at \*1 (Feb. 20, 2003).

110. See, e.g., *In re Dealer Registration of J.P. Morgan Securities Inc.*, No. 03-019, 2003 WL 21024847, at \*2 (Tex. St. Sec. Bd. April 24, 2003). See, e.g., *In re Dealer Registration of J.P. Morgan Sec. Inc.*, *supra* note 109, at \*2.

111. See, e.g., *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 02-41, 2002 WL 31685726, at \*2 (Tex. St. Sec. Bd. Nov. 26, 2002) (put legend on research might seek as underwriting client), \*3 (not to compensate research analysts on the basis of underwriting revenues), \*4 (have committee to monitor objectivity of analysts), \*5 (in underwriting solicitation that the company prohibits consideration of underwriting business in analysts' compensation).

investment advisor without being registered.<sup>112</sup> While the immediately preceding legislative session required registration,<sup>113</sup> this change makes failure to register as an investment advisor comparable to failure to register as a selling agent, subject to a prison term between two and ten years or a fine up to \$5,000, or both.<sup>114</sup>

The third change authorizes the Attorney General of Texas in an injunctive action to seek other equitable relief on behalf of the defrauded investor, in particular, restitution and disgorgement.<sup>115</sup>

## B. COURT DECISIONS UNDER THE TEXAS ACTS

The idea behind the basic anti-fraud provision of the Texas Securities Act is to remove certain elements from a common law cause of action, namely reliance and causation, making it easier for the investor to recover.<sup>116</sup> Nevertheless, some sellers attempt to reinsert the statutorily removed elements. Since the legislature modeled this anti-fraud provision after the federal law provision,<sup>117</sup> Texas courts use federal cases interpreting the federal provision as a guide in interpreting the Texas provision.<sup>118</sup> The 1995 amendment to the federal provision provided two litigants an argument to attempt to reverse a century of securities law.

### 1. *Texas Securities Act*

In *Murchison v. State*,<sup>119</sup> the trial court convicted the principals of a broker-dealer holding firm of securities fraud under the Texas Securities Act. These principals had sold holding firm debentures without disclosing to the investors that (1) the principals had two years before sold debentures of an affiliate to investors representing they were secured by Treasuries, when actually only a fraction were so secured and subsequently became unsecured; (2) another affiliate responsible for producing

112. See Act of Sept. 1, 2003, 78th Leg. R.S., ch. 108, § 3, 2003 Tex. Sess. Law Serv. 147, 148 (Vernon Supp. 2004) (adding TEX. REV. CIV. STAT. ANN. art. 581, § 281), see also Comm. on Gov't Org., Bill Analysis, Texas S.B. 1060, 78th Leg., R.S. (2003).

113. See TEX. REV. CIV. STAT. ANN. art. 581-13 (Vernon Supp. 2004); see also Flint, *supra* note 4, at 2011.

114. Compare Act of Sept. 2, 2003, 78th Leg., R.S., ch. 108, § 3, 2003 Tex. Sess. Law Serv. 147, 148 (Vernon Supp. 2004) (adding TEX. REV. CIV. STAT. ANN. art. 581, § 291), with TEX. REV. CIV. STAT. ANN. art. 581-29(G) (Vernon Supp. 2004).

115. See Act of Sept. 1, 2003, 78th Leg., R.S., ch. 108, 2003 Tex. Sess. Law Serv. 147, 149 (Vernon Supp. 2004) (amending TEX. REV. CIV. STAT. ANN. art. 581, § 32B and adding TEX. REV. CIV. STAT. ANN. art. 581, § 32C); see also Comm. on Gov't Org., Bill analysis, Tex. S.B. 1060, 78th Leg., R.S. (2003).

116. See TEX. REV. CIV. STAT. ANN. art. 581-33A(2) (Vernon Supp. 2003).

117. Compare TEX. REV. CIV. STAT. ANN. art. 581-33A(2) (Vernon Supp. 2003), with 15 U.S.C.A. § 771(a)(2) (West 1997); see Tex. Capital Sec., Inc. v. Sandefer, 58 S.W.3d 760, 775 (Tex. App.—Houston [1st Dist.] 2001, pet. denied); Anheuser-Busch Cos. v. Summit Coffee Co., 858 S.W.2d 928, 939 (Tex. App.—Dallas 1993, writ denied), *vacated on other grounds*, 514 U.S. 1001 (1995).

118. See *Summers v. WellTech, Inc.*, 935 S.W.2d 228, 232-33 (Tex. App.—Houston [1st Dist.] 1996, no writ).

119. *Murchison v. State*, 93 S.W.3d 239 (Tex. App.—Houston [14th Dist.] 2002, pet. ref'd). This opinion dates from before the Survey period, but appeared much later in the reporters with cases within the Survey period.



revenue had net operating losses in each of the last six months; (3) another affiliate had sold its inventory of securities, reducing its net capitalization balances to below the limits allowed by the National Association of Securities Dealers (NASD); (4) the disclosed prior year's financials were so outdated they showed a viable company when the company was not; and (5) the holding firm needed the revenues from the debenture sale to cover operating expenses. The principals challenged their convictions on the grounds that the court wrongly excluded their expert witness testimony. Other than the irrelevant testimony, the expert would testify that the federal securities acts impose a due diligence requirement on buyers of debentures.<sup>120</sup> The court recognized this argument for what it was—an attempt to introduce a reliance requirement—which is not part of the Texas Securities Act.<sup>121</sup>

The *Murchison* court easily disposed of the defendants' other alleged errors. The defendants complained of the refusal for a jury instruction on mistake of fact that would negate the intentional failure to disclose.<sup>122</sup> In a prosecution under the Texas Securities Act, the defendant must raise mistaken belief for each of the material facts.<sup>123</sup> Just as the defendants' attorney failed to provide expert testimony relevant to the five material facts, he also failed to point to any evidence, however slight, to raise an issue of mistaken belief with respect to those material facts.<sup>124</sup> The defendants also failed to win on a sufficiency of the evidence challenge as the court found more than ample evidence with respect to each of the five material facts.<sup>125</sup>

In *Geodyne Energy Income Production Partnership I-E v. Newton Corp.*,<sup>126</sup> the seller of a ten percent working interest in an oil and gas lease, well, and equipment did not disclose that the lease had expired.<sup>127</sup> The auction sale documents provided disclaimer of representations and

120. *Id.* at 250-51. The irrelevant testimony related to intent not to repay the debentures, knowing the company could not repay, and failure to disclose some repurchase agreements, none of which related to the five misstatements. For buyer's due diligence requirement under federal law, see *infra* note 132 and accompanying text.

121. *Murchison*, 93 S.W. 3d at 250-51 (citing *Birchfield v. State*, 401 S.W. 2d 825, 828 (Tex. Crim. App. 1966)).

122. *Id.* at 251-52. See TEX. PEN. CODE ANN. § 8.02(a) (Vernon 2003).

123. *Murchison*, 93 S.W.3d at 252 (citing *Gant v. State*, 814 S.W.2d 444, 452-53 (Tex. App.—Austin 1991, no writ)).

124. *Id.* at 252 (any evidence would have been sufficient to raise the mistake-of-fact issue).

125. *Id.* at 254-56.

126. *Geodyne Energy Income Prod. P'ship I-E v. Newton Corp.*, 97 S.W.3d 779 (Tex. App.—Dallas 2003, pet. filed).

127. *Id.* at 782, 787. An interest in or under an oil and gas lease is a security. See TEX. REV. CIV. STAT. ANN. art. 581-4A (Vernon Supp. 2004). The sale occurred by auction with a price of \$300. The suit involved liability for plugging the well in the amount of \$742,409. The interest's portion was \$74,241. The successful investor also obtained a judgment for \$161,269 in legal fees, far in excess of the securities law damage remedy. However, the appellate court remanded the attorney fee part to determine whether the fees for the securities litigation could be separated from the other causes of action. *Geodyne*, 97 S.W.3d at 782-83, 790.

various warranties.<sup>128</sup> The purchaser also agreed to take the property “as is”. The trial court found for the investors. On appeal, the seller claimed that the disclaimers and the “as is” language negated various elements of the investors’ cause of action under the Texas Securities Act, namely reliance, causation, and misrepresentation or omission. They further argued that the disclaimers constituted a waiver of the investors’ rights under the Texas Securities Act, and that the investors failed to conduct their own due diligence as required by the auction sale. The seller’s lawyer concocted a reliance and causation element from the Texas Deceptive Trade Act, which does have those two elements with the desired effect of an “as is” disclaimer on the misrepresentation or omission.<sup>129</sup> The rule for the Texas Securities Act, however, is different. The court noted that an action for fraud under the Texas Securities Act has no element of reliance.<sup>130</sup> The court then split causation into two parts: causation for the sale and causation for damages. The court concluded the Texas Securities Act also has no element for causation for the sale.<sup>131</sup> With respect to causation for damages, the Texas Securities Act follows the federal statute prior to its 1995 amendments to provide for reduced damages due to market declines.<sup>132</sup> That law also provided that there was no element for causation for damages.<sup>133</sup> The assertion that the disclaimers negated any misrepresentation or omission was an impermissible attempt to reintroduce reliance as an element of the cause of action.<sup>134</sup> The disclaimers

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128. *Id.* at 782-83 (the purchaser agreed the seller had made no representations regarding oil and gas production, marketable title, condition, quality, fitness for general or particular purposes, merchantability, accuracy of interest, or accuracy completeness of any data, information, or material supplied to the purchaser).

129. *Id.* at 786 (citing *Prudential Ins. Co. of Am. v. Jefferson Assocs., Ltd.*, 896 S.W.2d 156, 161 (Tex. 1995)).

130. *Id.* at 783-84 (citing *Hendricks v. Thornton*, 973 S.W.2d 348, 360 (Tex. App.—Beaumont 1998, pet. denied); *Summers v. WellTech, Inc.*, 935 S.W.2d 228, 234 (Tex. App.—Houston [1st Dist.] 1996, no writ); *Anheuser-Busch Cos. v. Summit Coffee Co.*, 858 S.W.2d 928, 936 (Tex. App.—Dallas 1993, writ denied)).

131. *Id.* at 784 (citing *Weatherly v. Deloitte & Touche*, 905 S.W.2d 642, 648-49 (Tex. App.—Houston [14th Dist.] 1995, writ dismissed w.o.j.); *Anheuser-Busch Cos.*, 858 S.W.2d at 936).

132. Compare TEX. REV. CIV. STAT. ANN. art. 581-33A(2) (Vernon Supp. 2004), with 15 U.S.C. § 771(b) (1997) (buyer’s due diligence requirement). For pre-1995 federal law, see *Gasner v. Bd. of Supervisors*, 103 F.3d 351, 360 n.10 (4th Cir. 1996). The Legislature specifically amended the Texas Securities Act in 1979 to make sure that there was no buyer’s due diligence requirement after a court had so determined. See TEX. REV. CIV. STAT. ANN. art. 581-33 and cmt. to art. 581-33A(2) (Vernon Supp. 2004) (plaintiffs are relieved from the difficult burden of proving that they could not have known of the untruth or omission). Similarly, Congress specifically inserted such a requirement in the corresponding federal provision in 1995. So federal and state law diverge on this point. The Fifth Circuit requires an additional buyer’s due diligence requirement as one of the elements of the cause of action for a fraud action under federal Rule 10b-5, 17 C.F.R. § 240.10b-5 (2003). See, e.g., *Schlesinger v. Herzog*, 2 F.3d 135, 139 (5th Cir. 1993) (a buyer who has exercised due diligence to pursue his own interest so that his reliance is justifiable).

133. *Geodyne*, 97 S.W.3d at 785 (citing *Duperior v. Tex. State Bank*, 28 S.W.3d 740, 753 (Tex. App.—Corpus Christi 2000, pet. dismissed); *Casella v. Webb*, 883 F.2d 805, 808 (9th Cir. 1989)).

134. *Id.* at 784 (citing *Johns Hopkins Univ. v. Hutton*, 422 F.2d 1124, 1129 (4th Cir. 1970)). The only causal connection required is that a misrepresentation or omission is

also do not constitute waivers since the Texas Securities Act voids such waivers.<sup>135</sup> Moreover, under the Texas Securities Act, the investor has no due diligence requirement.<sup>136</sup>

Although the *Geodyne* trial court found liability properly, it erred with respect to remedies. The trial court had awarded the purchase price as damages, rather than rescission. Since the remedy is statutory, the court merely reformed the judgment. The trial court also erred in failing to separate attorney's fees granted under the Texas Securities Act<sup>137</sup> from those connected to other claims and defenses. The court remanded for this issue.<sup>138</sup>

## 2. Texas Stock Fraud Act

Several cases appeared under the Texas Stock Fraud Act.<sup>139</sup> The Texas Stock Fraud Act does not remove the traditional elements of reliance and causation from a securities fraud action,<sup>140</sup> but it does allow punitive damages.<sup>141</sup> The cases under the Texas Stock Fraud Act involved an investor with no evidence of the various elements, the impact of a warranty disclaimer on the action, and the application of the statute to corporate misfeasance.

In *Kapur v. Goldstein*,<sup>142</sup> a co-investor induced the investor to purchase with him, by check and a promissory note, thirty units each of an oil and gas production securities project that would yield a profit from the outset. When the co-investor obtained a next-day refund, the promoter similarly promised the investor a refund, but did not perform. The investor relied on insufficient funds to thwart the check, however, a non-investor deposit caused the check to clear. Four years later, after having a chance to determine the investment's outcome, the investor sued the co-investor and promoter for stock fraud under the Texas Stock Fraud Act. The trial court granted a no evidence summary judgment for the defendants. The appellate court affirmed. The investor provided no evidence of damages, not the check, the cashing of the check, the promissory note, payments made on the note. There was no evidence of the profit or loss on the

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made in connection with the sale. *Id.* (citing *Duperior*, 28 S.W.3d at 753; *Anheuser-Busch Cos.*, 858 S.W.2d at 936). So state cases dealing with post sale misrepresentations and federal cases dealing with secondary liability were irrelevant.

135. *Id.* at 786; see TEX. REV. CIV. STAT. ANN. art. 581-33L (Vernon Supp. 2004). Waivers of past violations known to the waiving party are valid. *Geodyne*, 97 S.W.3d at 186 (citing *Anheuser-Busch Cos.*, 858 S.W.2d at 936).

136. *Geodyne*, 97 S.W.3d at 783-86 (citing *Duperior*, 28 S.W.3d at 753; *Summers*, 935 S.W.2d at 234; *In re Westcap Enters.*, 230 F.3d 717, 726 (5th Cir. 2000)).

137. TEX. REV. CIV. STAT. ANN. art. 581-33D(7) (Vernon Supp. 2003).

138. *Geodyne*, 97 S.W.3d at 783-90.

139. TEX. BUS. & COM. CODE ANN. § 27.01 (2002). One case dealt with recovery of attorney's fees under the Texas Stock Fraud Act. See *Webb v. Abbruzzese*, No. 4:03-CV-5, 2003 WL 21771017, at \*1 (W.D. Tex. Aug. 1, 2003).

140. See, e.g., *Burleson State Bank v. Plunkett*, 27 S.W.3d 605, 611 (Tex. App.—Waco 2000, pet. denied) (scienter remains as amendment).

141. See TEX. BUS. & COM. CODE ANN. § 27.01(c) (Vernon 2002).

142. *Kapur v. Goldstein*, No. 01-02-0023-CV, 2003 WL 1848559 (Tex. App.—Houston [1st Dist.] Apr. 10, 2003, no pet.) (memorandum opinion).

project, causation, nor evidence that the transaction involved “stock.” The court could not determine what the transaction consisted of, much less how it was to make a profit.<sup>143</sup>

The Texas Stock Fraud Act issue in *Benchmark Electronics, Inc. v. J.M. Huber Corp.*,<sup>144</sup> dealt with the impact of a disclaimer and warranty provision in a written stock purchase agreement under which a Texas corporation purchased the stock of a subsidiary of a New Jersey corporation. The trial court had determined that New York law, which allows no extra-contractual fraud and misrepresentation claims, applied to both the contract and tort claims and granted a summary judgment for the seller.<sup>145</sup> The Fifth Circuit, in reversing the summary judgment, however, determined that under the Texas choice of law rules, New York law governed contract interpretation under a contractual choice of law clause contained in the stock purchase agreement, but Texas law governed the tort claims. Then as guidance to the trial court, the court of appeals divided the misrepresentations into those made during the negotiations and those subjects of the warranty clause of the stock purchase agreement. Under New York law, the disclaimer eliminates reliance on the pre-contractual representations. Under Texas common law and the Texas Stock Fraud Act, the warranty provision does not bar tort claims for fraudulent inducement or fraud arising from false representations in the agreement.<sup>146</sup>

One litigant tried to use the Texas Stock Fraud Act, rather than federal law, to remedy alleged accounting fraud in the secondary market, probably to obtain punitive damages.<sup>147</sup> In *Stephens v. Halliburton Company*,<sup>148</sup> two minor shareholders attempted to use the Texas Stock Fraud Act and common law fraud to challenge the accounting method used by the issuer for reports to the public. The shareholders alleged an omission in not disclosing a change in accounting method and a resulting misrepresentation in the financial reports that recognized revenue from the change. The court dismissed the claim for a number of reasons, including failure to state a claim under the Texas Stock Fraud Act and common law fraud. The Texas Stock Fraud Act requires: (1) a false representation of a material fact; (2) made with the intent to induce another person to enter into a contract; and (3) was relied on by the person entering the contract. The shareholders petition was devoid of any allegations concerning entry into a contract or that the company induced them to purchase the stock. For omission under the common law fraud action, the shareholders needed to allege a duty to disclose. Texas law recognizes

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143. *Id.* at \*1-6.

144. *Benchmark Elecs., Inc. v. J.M. Huber Corp.*, 343 F.3d 719 (5th Cir. 2003).

145. *Id.* at 726. The trial court was the District Court for the Southern District of Texas. *Id.* at 719.

146. *Id.* at 726-30 (citing *Formosa Plastics Corp. USA v. Presidio Eng'rs & Contractors, Inc.*, 960 S.W.2d 41, 47 (Tex. 1998) (common law); *SMB Partners, Ltd. v. Osloub*, 4 S.W.3d 368 (Tex. App.—Houston [1st Dist.] 1999, no pet.) (Texas Stock Fraud Act)).

147. TEX. BUS. & COM. CODE ANN. § 27.01(c) (2002).

148. *Stephens v. Halliburton Co.*, No. CIV. A03:02-CV-1442-L, 2003 WL 22077752 (N.D. Tex. Sept. 5, 2003) (memorandum opinion).

four such situations, none of which the shareholders alleged.<sup>149</sup> For the misrepresentation peculiarly within the perpetrator's knowledge, the investors may base their allegations on information and belief, but under the federal pleading rules interpreted in the Fifth Circuit, they must allege a factual basis for the belief.<sup>150</sup> The investors' pleadings lacked any factual basis for believing that the issuer's treatment of unresolved claims and change orders were based on speculation rather than reasonable expectations, or that revenues reported from the unresolved claims and change orders were not probable and could not be reliably estimated. The investors also failed to explain why the SEC filings were false or misleading.<sup>151</sup>

### C. ARBITRATIONS UNDER THE TEXAS ACTS

Securities fraud is also a method for investors to reach their own brokers; however, these actions are usually subject to arbitration as provided in their broker contracts.<sup>152</sup> There were several arbitrations against brokers conducted by the NASD involving the Texas Securities Acts. Arbiters seldom explain their decisions as appellate courts<sup>153</sup> do and need not follow the rules of law.<sup>154</sup> Yet, some trends are ascertainable.

Arbitrations almost invariably deal with investments that declined in value—typically more than \$100,000—although recently most claims involved far more.<sup>155</sup> One reason for the high threshold may be attorney's fees, for which the Texas Securities Act allows recovery.<sup>156</sup> Most com-

149. *Id.* at \*7-10. The four are (1) a special or fiduciary relationship; (2) partial disclosure failing to disclose the whole truth; (3) failure to disclose new information that would make prior information not misleading; and (4) partial disclosure conveying a false impression. *Id.* (citing *Lesikar v. Rappeport*, 33 S.W.3d 282, 299 (Tex. App.—Texarkana 2000, pet. denied)).

150. *Id.* at \*8 (citing *United States ex rel. Thompson v. Columbia HCA/Healthcare Corp.*, 125 F.3d 899, 903 (5th Cir. 1997)). The rule is FED. R. CIV. P. 9(b).

151. *Stephens*, 2003 WL 22077752 at \*1-9.

152. 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. 2003). *See, e.g., In re Mony Sec. 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/Am. Express, Inc.*, 490 U.S. 477 (1989) (reversing *Wilko v. Swan*, 346 U.S. 427 (1953) (for claims under the Securities Act of 1933)); *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220 (1987) (reversing *Wilko*, 346 U.S. at 438 (banning securities arbitration for claims under the Exchange Act of 1934)).

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

154. *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), *cert. denied*, 497 U.S. 1004 (1990) (for securities arbitration to reverse the arbiters it is not enough to show they misinterpreted the law or misapplied the law).

155. *See infra* notes 157-166.

156. *See* TEX. REV. CIV. STAT. ANN. art. 581, § 33(D)(7) (Vernon Supp. 2003). Not every arbitrator is allowed attorney's fees, but those allowed amounted to approximately \$50,000. *See Ferguson v. Prospera Fin. Servs., Inc.*, No. 02-01254, 2003 WL 21441817, at \*3 (June 6, 2003) (N.A.S.D., Arb.) (\$60,000 attorney fees and \$8,000 costs); *Coselli v. Primex*

plaints concerned volatile recommendations<sup>157</sup> or unauthorized trades.<sup>158</sup> Other complaints involved losses in a declining market,<sup>159</sup> unsuitabil-

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Prime Elect. Execution, Inc., No. 01-06623, 2003 WL 450645, at \*3 (Jan. 29, 2003) (NASD Arb.) (attorney's fees of \$56,000); Bloomer v. Josephthal & Co., Inc., No. 01-06025, 2002 WL 31971782, at \*2 (Dec. 24, 2002) (NASD Arb.) (\$20,000 attorney's fees); Rottler v. Sands Bros. & Co., No. 01-04036, 2002 WL 31987266, at \*2 (Dec. 13, 2002) (N.A.S.D. Arb.) (\$31,080 attorney's fees); de Luna Valenzuela v. WM Fin. Sers., No. 01-05914, 2002 WL 31656721, at \*2 (Nov. 7, 2002) (N.A.S.D. Arb.) (\$126,400 attorney's fees). There is also the claimant's risk of paying the other party's legal fees. See *Howe v. Carty & Co.*, No. 01-06490, 2003 WL 271329, at \*3 (Jan. 23, 2003) (N.A.S.D. Arb.) (claimant pay to brokerage \$2774 attorney's fees). Expert witness fees are also not small. See *Thurston v. S.W. Sec., Inc.*, No. 01-06902, 2003 WL 1192951, at \*2 (Feb. 27, 2003) (N.A.S.D. Arb.) (\$13,500 expert witness fee); *Bloomer*, 2002 WL 31971782, at \*3 (\$6,000 expert witness fee).

157. For claimant recoveries, see *Thurston*, 2003 WL 1192951, at \*1-2 (\$1,000,000 claim for selling conservative investments for investment trusts composed of technology and telecommunication stocks under the TSA; recovered \$66,500 and \$13,500 expert witness fee); *Vaughan v. A.G. Edwards & Sons, Inc.*, No. 01-01931, 2002 WL 31656639, at \*4-5 (Nov. 5, 2002) (N.A.S.D. Arb.) (\$2,600,000 claim for transactions in high risk stocks and mutual funds under TSA; recovered about \$145,000 plus \$60,000 costs); *Pryor v. CIBC World Mkts. Corp.*, No. 02-02367, 2003 WL 21262116, at \*1-2 (May 22, 2003) (N.A.S.D. Arb.) (\$500,000 claim for risky and unsuitable mutual fund investments under the Texas Securities Act (TSA), the Texas Stock Fraud Act (TSFA), and the Texas Deceptive Trade Practice Act (DTPA); recovered \$25,840); *Levitt v. A.G. Edwards & Sons, Inc.*, No. 01-04609, 2002 WL 31957693, at \*2-3 (Dec. 31, 2002) (N.A.S.D. Arb.) (\$699,897 claim for trading in unmanaged mutual fund shares (unitrusts) and day trading under TSA, TSFA, and DTPA; recovered approximately \$65,000). For respondent dismissals, see *Stein v. UBS Fin. Servs., Inc.*, No. 02-02931, 2003 WL 22096987, at \*2 (Aug. 25, 2003) (N.A.S.D. Arb.) (\$96,000 claim for recommendation of a volatile, high risk mutual fund for four conservative risk accounts, under TSA; dismissed and expunged); *Stanmyre v. Radzikowski*, No. 01-04778, 2003 WL 271331, at \*2 (Jan. 21, 2003) (N.A.S.D. Arb.) (\$2,300,000 claim for selling to claimants lesser known and extremely volatile risky high tech stocks under TSA, TSFA, and DTPA; dismissed); *Vitale v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 01-05618, 2003 WL 223360 (Jan. 14, 2003) (N.A.S.D., Arb.) (\$1,000,000 claim for recommending investment in high risk high tech companies under TSA, TSFA, and DTPA; dismissed); *Cutbirth v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 01-04013, 2003 WL 21183554, at \*2 (May 6, 2003) (N.A.S.D., Arb.) (\$500,000 claim for purchase of aggressive growth stocks, aggressive growth mutual funds and options under TSFA and DTPA; dismissed).

158. For claimant recoveries, see *Crusius v. Sunamerica Sec., Inc.*, No. 01-05590, 2003 WL 21221837, at \*2-3 (April 28, 2003) (N.A.S.D., Arb.) (\$2,500,000 claim for unauthorized investment in mutual funds; recovered \$2,500,000; ordered surrender of mutual funds by claimant; Karosa to reimburse brokerage for \$61,000 in commissions and pay exemplary damages of \$100,000); *Hersh v. Kaufman*, No. 02-01563, 2003 WL 1193047, at \*2-3 (Feb. 27, 2003) (N.A.S.D., Arb.) (\$67,000 and \$201,000 punitives under Florida law, but agreement is governed by Texas law, for failure to supervise, churning, and unauthorized trading; recovered \$67,000 and attorney's fees); *Coselli*, 2003 WL 450645, at \*2-3 (\$509,887 for losses on unsuitable penny stocks including mental anguish under DTPA, TSA, and TSFA; recovered \$436,398, plus attorney's fees of \$56,000 and costs of \$1,500). For respondent dismissals, see *Khavanin v. Fins. & Sec., Inc.*, No. 01-06669, 2003 WL 1986974, at \*2-3 (April 17, 2003) (N.A.S.D. Arb.) (\$227,583 claim for unauthorized trading of stock and failure to follow instructions under TSA, dismissed); *Rosemaladi v. First Union Sec., Inc.*, No. 01-07115, 2003 WL 21518515, at \*2 (June 18, 2003) (N.A.S.D., Arb.) (\$250,000 claim for unauthorized trades, churning, and unsuitable investments from 1994 to 1996 under TSA, TSFA, and DTPA; dismissed due to statute of limitation).

159. For claimant recoveries, see *Ikbal v. Cantella & Co., Inc.*, No. 02-01695, 2003 WL 22096732, at \*1-4 (Aug. 25, 2003) (N.A.S.D., Arb.) (\$500,000 claim for investments declined, under TSA and TSFA; dismissed and expunged as settled for \$169,500); *Adin v. Henry*, No. 00-02683, 2003 WL 1210899, at \*2-5 (Mar. 3, 2003) (N.A.S.D., Arb.) (about \$260,000 claim for purchase of debentures and common stock now worthless under TSA; recovered about \$50,000 against Stoeger who did not appear or answer; against remaining parties dismissed). For respondent dismissals, see *Howe*, 2003 WL 271329, at \*2-3

ity,<sup>160</sup> mismanagement of investments,<sup>161</sup> unregistered securities,<sup>162</sup> investments in Enron Corporation,<sup>163</sup> lack of broker supervision,<sup>164</sup> and execution errors.<sup>165</sup> Other reported actions did not specify the offense.<sup>166</sup>

#### D. COURT DECISIONS UNDER THE FEDERAL ACTS

The Fifth Circuit delivered four opinions involving the federal securities laws—one criminal action and three class actions under the Private Securities Litigation Reform Act of 1995 (PSLRA).<sup>167</sup> The criminal prosecution for fraud in a private placement offering under Section 17 of the Securities Act of 1933<sup>168</sup> involved various securities law challenges to the exclusion of expert witness testimony and to the jury charge. The three class actions, each dealing with the private cause of action under Rule 10b-5<sup>169</sup> under the Exchange Act of 1934, floundered on the failure to sufficiently plead a strong inference of scienter under the PSLRA.<sup>170</sup> The

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(\$1,000,000 claim for bond transactions under TSA, TSFA, and DTPA; dismissed and claimant ordered to pay brokerage \$2774 in attorney's fees).

160. For complainant recoveries, see *Ferguson*, 2003 WL 21441817, at \*2-3 (\$500,000 claim and \$5 million punitive for unsuitable trading, churning, and failure to supervise under TSA, TSFA, and DTPA; recovered from agent about \$425,000 with \$25,000 punitive, \$60,000 attorney fees, and \$8,000 costs when agent did not appear or answer); *Bloomer*, 2002 WL 31971782, at \*2-3 (\$63,000 claim for unsuitability of risky small-cap, high beta stocks purchased on margin under TSA; recovered \$78,000, \$20,000 attorney's fees under TSA, and \$6,000 expert witness fee).

161. For complainant recoveries, see *Robin Allen Revocable Trust v. Morgan Stanley Dean Witter*, No. 02-00400, 2003 WL 1860712, at \*2 (Mar. 24, 2003) (N.A.S.D., Arb.) (\$2,659,155 claim for gross mismanagement of a mutual fund under TSA, TSFA, and DTPA; dismissed and expunged as settled (amount unspecified)); *Freeman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 02-00117, 2003 WL 431608, at \*2 (Feb. 5, 2003) (N.A.S.D., Arb.) (\$360,535 claim for failure to supervise through mishandling of assets by various investment advisors selected by defendants under DTPA; recovered \$90,360).

162. For complainant recovery, see *de Luna Valenzuela*, 2002 WL 31656721, at \*1-2 (\$100,000 claim for purchase of unregistered security under the TSA, TSFA, and DTPA; recovered \$91,500 plus \$126,400 attorney's fees).

163. For respondent dismissals, see *McCandlish v. Salomon Smith Barney Inc.*, No. 02-00995, 2003 WL 21554344, at \*1 (June 20, 2003) (N.A.S.D., Arb.) (\$5,109 claim for recommendation of Enron bonds under DTPA; dismissed)

164. For complainant recovery, see *Waldrop v. UBS Painewebber, Inc.*, No. 02-01397, 2002 WL 21378124 (May 27, 2003) (N.A.S.D., Arb.) (\$2,800,000 claim for failure to supervise with respect to technology stocks under TSA, TSFA, and DTPA; recovered \$595,000).

165. For respondent dismissal, see *Roal Global Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 00-04163, 2003 WL 21439839, at \*1-2 (May 27, 2003) (N.A.S.D., Arb.) (\$9,000,000 claim for failing to execute limit orders and errors with respect to executions in trading of common stock and treasury securities under DTPA; dismissed).

166. For complainant recoveries, see *Prappas v. TD Waterhouse Investor Servs., Inc.*, No. 01-05299, 2003 WL 21262044, at \*1 (May 22, 2003) (N.A.S.D., Arb.) (\$500,000 unspecified under TSA and DTPA; dismissed and expunged as settled (amount unspecified)); *Rortler*, 2002 WL 31987266, at \*102 (100,000 claim for OTC trades and IPOs under TSA and DTPA; recovered \$62,000 and \$31,080 in attorney's fees).

For respondent dismissal, see *Givens v. Salomon Smith Barney, Inc.*, No. 01-06566, 2002 WL 331783079 (Nov. 25, 2002) (N.A.S.D., Arb.) (\$250,000 claim with respect to investment account under TSA, TSFA, and DTPA; recovered \$43,000).

167. 15 U.S.C. § 78u-4(b)(2) (1997).

168. 15 U.S.C. § 77q (1997).

169. 17 C.F.R. § 240.10b-5 (2003).

170. See 15 U.S.C. § 78u-4(b)(2) (1997).

Fifth Circuit used these three opinions to expand its protection of issuers from harassing lawsuits beyond the insufficiency of pleading scienter by motive and opportunity, as provided in *Nathenson v. Zonagen, Inc.*,<sup>171</sup> to include insufficiency of only additional hindsight for forward-looking statements and to also include insufficiency of only additional decision-making roles. One of the three also involved sections 11 and 12 of the Securities Act of 1933,<sup>172</sup> providing the Fifth Circuit an opportunity to join the Third Circuit in determining that general statements of future prospects are not material. Moreover, the Fifth Circuit joined other circuits in permitting aftermarket purchasers standing to sue under Section 11 for misstatements in registration statements.

In the criminal case of *United States v. Tucker*,<sup>173</sup> the chief executive officer of a company engaged in acquiring automobile loans and packaging them for sale to financial institutions and large investors, and also organized trusts with the goal of raising money for the company to borrow. The officer drafted a private placement memorandum for the sale of the trust certificates, representing that the trusts would only use the funds raised to invest in automobile loans, insurance reserves, or cash reserves. In Regulation D filings, the officer represented that the money would not be used for salaries, fees, or repayment of debt. The officer later prepared financial records demonstrating use of the offered proceeds as called for in the private placement memoranda, while actually the officer had used substantial amounts for company salaries, rent, legal fees, reimbursement payments to investors of earlier trusts, and other operating expenses, such as travel and entertainment. The officer also concealed information from the selling brokers concerning non-accredited investors investing in the trusts. To overturn his conviction for securities fraud, the officer devised a number of securities arguments with respect to the exclusion of his expert witness' testimony and the trial court's jury charge. The expert witness was to testify that (1) the securities industry use of the term "invest" included payment for certain operating expenses; (2) the certificates redeemable on demand were not "securities;" (3) the officer relied on advice of counsel that the certificates were not securities; and (4) the selling brokers, not the officer, were responsible for the Regulation D filings reporting an incorrect number of non-accredited investors. The court determined that excluding the testimony on the term "invest" was not manifestly erroneous, since the proceeds were used for other items, such as the Ponzi scheme of repayments to earlier investors. Ex-

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171. *Nathenson v. Zonagen*, 267 F.3d 400, 412 (5th Cir. 2001); see *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 867 (5th Cir. 2003) (citing *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 430 (5th Cir. 2002), for the proposition); *Goldstein v. MCI WorldCom*, 340 F.3d 238, 246 (5th Cir. 2003). Some other circuits claim that motive and opportunity are sufficient. See, e.g., *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000), cert. denied, 531 U.S. 1012 (2000); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525 (3d Cir. 1999). The Fifth Circuit differs from these other circuits on this point.

172. 15 U.S.C. § 77k-1 (1997)

173. *United States v. Tucker*, 345 F.3d 320 (5th Cir. 2003). The trial court was the Eastern District of Texas. *Id.* at 320.



clusion of the securities definition was proper since the officer only offered it for a legal determination, and the court believed under the Supreme Court's "family resemblance" approach that the certificates were securities.<sup>174</sup> To determine that exclusion of the officer's reliance testimony was proper, the Fifth Circuit adopted the Ninth Circuit's position that the focus is on the seller's intent to defraud investors, rather than the seller's belief concerning the nature of the securities.<sup>175</sup> Exclusion of the Regulation D testimony was proper since it would not be helpful to a trier of fact because the officer had sabotaged the broker's obligation. The officer presented two securities law challenges to the jury charge—that it failed to submit the "security" element to the jury and that it incorrectly stated the intent as "knowingly or willfully." The court found no error on the security element, since the officer had admitted this was a legal question and the judge found the certificates to be securities. Although the intent charge was incorrect, other parts of the jury charge made it quite clear that requisite *mens rea* included "willfully."<sup>176</sup>

In the class action dealing with forward-looking statements concerning purchases in the aftermarket for an initial public offering, *Rosenzweig v. Azurix Corp.*,<sup>177</sup> aftermarket investors in a global water and wastewater company filed a class action lawsuit complaining of optimistic, forward-looking statements. Such statements were made in the prospectus and registration statement, in post-IPO Securities and Exchange Commission filings, press releases, and in a news article. The class brought the action under both the Securities Act of 1933 and the Exchange Act of 1934.<sup>178</sup> The district court dismissed the action. The Fifth Circuit affirmed. In dismissing the fraud in connection with a sale action, the Fifth Circuit received another opportunity to deal with the sufficiency of scienter pleadings under the Exchange Act.<sup>179</sup> The PSLRA requires particularity of facts giving rise to a strong inference of scienter.<sup>180</sup> The class pled little more than insufficient motive and opportunity. The additional allegations related to statements in a subsequent report, subsequent failures of the company's core businesses, and subsequent resignation of officers. These allegations failed to provide a strong inference of scienter since they dealt only with a hindsight assessment of the company's forward looking statements—the alleged misrepresentations. The Fifth Circuit also grabbed the opportunity to partially insulate forward-looking statements as immaterial. The PSLRA provides a safe harbor provision for

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174. *Id.* at 329 (citing *Reves v. Ernst & Young*, 494 U.S. 56, 66-77 (1990)).

175. *Id.* at 331 (citing *United States v. Brown*, 578 F.2d 1280, 1284 (9th Cir. 1978); *Buffo v. Graddick*, 742 F.2d 592, 597 (11th Cir. 1984)).

176. *Id.* at 334-35.

177. *Rosenzweig v. Azurix Corp.*, 332 F.3d 854 (5th Cir. 2003). The trial court was the District Court of the Southern District of Texas. *Id.* at 854.

178. *Id.* at 861-62 (bringing the action under Sections 11, 12, and 15 of the 1933 Act and Rule 10b-5 under the 1934 Act).

179. *Id.* at 867-68; see *Flint*, *supra* note 4, at 2021-22 (discussing *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 430 (5th Cir. 2002)).

180. *Rosenzweig*, 332 F.3d at 866; see 15 U.S.C. § 78u-4(b)(2) (1997).

forward-looking statements if the speaker identifies the statement as a forward-looking statement and accompanies it with a meaningful cautionary statement.<sup>181</sup> All of the challenged documents satisfied this safe harbor provision. The Fifth Circuit, nevertheless, went on to join the Fourth Circuit by noting that generalized, positive statements about the company's strengths, management, and prospects are immaterial since analysts rely on facts, not company expressions of optimism in determining security prices.<sup>182</sup> Consequently, actionable predictive statements typically cause a price reaction, coupled with insider trading in suspicious amounts and at suspicious times, none of which did the class plead.<sup>183</sup> The Fifth Circuit disposed of the Securities Act action under standing and materiality. For the misrepresentation in a sale action,<sup>184</sup> the Fifth Circuit noted that liability falls only on the direct seller, his agent, or a financially interested party who solicits the sale.<sup>185</sup> The Fifth Circuit joined the Third Circuit by rejecting the class' contention that signing the registration statement constituted solicitation and requiring the solicitor to have a direct communication with the buyer.<sup>186</sup> For the misrepresentation in a registration statement action,<sup>187</sup> the Fifth Circuit joined several other circuits in finding that aftermarket purchasers have standing to sue.<sup>188</sup> Nevertheless, the Fifth Circuit dismissed the action, along with the control person action,<sup>189</sup> on the basis of its materiality rationale for the Exchange Act action.<sup>190</sup>

In the class action of *Goldstein v. MCI WorldCom*,<sup>191</sup> dealing with the decision-making role of the perpetrators, the class complained in a Rule 10b-5 action under the Exchange Act. The class asserted that the chief executive officer and chief financial officer delayed writing off \$685 million in uncollectible receivables to artificially inflate the stock price during a pending merger, which, when revealed, caused a twenty percent drop in the stock price. The district court dismissed the actions against the officers and the Fifth Circuit affirmed. The alleged misstatements ap-

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181. *Rosenzweig*, 332 F.3d at 866; see 15 U.S.C. § 78u-5(a)(ii) (1997).

182. *Rosenzweig*, 332 F.3d at 869 (citing *Raab v. Gen. Physics Corp.*, 4 F.3d 286, 290 (4th Cir. 1993)).

183. *Id.* at 870 (citing *Rubinstein v. Collins*, 20 F.3d 160, 169 (5th Cir. 1994)).

184. See 15 U.S.C. § 77l(a) (1997).

185. *Rosenzweig*, 332 F.3d at 871 (citing *Pinter v. Dahl*, 486 U.S. 622, 647 (1988)).

186. *Id.* at 871 (citing *Craftmatic Sec. Litig. v. Kraftsow*, 890 F.2d 628, 636 (3d Cir. 1989)).

187. See 15 U.S.C. § 77k(a) (1997).

188. *Rosenzweig*, 332 F.3d at 872-73 (citing *Demaria v. Andersen*, 318 F.3d 170, 175-78 (2d Cir. 2003); *Lee v. Ernst & Young, LLP*, 294 F.3d 969, 974-78 (8th Cir. 2002); *Joseph v. Wiles*, 223 F.3d 1155, 1158-61 (10th Cir. 2000); *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076, 1079-82 (9th Cir. 1999)). Supreme Court dicta in *Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561, 572 (1995), created the possibility that aftermarket purchasers lacked standing under Section 11. See *Rosenzweig*, 332 F.3d at 872.

189. 15 U.S.C. § 77o (1997).

190. *Rosenzweig*, 332 F.3d at 858-74.

191. *Goldstein v. MCI WorldCom*, 340 F.3d 238 (5th Cir. 2003). The district court was the Southern District of Mississippi. *Id.* at 238. Although this is not in Texas, the Fifth Circuit's opinion applies in Texas.

peared in press releases, telephone conferences with the investing community, Forms 10-K, and 10-Q, and a prospectus. The Fifth Circuit accepted the falsity of the statements for purposes of the dismissal on the basis of an SEC rule, deeming the financial statements not to have been prepared in accordance with Generally Accepted Accounting Practices.<sup>192</sup> The main issue for the Fifth Circuit dealt with what additional circumstantial evidence would satisfy the PSLRA's requirement for a strong inference of scienter when only motive and opportunity are insufficient. The class listed four additional items, besides the motive of performance-based compensation, as evidence of scienter: (1) the timing of the write-offs; (2) the size of the write-offs; (3) involvement in the day-to-day operations; and (4) decision-making roles. With respect to these items, the Fifth Circuit hunted for allegations that tied these events to the misstatements. The class provided no allegations tying the officers to the instruction of a lower officer to perform the write-off and so did not indicate knowledge of the instruction. The size of the write-offs were no greater than earlier write-offs of the company and did not indicate knowledge of the problem. Similarly, close involvement in management does not imply knowledge of the problem. As to the decision-making process, the class' pleadings indicated that the legal department, not the officers, initiated write-offs and this also did not indicate a knowledge of the problem. A second issue dealt with relief from the judgment due to new evidence, namely SEC filings, guilty pleas in criminal proceedings, numerous internal memoranda, various court pleadings, congressional documents, and press releases, to supply the missing strong inference of scienter.<sup>193</sup> Determining that the PSLRA does not bar such evidence, nevertheless, the class failed since they did not provide any explanation as to how the new evidence was material and controlling and would have produced a different result.<sup>194</sup>

In the third class action of *Zishka v. American Pad & Paper Co.*,<sup>195</sup> the class alleged misrepresentations with respect to an acquisition strategy, a pricing strategy, and in manipulating the last-in first-out accounting method to maintain false earnings. The district court dismissed the action and the Fifth Circuit affirmed since the class failed to adequately plead scienter. The only allegations to infer scienter involved insider trading and the officers' positions, which the Fifth Circuit found regular and insufficient to infer scienter.<sup>196</sup>

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192. *Id.* at 249 (citing 17 C.F.R. § 210.4-10(a)(1)).

193. *Id.* at 255-56 (under a FED. R. CIV. P. 60 motion for relief from the judgment).

194. *Id.* at 241-59.

195. *Zishka v. Am. Pad & Paper Co.*, 72 Fed. Appx. 130 (5th Cir. 2003). The district court was the Northern District of Texas. The opinion has little precedential value.

196. *Id.* at 131-32.