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# Texas Annual Survey: Securities Regulation

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# SECURITIES REGULATION

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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, the author has attempted to limit the material to that involving state law,[1] and only briefly touches federal securities law.[2] 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 SECURITIES ACTS

The definitions, especially those relating to the issues of what constitutes a security, who may recover, and the territorial reach, determine the scope of the securities acts.

### A. THE SECURITY DEFINITION

In the criminal case of *Bailey v. State*, the El Paso Court of Appeals faced the issue of whether a bank certificate of deposit constituted a security. The trial court had convicted the defendant of selling unregistered securities fraudulently without being a registered salesman in violation of the Texas Securities Act ("TSA"). The alleged securities were uninsured certificates of deposit issued by a Granadian bank, sold through advertisements touting the certificates as federally-insured. The definition of a security contained in the TSA does not include the phrase "certificate of deposit."[3] At trial, the Director of the Enforcement Division of the Texas

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1. Texas has two major statutes to combat securities fraud: the Texas Securities Act [hereinafter TSA] and the Texas Stock Fraud Act [hereinafter TSFA]. *See* TEX. REV. CIV. STAT. ANN. arts. 581-1-10 (Vernon Supp. 2004) ("TSA"); TEX. BUS. & COM. CODE ANN. § 27.01 (Vernon 2002) ("TSFA").

2. Since the Texas Legislature based portions of the TSA on the federal securities statutes and Texas courts rely on federal decisions to interpret the corresponding sections of the TSA, this article also examines federal developments in the Fifth Circuit. *See, e.g.*, COMMITTEE ON SECURITIES & INVESTMENT BANKING OF THE SECTION ON BANKING AND BUSINESS LAW OF THE STATE BAR OF TEXAS, COMMENT—*1977 Amendment*, following TEX. REV. CIV. STAT. ANN. art. 581-33 (Vernon Supp. 2004); Herman Holdings Ltd. v. Lucent Techs., Inc., 302 F.3d 552, 563-64 (5th Cir. 2002) (for TSA fraud provision, TEX. REV. CIV. STAT. ANN. art. 581-33 (Vernon Supp. 2004)).

3. *See* TEX. CIV. STAT. ANN. art. 581-4A (Vernon Supp. 2004).

State Securities Board ("Board") testified as an expert witness out of the presence of the jury that, in his opinion, the certificates were securities because they were "investment contracts" and "evidences of indebtedness," both of which are included within the definition of a security. Consequently, the trial court charged the jury that the certificates of deposit were securities. Focusing on the prosecution's U.S. Supreme Court cases laying out the tests for "investment contracts" and "uncollateralized and uninsured promissory notes," the appellate court held that whether certificates of deposit were securities was a fact question for the jury, not a question of law for the court, and so reversed and remanded for a new trial.[4]

Federal cases accepted by Texas courts, however, specify in the civil context that whether an instrument is a security is a matter of law.[5] But for criminal matters, the U.S. Supreme Court has determined that a criminal defendant has a right to a jury determination of all elements of the crime.[6] One element of the securities fraud conviction is that "securities" be sold or offered.

In the civil rescission case of *Griffitts v. Life Partners, Inc.*, the appellate court replayed the fact pattern of *SEC v. Life Partners Incorporated*[7] for the TSA rather than the federal securities acts.[8] The investment involved

4. Bailey v. State, 155 S.W.3d 346, 350 (Tex. App.—El Paso 2004, pet. struck). The U.S. Supreme Court cases were SEC v. Howey, 328 U.S. 293, 299 (1946) (defining an investment contract), and Reves v. Ernst & Young, 494 U.S. 56, 63 (1990) (laying out potential tests for whether a note is a security).

Under federal law, some cases find certificates of deposit to be securities, others find certificates of deposit not securities. *See* James L. Rigelhaupt, *Certificate of deposit as "Security" Under Federal Securities Laws*, 82 A.L.R. FED. 553, 566-86 (1987). The Securities Act mentions "certificates of deposit;" however, it probably refers to certificates issued for depositing other securities. 15 U.S.C. § 77b(a)(1) (1997) ("certificate of deposit for a security"). So a certificate of deposit in Texas would not be what is "commonly known as a security, whether similar to those herein referred or not." *See* TEX. REV. CIV. STAT. ANN. art. 581-4A (Vernon Supp. 2004).

5. *See* Reves v. Ernst & Young, 494 U.S. 56, 61 (1990) (evidence of indebtedness); SEC v. Life Partners, Inc., 87 F.3d 536, 540-41 (D.C. Cir. 1996) (investment contract); Campbell v. C.D. Payne & Gelderman Sec., Inc., 894 S.W.2d 411, 417-18 (Tex. App.—Amarillo 1995, writ denied).

6. *See* United States v. Gaudin, 515 U.S. 506, 510 (1995) ("We have held [the due process requirement of the Fifth Amendment] to require criminal conviction to rest upon a jury determination that the defendant is guilty of every element of the crime with which he is charged beyond a reasonable doubt.")

7. *See generally* SEC v. Life Partners, Inc., 87 F.3d 536, 541 (D.C. Cir. 1996) (Judge Ginsburg). The principal behind Life Partners, Incorporated is Brian D. Pardo. The author's law firm represented Pardo's prior public company, American Solar King Corporation, with respect to securities matters. After the author left Waco, the Securities and Exchange Commission [hereinafter SEC] sanctioned Pardo for filing fraudulent financial statements for American Solar King Corporation. *See* Accounting & Auditing Enforcement Act, SEC Litigation Rel. No. 12762, 48 SEC Docket 64 (Jan. 18, 1991) (consent to permanent injunction); *Complaint Names Ask Corp. & Brian D. Pardo* 1989 SEC News LEXIS 115, July 29, 1989, *available at* SEC News Digest Issue No. 89-137 (complaint for materially overstating revenues in 1983, 1984, and 1985); *see also* Fine v. Am. Solar King Corp., 919 F.2d 290, 293-94 (5th Cir. 1990) (detailing the method of overstatement), *cert. denied sub nom.* Main Hurdman v. Fine, 502 U.S. 976 (1991).

8. The definition of "security" is not exactly the same under the two acts, but for the instruments in question, they resemble each other. *Compare* TEX. REV. CIV. STAT. ANN.

a purchase of a viatical settlement by an IRA. In a viatical settlement, the investor acquires a fractional interest in a life insurance policy held by a terminally ill person for a steep discount that depends on the insured's remaining life expectancy. The success of the investment depends on pre-sale estimates of the insured's life expectancy and the post-sale length of the insured's life. Federal law does not permit IRAs to invest in insurance contracts,[9] so the transaction is structured through a trust, which buys the interest in the insurance contract and sells a non-recourse promissory note, secured by the insurance policy proceeds, to the investor. The District of Columbia Circuit Court, in an opinion by Justice Ruth Ginsburg, determined that the viatical interest was not an investment contract under the federal securities laws because, although it satisfied the expectation of profits and common enterprise elements, it lacked profits derived from the non-ministerial efforts of others post-sale. The dissent urged that the non-ministerial pre-sale efforts, where the potential for fraud exists, should satisfy the requirement. The Circuit Court also determined that the promissory note feature would not turn the non-securities investment into a security. In the replay under the Texas statute, the Texas trial court granted a motion for summary judgment denying the rescission of the purchase. The appeals court affirmed and noted that the Texas Supreme Court has accepted the federal definition of an investment contract, contained in the TSA,[10] and that Texas courts additionally have found the profits-from-the-efforts-of-others element unsatisfied when the investor merely holds an investment in anticipation of maturity.[11] The Board does not agree.[12] Similarly, the court refused to convert the transaction into a security because of the use of the trust and note structure for IRA investments.[13]

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art. 581-4A (Vernon Supp. 2004) ("mortgage certificate or other evidence of indebtedness . . . investment contract . . . or any other instrument commonly known as a security . . . .") *with* 15 U.S.C. § 77b(a)(1) (2002) ("evidence of indebtedness . . . investment contract . . . any instrument commonly known as a security . . . ."); *see also* Searsy v. Commercial Trading Corp., 560 S.W.2d 637, 639 (Tex. 1977) ("'investment contract' and 'evidence of indebtedness' of the TSA appear to have been taken from . . . the Securities Act of 1933").

9. *See* I.R.C. § 408(a)(3) (2002).

10. *See Searsy*, 560 S.W.2d at 640.

11. *See* Wilson v. Lee, 601 S.W.2d 483, 486 (Tex. Civ. App.—Dallas 1980, no writ) (interests in raw land); McConathy v. Dal Mac Commercial Real Estate, Inc., 545 S.W.2d 871, 875 (Tex. Civ. App.—Texarkana 1976, no writ) (same).

12. *See In re* Agent Registration of Larry James Kiefer, No. IC04-SUS-02, 2004 WL 284157, at *2-3 (Tex. St. Sec. Bd. Jan. 30, 2004) (finding viatical settlements securities in order to reprimand and suspend agent for selling unregistered interests in viatical settlements).

13. Griffitts v. Life Partners, Inc., No. 10-01-00271-CV, 2004 WL 1178418, at *3 (Tex. App.—Waco May 26, 2004, pet. granted). The court summarily disregarded plaintiff's arguments for securities status by reason of "other evidences of indebtedness," also included in the definition of securities under the TSA, as insufficiently fleshed out. Since the court found no security, it did not reach the insurance contract exception to the definition of a security under the TSA. *See* TEX. REV. CIV. STAT. ANN. art. 581-4A (Vernon Supp. 2004).

### B. STANDING TO SUE

In *Caso-Bercht v. Striker Industries, Inc.*, the Corpus Christi Court of Appeals confronted the argument that shareholders holding in "street name" as beneficial owners have no standing to sue for the fraud remedies under both the state and federal securities laws. The securities laws provide remedies for purchasers and sellers,[14] since these investors generally have privity with the fraudulent promoter. The trial court granted summary judgment dismissing the investors' causes of action based on affidavits claiming the issuer's records showed no purchases by the investors, but without attaching those records. It is well known, and the appellate court took judicial notice, that many shareholders purchase securities in street name, thrice removed from the name appearing on the issuer's shareholder list. The shareholder leaves the securities with their broker, who leaves them with a depository firm, who uses a nominee name for the issuer's shareholder list. Securities and Exchange Commission regulations provide that brokers and depositories must compile a list of non-objecting beneficial owners with name, address, and positions at an issuer's request within five business days.[15] This means that the issuer could have discovered the identities of most of the beneficial owners had they tried. Based on decisions under federal law permitting beneficial owners to sue,[16] the court concluded that beneficial owners had sufficient interests to sue for fraud with respect to the purchases made through their brokers' depository by their brokers exercising authority under discretionary accounts. The investors showed that the issuer's shareholder list contained the name of their depository. Since the issuer's supporting affidavits for the summary judgment did not mention the depository's name or the possibility that the investors were beneficial owners, the affidavits were defective as not attaching the issuer's records. The court reversed the trial court's summary judgment.[17]

In *Kelly v. Rio Grande Computerland Group*, the El Paso Court of Appeals dealt with another standing problem, this time with respect to the Texas Stock Fraud Act ("TSFA"), for a corporate officer expelled by the new controlling owners of the corporation. The officer had entered into a stock issuance agreement with the new owners for sixty percent of the corporation. The prior letter of intent for the transaction provided for a

14. *See* TEX. CIV. STAT. ANN. art. 581-33A (Vernon Supp. 2004) ("to the person buying the security from him"); TEX. CIV. STAT. ANN. art. 81-33B (Vernon Supp. 2004) ("to the person selling the security to him"); 15 U.S.C. § 77k(a) ("any person acquiring"); 15 U.S.C. 77l(2) (2002) ("person purchasing such security from him").

15. *See* 17 C.F.R. § 240.14b-1(b)(3)(i) (2004).

16. *See* 7547 Corp. v. Parker & Parsley Dev. Partners, 38 F.3d 211, 226-29 (5th Cir. 1994) (beneficial owners of limited partnership units exchanged for stock had standing to sue under section 10-b and Rule 10b-5 of the Securities Act for misrepresentations and omissions); *In re* Nucorp Energy Sec. Litig., 772 F.2d 1486, 1489-90 (9th Cir. 1985) (can expressly assign a cause of action under the trust indenture act for misrepresentation or omission).

17. Caso-Bercht v. Striker Indus., 147 S.W.3d 460, 466 (Tex. App.—Corpus Christi 2004, pet. ref'd).

shareholder agreement to elect the officer as a director and an employment agreement for the officer. These documents were never prepared, and the new owners never elected the officer as a director and fired him as officer within five months of the closing. Among the many causes of action was the claim under the TSFA, which allows recovery for fraudulently inducing a person to enter into a contract involving the sale of stock.[18] The officer contended that the representations made in the letter of intent were future promises of material facts made with no intention of fulfilling them. The trial court had granted summary judgment to the new owners based on the idea that only a purchaser or seller of stock can enforce the TSFA. The appellate court noted that the specific language of the TSFA is not limited to purchasers or sellers, but permits a remedy to a person induced into the contract involving the sale of the stock.[19] The court reversed the summary judgment and remanded.[20]

### C. Territorial Extent

The two courts considering the application of the Texas securities acts in multi-state situations used the most significant relations test adopted by the Texas Supreme Court.[21] Both cases dealt with those who assisted in the fraud.[22] It is not clear that this is the correct approach to handle the choice of law issue for the TSA. The most significant relations test applies only if the state statute does not contain a directive.[23] Last year, a Texas court adjudicating an action against an unregistered seller selling from Texas to non-residents ruled that the TSA contained a directive to use Texas law.[24] The test of the Texas Supreme Court, however, might

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18. Tex. Bus. & Com. Code Ann. § 27.01(a)(2) (Vernon 2002) ("Fraud in a transaction involving . . . stock in a corporation . . . consists of a false promise to do an act, when the false promise is (a) material; (b) made with the intention of not fulfilling it; (c) made to a person for the purpose of inducing the person to enter into a contract . . . .").

19. Tex. Bus. & Com. Code Ann. § 27.01(b) (Vernon 2002) ("A person who makes . . . a false promise . . . is liable to the person defrauded . . . ."). For additional support, the court in *Caso-Bercht* cited cases under the TSA, a statute that mentions only the liability of sellers and purchasers. *See* Tex. Rev. Civ. Stat. Ann. arts. 581-29(c), 581-33 (Vernon Supp. 2004) (penal and civil provisions, providing remedies for co-venturers against the venturing promoter); Lewis v. Davis, 199 S.W.2d 146, 149 (Tex. 1947) (prior version of the TSA); Manley v. State, 774 S.W.2d 334, 338 (Tex. App.—Austin 1989, writ ref'd).

20. Kelly v. Rio Grande Computerland Group, 128 S.W.3d 759, 771 (Tex. App.—El Paso 2004, no pet. h.).

21. *See* Hughes Wood Prods., Inc. v. Wagner, 18 S.W.3d 202, 205 (Tex. 2000) (citing Restatement (Second) of Conflict of Laws § 6(2) (1971), the law in Texas since 1979).

22. *See* Tex. Rev. Civ. Stat. Ann. art. 581-33F(2) (Vernon Supp. 2004).

23. *See* Restatement (Second) of Conflict of Laws § 6(1) (1971) ("A court, subject to its constitutional restrictions will follow a statutory directive of its own state on choice of law . . . .").

24. *See* Citizens Ins. Co. of Am. v. Hakim Daccach, 105 S.W.3d 712, 723 (Tex. App.—Austin 2003, pet. granted) (the issue arose in an attempt to defeat a class certification). The rationale was that the definition of sale included "every disposition," including those made from Texas. *See* Tex. Rev. Civ. Stat. Ann. art. 581-4E (Vernon Supp. 2004). So the remedy for the sale of securities by an unregistered dealer under the TSA applied to sales made from Texas affecting non-residents. *See* Tex. Rev. Civ. Stat. Ann. art. 581-33A(1) (Vernon Supp. 2004). The State Securities Board has long contended the TSA

not conclude similarly.[25] The issue will be whether the statutory directive must provide the choice of law rule or merely an unlimited definition implying Texas law.

The importance of whether the TSA applies to the transaction involves the ability to recover. The New York Blue Sky Law does not provide for an express or implied remedy for securities fraud.[26] The Uniform Securities Act, adopted by many states, does not provide for aider liability.[27]

In *Greenberg Traurig of New York, P.C. v. Moody*, the Houston Fourteenth District Court of Appeals dealt with an out-of-state bankrupt corporation that had sold its securities to Texas accredited investors under the representation that an initial public offering was imminent. The investors sued the New York law firm, which parties handled in handling the corporation's securities matters, for assisting the corporation's fraud by failing to disclose certain items that would have tipped investors to the fact that the corporation's principal was a defrauder. The investors had no contact or direct dealings with the law firm. The acts of the law firm participating in the fraud consisted of an opinion letter used to obtain a bank loan, a communication to some shareholders with respect to a rescission offer, attendance at the annual shareholder meeting, and introducing the corporation to investment bankers. All of these acts enabled the corporation to maintain the illusion of an imminent public offering; all the acts occurred in New York. The jury found the law firm liable for violations of the TSA and the TSFA, among other causes of action, and the trial court awarded substantial damages. Focusing on the factors mandated by the most significant relationship test for torts and damages arising from fraud,[28] predominately where the conduct occurred, the ap-

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applied to sales made from Texas to non-residents. *See* Enntex Oil & Gas Co. v. State, 560 S.W.2d 494, 497 (Tex. Civ. App.—Texarkana 1977, writ ref'd n.r.e.) (Regulation B offering) (citing Rio Grande Oil Co. v. State, 539 S.W.2d 917, 921 (Tex. Civ. App.—Houston [1st Dist.] 1976, writ ref'd n.r.e.)); 7 TEX. ADMIN. CODE § 139.7 (West 2005). Texas courts have also held that similar statutory definitions constitute the directive for the choice of Texas law, even for the reverse situation of out-of-state facts affecting Texas residents. *See* Busse v. Pac. Cattle & Feeding Fund No. 1, Ltd., 896 S.W.2d 807, 814 (Tex. App.—Texarkana 1995, writ denied) (definition of "trade" as including a sale "wherever situated" meant Texas Deceptive Trade Practices Act, TEX. BUS. & COM. CODE ANN. § 17.45(6) (Vernon 2002), applied to out-of-state acts affecting Texas residents).

*But see* Lutheran Bhd. v. Kidder Peabody & Co., 829 S.W.2d 300, 309-10 (Tex. App.—Texarkana 1992, pet. granted, *jdgm't vacated w.r.m.*, 820 S.W.2d 384 (Tex. 1992)) (using the most significant relations test for misrepresenting out-of-state seller under TEX. REV. CIV. STAT. ANN. arts. 581-33A(2) (Vernon Supp. 2004), concluding Texans use TSA, non-Texans do not).

25. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 6 cmt. to 6(1) (1971) (stating that such statutes are rare, and providing examples from the Uniform Commercial Code mentioning parties choice of law specifically); *see also* Mitchell v. State Farm Ins. Co., 68 P.3d 703, 708 (Mont. 2003) (using § 6(1) to use MONT. CODE ANN. § 28-3-102 (2003) (to interpret a contract, use law where performed)); State *ex rel.* Smith v. Early, 934 S.W.2d 655, 657 (Tenn. App. 1996) (using § 6(1) to use TENN. CODE ANN. § 36-5-207(a) (2001) (for support, use laws of "state where obligor was present during period for which support is sought")).

26. *See* CPC Intern'l, Inc. v. McKesson Corp., 514 N.E.2d 116, 118-19 (N.Y. 1987).

27. *See* TEX. REV. CIV. STAT. ANN. arts. 581-33 cmt. 33F (Vernon Supp. 2004).

28. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 145, 148 (1971).

pellate court noted that substantially all the conduct occurred in New York, rather than Texas. The appellate court then examined the general principles of the most significant relationship test. It noted that (1) New York has a substantial interest in regulating fraudulent conduct in New York, (2) New York lawyers rendering legal services in New York would have no reasonable expectations that Texas law would apply, and (3) Texas has no interest in regulating the communications between New York lawyers and their non-Texas clients. Consequently, the court reversed judgments with respect to the TSA and the TSFA, and in light of the New York rule against express and implied private causes of action, rendered judgment.[29]

The rationale behind the passage of the Blue Sky laws was to allow the state to protect its citizens from fraud perpetrated out of state.[30] Certainly, Texas has an interest in preventing out of state acts that aid commission of fraud on Texas residents, rather than to insulate acts that aid fraud solely because they occurred out of state. These aiders know and expect that, if the securities are sold to Texans, the TSA applies to those transactions. It is not clear that the court decided this matter correctly, ignoring these two elements of the choice of law test.

In *Grant Thornton LLP v. Suntrust Bank*, the Dallas Court of Appeals considered the reverse situation. A corporation headquartered in Texas sold securities to non-residents by means of misstatements contained in the registration statement. Since the stock plunged in value, two non-resident investors sought class certification for violation of the federal and Texas securities acts against the corporation's independent auditors. The acts aiding the corporation's fraud consisted of amending the registration statement's financials to claim "accounting error" rather than management misrepresentations that mislabeled certain transactions as sales rather than consignments resulting in an overstatement of earnings. The aid also included failure to disclose the auditors' payment from the proceeds of the offering. The trial court certified the class. The auditors opposed the certification on interlocutory appeal on the ground that the choice of law issue mandated that all fifty state's securities laws destroyed the uniformity of issues for the class. Applying the factors mandated by the most significant relationship test for torts and damages arising from fraud,[31] the court could not decide which law applied because receipt by

29. Greenberg Traurig of New York, P.C. v. Moody, No. 14-02-00581-CV, 2004 WL 2188088, at *38 (Tex. App.—Houston [14th Dist.] Sept. 30, 2004, no pet. h.).

30. *See* Merrick v. N.W. Halsey & Co., 242 U.S. 568, 588 (1917) (purpose is to prevent fraud against Michigan residents); Caldwell v. Sioux Falls Stock Yard Co., 242 U.S. 559, 564 (1917) (in title to prevent fraud in sale of securities to South Dakota residents); Hall v. Geiger-Jones Co., 242 U.S. 539, 557-58 (1917) (prevention of deception against Ohio residents); Jonathan R. Macey and Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 353-60 (1991) (purpose is to prevent sale to local residents of overvalued, speculative and fraudulent securities); Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 19-20 (1983) (in response to corporate fraud schemes of 1910-1987 on local residents).

31. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 145, 148 (1971).

many investors of the prospectus and purchases occurred outside of Texas and was balanced by the auditors' work and misrepresentations occurring in Texas. Turning to the general principles of the most significant relationship test, the court noted that: Texas had the most incentive to regulate corporations operating in Texas; the Texas act is not limited to protecting residents, other states with aid prohibitions or short statutes of limitations have little interest in regulating auditors of corporations in Texas; investors in corporations in Texas would expect Texas law to apply, other states support the Texas policy of protecting investors; and allowing Texas law to apply to corporations in Texas provides certainty and ease of application. The court concluded the trial court did not err in applying the TSA to all investors, including non-residents.[32]

## II. ORGANIZATION OF THE STATE SECURITIES BOARD

The TSA created the State Securities Board ("Board"), a regulatory body to handle the registrations required by those laws, as well as to serve as an enforcement mechanism. The Board amended its hearings rules to give the Director of Inspections and Compliance Division authorization to sign a notice of hearing in an administrative case filed with the State Office of Administrative Hearings; this removed the need to keep assistant directors in the Enforcement Division in that capacity.[33]

## 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 registration. The Board made several cosmetic changes to its securities registration rules to reflect current developments. The Board amended its rules regarding applications for registration,[34] forms for registration,[35] conditional exemption for money market funds,[36] and filings and fees[37] to reflect recent changes to the TSA.

The Board had numerous enforcement actions against issuers who did not register their securities, and some involved the internet.[38] One action

32. Grant Thornton LLP v. Suntrust Bank, 133 S.W.3d 342, 361 (Tex. App.—Dallas 2004, pet. filed).

33. 29 Tex. Reg. 7966 (2004) (amending 7 TEX. ADMIN CODE § 105.6 without comment); 29 Tex. Reg. 1756 (2004) (proposed Feb. 27, 2004).

34. 29 Tex. Reg. 1643 (2004) (amending 7 TEX. ADMIN CODE § 113.4 without comment); 28 Tex. Reg. 9176 (2003) (proposed Oct. 24, 2003).

35. 29 Tex. Reg. 1645 (2004) (amending 7 TEX. ADMIN CODE §§ 133.7, 133.12, 133.13, 133.26 without comment); 28 Tex. Reg. 9180 (2003) (proposed Oct. 24, 2003).

36. 29 Tex. Reg. 1644 (2004) (amending 7 TEX. ADMIN CODE § 123.3 without comment); 28 Tex. Reg. 9179 (2003) (proposed Oct. 24, 2003).

37. 29 Tex. Reg. 1643 (2004) (amending 7 TEX. ADMIN CODE § 114.4 without comment); 28 Tex. Reg. 9176 (2003) (proposed Feb. 20, 2004).

38. *See* Auto Depot, Order No. ENF-04-CDO-1575, 2004 WL 2359727, at *1 (Tex. St. Sec. Bd. Oct. 11, 2004) (emergency cease and desist order for internet offer of unregistered notes by unregistered dealers with respect to substandard auto credit without disclosing federal tax liens, two Texas judgments against the company, risks of the notes, financial information, and the identity of the principals); *In re* Nat'l Private Mortgage Serv., Inc.,

involved a challenge to an emergency cease and desist order.[39] A considerable portion dealt with sale of oil and gas working interests.[40] Others involved botched attempts at exemptions from registration,[41] non-disclosures of material information,[42] and sales to the public without proper

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Order No. ENF-04-CDO-1567, 2004 WL 1869744, at *1 (Tex. St. Sec. Bd. Aug. 10, 2004) (emergency cease and desist order for internet offer of unregistered lending by unregistered dealers of loans for real estate development without disclosing bankruptcy of, and tax lien against, the principal, financial data; risks of adverse economic conditions; effect of delays; potential conflict of interests; short operating history; and losses not covered by insurance); *In re* Manhattan Gold, Inc., No. ENF-04-CDO-1558, 2004 WL 859153, at *1 (Tex. St. Sec. Bd. April 8, 2004) (emergency cease and desist order for sale of unregistered stock by unregistered dealers on the internet); *In re* Mid-Continent Oil & Gas, Inc., No. ENF-04-FIN-1557, 2004 WL 596705, at *1, 3 (Tex. St. Sec. Bd. Mar. 15, 2004) (agreed cease and desist order with two administrative fines of $1,250 for offering oil and gas working interests in Texas wells to Texans on the internet).

39. *See In re* Thell G. Prueitt, Order No. ENF-04-CDO-1572, 2004 WL 2314506, at *3 (Tex. St. Sec. Bd. Sept. 22, 2004) (confirming emergency cease and desist order against investment contract for ATM machine sold by seminar); *see also In re* Thell G. Prueitt, Order No. CDO-1538, 2003 WL 22284602, at *1 (Tex. St. Sec. Bd. Sept. 22, 2004).

40. *See In re* Hew-Tex Oil & Gas Corp., Order No. ENF-04-CDO-1571, 2004 WL 2077464, at *1 (Tex. St. Sec. Bd. Sept. 8, 2004) (cease and desist order to company selling unregistered oil and gas working interest in Louisiana well without registering as a dealer and without disclosing a Pennsylvania cease and desist order); *In re* Dunwell Corp., Order No. ENF-04-CDO-1569, 2004 WL 1925428, at *1 (Tex. St. Sec. Bd. Aug. 20, 2004) (emergency cease and desist order to company selling oil and gas working interests in Alabama without disclosing use of funds if insufficient, unlimited liability of working interest, financial data, prior drilling results, and other offers on different terms, and misleading investors with claim of no production declines over eight years and describing the risk as "some risk"); *In re* Allied Energy Group, Order No. ENF-04-CDO-1562, 2004 WL 1217359, at *1-3 (Tex. St. Sec. Bd. May 27, 2004) (agreed cease and desist order and administrative fine of $8,000 for unregistered oil and gas working interests in Texas without registering as a dealer and without disclosing a Kentucky cease and desist order); *In re* First Am. Operating Co., Order No. ENF-04-CDO-1563, 2004 WL 284158, at *1-2 (Tex. St. Sec. Bd. Jan. 30, 2004) (emergency cease and desist order for unregistered oil and gas working interests in Texas without registering as a dealer; misrepresentations regarded flow gas from a particular well, low risk when there was unlimited liability, claim of ninety percent success rate, and no disclosure of judgments, fines, and lack of good standing as an operator of corporation).

41. *See In re* FilmMates Partners, LLC, No. ENF-04-CDO-1556, 2004 WL 506199, at *1 (Tex. St. Sec. Bd. Mar. 5, 2004) (emergency cease and desist order for offer of unregistered units of California limited liability company by unregistered dealers allegedly exempt for accredited investors, sold by representing minimal risk, registered with SEC, and exempt from TSA, when offering document says high risk and exempt from federal registration, and urging all investors to represent accredited investor status); *In re* KnowledgeBroadcasting.com., LLC, Order No. ENF 04-CDO/FIN-1551, 2004 WL 97526, at *1 (Tex. St. Sec. Bd. Jan. 9, 2004) (cease and desist order with administrative fine of $5,000 for selling unregistered preferred units to Texas investors by unregistered dealers pursuant to a confidential information memorandum).

42. *See In re* Am. Merchant Consultants, Inc., Order No. ENF-04-CDO-1573, 2004 WL 2314505, at *1 (Tex. St. Sec. Bd. Sept. 27, 2004) (emergency cease and desist order for sale of ATMs with servicing contract without disclosing financials and identities of officers and directors); *In re* Kevin D. Sepe, Order No. ENF-04-CDO-1570, 2004 WL 2077463, at *1 (Tex. St. Sec. Bd. Sept. 2, 2004) (emergency cease and desist order for sale of unregistered stock in companies without dealer registrations and misrepresenting present and future takeover possibilities and omitting bankruptcy filings of principals and financials of companies); *In re* John Frederick Williams II, Order No. ENF-04-CDO-1568, 2004 WL 1925427, at *1 (Tex. St. Sec. Bd. Aug. 20, 2004) (emergency cease and desist order for the sale of unregistered investment program in heart and body scan imaging center with twenty percent of common stock sold through newspaper ads without disclosing company

registration.[43]

The Board also issued a number of no-action letters dealing with issuers. These dealt with plans to privately place notes of a country club to members,[44] to offer limited partnership interests to fund insurance premiums,[45] to issue certificates of deposit,[46] and to buy and sell limited partnership interests for firm members.[47]

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not of record with Secretary of State, bankruptcies, and forgery conviction of principals); *In re* Glen R. ("Corkey") Campbell, Order No. ENF-04-CDO-1566, 2004 WL 1631681, at *1 (Tex. St. Sec. Bd. July 15, 2004) (emergency cease and desist order for sale by newspaper of investment program to purchase land and resell under lease/purchase or contract-for-deed misrepresenting it as "absolutely safe" and without disclosing the risks of defaults and financials of guarantor); *In re* Ronald Rae Barrick, Order No. ENF-04-CDO-1564, 2004 WL 1474955, at *1 (Tex. St. Sec. Bd. June 17, 2004) (agreed cease and desist order for sale by newspaper of unregistered foreclosure investment program, flipping foreclosures and splitting the profits, by unregistered dealer without disclosing disbarment, fraud conviction, jail term, and restitution payment of principal); *In re* BHT Inv. Inc., Order No. ENF-04-CDO-1559, 2004 WL 859154, at *1-2 (Tex. St. Sec. Bd. April 13, 2004) (emergency cease and desist order for sale of unregistered investment opportunities, one to buy late model cars and sell on e-Bay.com, the other to participate in T-bill lending contracts, by unregistered dealers without disclosing default judgments of principals for investment agreements, the risks involved, and the company's operating history).

43. *See In re* Marc Randall Hall, Order No. ENF-04-CDO-1565, 2004 WL 1599841, at *1 (Tex. St. Sec. Bd. July 6, 2004) (agreed cease and desist for sale of unregistered builder investment program by unregistered dealer using funds to buy land, build homes, and sell to the public, splitting the profits); *In re* Cash Link Sys. Inc., Order No. ENF-04-CDO-1563, 2004 WL 1217363, at *1-2 (Tex. St. Sec. Bd. May 27, 2004) (agreed cease and desist order with administrative fine of $2,000 for sale of unregistered investment contract, an ATM machine with service contract, by unregistered dealers); *In re* Midessa Prop., LP, Order No. ENF-04-CDO-1561, 2004 WL 1017064, at *1-2 (Tex. St. Sec. Bd. April 29, 2004) (agreed cease and desist order for sale of unregistered secured first mortgages of Texas single family homes by unregistered dealers); *In re* Edward D. Karaback, Order No. ENF-04-CDO-1560, 2004 WL 1017063, at *1 (Tex. St. Sec. Bd. April 27, 2004) (agreed cease and desist order for sale of unregistered penny stock management program by unregistered dealers in newspapers).

44. *See In re* Riverhill Country Club, Tex. St. Sec. Bd. No-Action Letter, 2004 WL 2077475, at *1 (July 30, 2004) (granted); *In re* Dallas Pistol Club, Inc., Tex. St. Sec. Bd. No-Action Letter, 2004 WL 2077472, at *1 (April 26, 2004) (some sales to non-members, granted).

45. *See In re* Elite Premium Fin., Ltd., Tex. St. Sec. Bd. No-Action Letter, 2004 WL 2077477, at *1 (July 30, 2004) (to the insurance agents selling the insurance structured to comply with the Texas Insurance Code; granted as heavily regulated by the Department of Insurance); *In re* First Portfolio Funding, Ltd., Tex. St. Sec. Bd. No-Action Letter, 2004 WL 2077469, at *1 (Jan. 16, 2004) (same).

46. *See In re* GMAC Commercial Mortgage Bank, Tex. St. Sec. Bd. No-Action Letter, 2004 WL 2077474, at *1 (June 28, 2004) (although Utah industrial loan corporation is not technically a bank and hence does not fit the exemption from registration for banks (citing TEX. REV. CIV. STAT. ANN. art. 581-5L (Vernon Supp. 2004)); *In re* State Farm Fin. Servs., F.S.B., Tex. St. Sec . Bd. No-Action Letter, 2004 WL 2077473, at *2-3 (May 5, 2004) (decline to recommend, since sale by third parties does not fit exemption for banks, TEX. REV. CIV. STAT. ANN. art. 581-5L (Vernon Supp. 2004), and since amounts over the federal insurance of $100,000 do not fit exemption for guaranteed securities, TEX. REV. CIV. STAT. ANN. art. 581-5M (Vernon Supp. 2004), and third parties are dealers requiring registration, but will recommend they need not take examination over general securities if sales limited).

47. *See In re* Wortham Fin., LP, Tex. St. Sec. Bd. No-Action Letter, 2004 WL 2077471 (Mar. 9, 2004) (granted for restructuring of firm to permit small numbers of members to enter and leave firm, with one entity the buyer and seller of the limited partnership units from and to the members, provided no more than ten in any twelve months).

## IV. REGISTRATION OF MARKET OPERATORS

One of the underpinnings of state regulation of securities is the requirement to register as a seller of securities before selling securities in the state and as an investment advisor before rendering investment advice.[48] Registration infractions generally surface when applying or reapplying for registration.

### A. DEALERS

The State Securities Board amended its rules for registration of dealers several times during the Survey period. The Board added a section exempting dealers and their agents from the Board's rules if an exemption from registration is available or if the antifraud provisions do not apply.[49] The Board amended its rule on the application of branch managers; the Board reduced the examination qualification requirements of branch managers operating branches limited to activities within the managers' qualification so as to avoid waiver requests and the subsequent undertaking agreements.[50] The Board added several new record keeping requirements, focusing on compliance documentation and extending the retention period to improve the ability of registered dealers to carry out their supervisory duties and expending the period for the Board to inspect registered dealers and coordinate the rules with the federal requirements.[51] The Board also amended its fee requirements for dealers[52] and its exemption for third party brokerage arrangements on financial entity premises,[53] to correspond to recent legislative changes.

The Board pursued numerous enforcement actions against selling agents and dealers. Selling agent infractions involved selling securities

48. *See* TEX. REV. CIV. STAT. ANN. art. 581-13 (Vernon Supp. 2004).
49. 29 Tex. Reg. 7966 (2004) (amending 7 TEX. ADMIN CODE § 115.1 without comment); 29 Tex. Reg. 1758 (2004) (proposed Feb. 27, 2004).
50. 29 Tex. Reg. 7968 (2004) (amending 7 TEX. ADMIN CODE § 115.2 without comment); 29 Tex. Reg. 1759 (2004) (proposed Feb. 27, 2004).
51. 28 Tex. Reg. 9236 (2003) (amending 7 TEX. ADMIN CODE § 115.5 without comment); 28 Tex. Reg. 5949 (2003) (proposed Aug. 1, 2003).
52. 29 Tex. Reg. 1643 (2004) (amending 7 TEX. ADMIN CODE § 115.8 without comment); 28 Tex. Reg. 9177 (2003) (proposed Oct. 24, 2003).
53. 29 Tex. Reg. 1645 (2004) (amending 7 TEX. ADMIN CODE § 139.20 without comment); 28 Tex. Reg. 9181 (2003) (proposed Oct. 24, 2003).

while unregistered[54] for another dealer,[55] and failing to timely disclose outside business or other material information. Dealer infractions involved operating branch offices without registration[56] and the failure to supervise selling agents.[57]

The Board also issued a no-action letter dealing a proposal to auction oil and gas interests over the internet through selling agents.[58]

### B. Investment Advisers

The Board twice amended its rules for registration of investment advisers. The Board added a section exempting investment advisers from the Board's rules if an exemption from registration is available or if the antifraud provisions do not apply.[59] The Board also amended its fee requirements for investment advisers to correspond to recent legislative

54. *See In re* Rosemary Laughlin, Order No. ENF-04-CDO-1574, 2004 WL 2334055, at *1 (Tex. St. Sec. Bd. Oct. 6, 2004) (agreed cease and desist for selling unregistered oil and gas working interest in Louisiana while unregistered); *In re* Agent Registration of John Frank Lopez, Order No. IC04-SUS-13, 2004 WL 1812690, at *2-3 (Tex. St. Sec. Bd. July 30, 2004) (reprimanding and suspending for thirty days for selling unregistered coin-operated, customer-owned telephone units while unregistered and failing to disclose it on Form U-4); *In re* Agent Registration of Gayland Kyle James, Order No. IC04-FIN-08, 2004 WL 1166369, at *3 (Tex. St. Sec. Bd. May 13, 2004) (reprimanding and ordering administrative fine of $1,600 for selling securities while unregistered and not timely filing Form U-4); *In re* Agent Registration of Mark Andrew Womack, Order No. IC04-CEN-01, 2004 WL 97542, at *3 (Tex. St. Sec. Bd. Jan. 14, 2004) (granting application and reprimanding for selling unregistered investment opportunities while unregistered and failing to determine investors' suitability, disclose other business on Form U-4, or disclose exorbitant commission); *In re* Phil Head, Order No. ENF-04-CDO-1552, 2004 WL 179864, at *2 (Tex. St. Sec. Bd. Jan. 21, 2004) (cease and desist order for offering certificates of deposit by newspapers without being registered to sell securities or as investment advisers).

55. *See In re* Agent Registration of Timothy William Harris, Order No. IC04-FIN-04, 2004 WL 474199, at *1 (Tex. St. Sec. Bd. March 3, 2004) (reprimanding and ordering administrative fine of $7,000 for selling unregistered coin-operated, customer-owned telephone units for another dealer and failing to obtain consent of registered dealer or disclose it on Form U-4); *In re* Agent Registration of Larry James Kiefer, Order No. IC04-SUS-02, 2004 WL 284157 (Tex. St. Sec. Bd. Jan. 30, 2004) (reprimanding and suspending for thirty days for selling unregistered interests in viatical settlements for another dealer and failing to obtain consent of registered dealer or disclose it on Form U-4).

56. *See In re* Dealer Registration of Pruco Sec., LLC, Order No. IO-4-CAF-12, 2004 WL 1698101, at *2 (Tex. St. Sec. Bd. July 13, 2004) (reprimanding and ordering administrative fine of $10,000 for operating office not registered as branch office); *In re* Dealer Registration of Woodbury Fin. Servs., Inc., Order No. ID04-FIN-05, 2004 WL 762536, at *1, 3 (Tex. St. Sec. Bd. March 25, 2004) (reprimanding and ordering administrative fine of $12,500 for operating numerous offices not registered and using post office boxes as addresses on Forms U-4).

57. *See In re* Dealer Registration of Milkie/Ferguson Invs., Inc., Order No. IC04-CAF-11, 2004 WL 1631679, at *3 (Tex. St. Sec. Bd. July 13, 2004) (granting selling agent's application while reprimanding and ordering administrative fines of $5,000 from the agent and $12,000 from the dealer for agent's selling while unregistered and dealer's failures to enforce supervisory manual, to establish procedures to ensure only registered agents sell, and to amend Form U-4 within thirty days for changes in employment and office location).

58. *See In re* Energynet.com, Tex St. Sec. Bd. No-Action Letter, 2003 WL 23784, at *1182 (Nov. 23, 2004) (without registration of the auctioneer; refused since 7 Tex. Admin Code § 139.12 requires auction by seller or registered dealer and registered agents).

59. 29 Tex. Reg. 1644 (2004) (amending 7 Tex. Admin Code § 116.8 without comment); 28 Tex. Reg. 9178 (2003) (proposed Oct. 24, 2003).

changes and to include a reference to the Board's web site.[60]

The Board had several enforcement actions against investment advisers. These actions primarily involved rendering service before registration,[61] after registration lapsed and before renewal, or without registration.[62] One action involved an unannounced inspection of an investment advisor and the discovery of numerous violations along with refusals to promptly provide documentation and answers, resulting in the revocation of the investment adviser's registration.[63]

The Board also issued a number of no-action letters dealing with investment advisers. These dealt with plans to provide divorcing couples with a broad range of advice[64] and to allow subscribers to be instantly aware when limited partnership's portfolio changes.[65]

## V. SECURITIES FRAUD

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

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60. 29 Tex. Reg. 1643 (2004) (amending 7 TEX. ADMIN CODE § 115.8 without comment); *see* 28 Tex. Reg. 9177 (2003) (proposed Oct. 24, 2003).

61. *See In re* Applications for the Inv. Adviser Registrations of Flyline Mgmt., L.P., Order No. IC04-CAF-14, 2004 WL 1812692, at *2 (Tex. St. Sec. Bd. Aug. 2, 2004) (granting application while reprimanding and ordering two administrative fines of $16,000 for rendering services without registration).

62. *See In re* Applications for Inv. Adviser Registration of Legacy Harbor, Order No. IC04-CAF-10, 2004 WL 1541320, at *3 (Tex. St. Sec. Bd. June 30, 2004) (granting application while reprimanding and ordering administrative fine of $18,750 for rendering services while registration lapsed); *In re* Application for the Inv. Adviser Representative Registration of John Kenneth Link, No. IC04-CAF-09, 2004 WL 1541319, at *2 (Tex. St. Sec. Bd. June 28, 2004) (granting application while reprimanding and ordering administrative fine of $35,000 and forty-day suspension for rendering services while registration lapsed); *In re* Inv. Adviser Registration of Stanley Keith Jones, Order No. IC04-FIN-07, 2004 WL 823721, at *2 (Tex. St. Sec. Bd. April 7, 2004) (granting application while reprimanding and ordering administrative fine of $4,000 for rendering services while registration lapsed); *In re* TheHedgeFund.com, LLC, Order No. IC04-CDO-06, 2004 WL 762537, at *2 (Tex. St. Sec. Bd. March 25, 2004) (cease and desist order with administrative fine of $12,000 for giving advice without registration).

63. *See In re* Inv. Adviser Registration of Veras Inv. Partners, LLC, Order No. IC04-REV-03, 2004 WL 396815, at *3 (Tex. St. Sec. Bd. Feb. 24, 2004) (violations of operating at a different location, refusal to answer staff questions, failure to disclose other businesses on Form U-4, failure to immediately provide copies of emails, failure to disclose proper amount of funds under management and number of limited partnerships for which it is a general partner on Form ADV, failure to change information on Forms U-4 and ADV within thirty days, and employing unregistered agent to operate hedge fund).

64. *See In re* Equitable Divorce Strategies, LLC, Tex. St. Sec. Bd. No-Action Letter, 2003 WL 23784183, at *1 (Nov. 25, 2003) (including tax consequences, real estate obligations, valuation of retirement plans, as well as investment advice, all without registration as an investment adviser; refused since likely that for most clients the service will investment advice).

65. *See In re* Subscription to Wealth, L.P., Tex. St. Sec. Bd. No-Action Letter, 2004 WL 2077470 (Feb. 27, 2004) (granted for one-hour delayed emails of portfolio changes for monthly fee as not within definition of investment adviser).

### A. INDEMNIFICATION UNDER THE TEXAS ACTS

The Fifth Circuit considered investor recovery under an "errors and omissions" insurance policy held by the directors and officers of the issuer committing the fraud found liable under the TSA and the TSFA. The insurance company had forum-shopped by filing a declarative action in the federal district court based on diversity,[66] rather than filing in state court. The Fifth Circuit is enormously biased in favor of insurance companies.[67] The Fifth Circuit refuses to apply Texas's well-settled principles of insurance law and instead engages in tortured reasoning to arrive at a predetermined result.[68] The Fifth Circuit's application of the exclusionary clause to a securities fraud lawsuit fits this mold.

In *TIG Specialty Insurance Co v. PinkMonkey.com Inc.*, a state court had found, among other violations, that a CEO had violated the TSFA by inducing the investors to purchase the issuer's stock,[69] the selling agent had violated the TSA by aiding the CEO,[70] the other directors had violated the TSA as controlling the issuer,[71] and the issuer had violated the TSA through its agents.[72] The issuer had purchased an insurance policy with a securities claims endorsement covering claims for violation of state securities laws. The policy also had a personal profit exclusion for an insured who profited from the violation. The insurance company denied the coverage claims of the perpetrators and filed the declaratory action in federal court. The district court granted summary judgment for the insurance company; the Fifth Circuit affirmed. The exclusion removed coverage for the CEO. The investors, by proving the elements for the Texas Stock Act violation, satisfied the exclusion's two elements, a benefit from a false representation and no legal entitlement to the benefit.[73] A tor-

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66. *See* 28 U.S.C. § 1332 (2002).

67. *See* Willy E. Rice, *Insurance Decisions—A Survey and an Empirical Analysis*, 35 TEX. TECH L. REV. 947, 1031-35 (2004).

68. *See id.* at 1035-36.

> [F]ar too many of the Fifth Circuit's conclusions evolved out of thin air. This was especially true in controversies involving Texas litigants. The court of appeals either ignored or refused to apply Texas's undisputed principles of insurance law. Instead the Fifth Circuit created new law and engaged in strained and convoluted analyses to reach, arguably, predetermined results . . . . [S]uch an enterprise does little to garner respect for the court and its rulings . . . . [T]he Fifth Circuit's propensity to ignore settled principles of law conversely cause learned jurists to conclude rightly or wrongly that the court is biased against insureds.

*Id.*

69. *See* TEX. BUS. & COM. CODE ANN. § 27.01 (Vernon 2002).

70. *See* TEX. REV. CIV. STAT. ANN. arts. 581-33F(2) (Vernon Supp. 2004) (aider liability).

71. *See* TEX. REV. CIV. STAT. ANN. arts. 581-33F(2) (Vernon Supp. 2004) (control person liability).

72. *See* TEX. REV. CIV. STAT. ANN. arts. 581-33A (Vernon Supp. 2004) (includes issuer as seller).

73. The Fifth Circuit previously decided that any infusion of capital into an issuer provided the benefit to major shareholders of the opportunity to own and participate in a successful business. *See* Jarvis Christian Coll. v. Nat'l Union Fire Ins. Co., 197 F.3d 742, 747 (5th Cir. 1999) (school board errors and omission insurance policy for board recom-

tured interpretation of the language of the exclusion removed coverage for the selling agent and other directors, defined in the policy as insureds. Seizing upon a lower court opinion, whose reasoning must be superior to anything the Fifth Circuit could devise, the Fifth Circuit concluded that exclusions, such as the one before the court, using "the acts of 'an' or 'any' insured, as opposed to exclusions concerning acts of 'the' insured, operate to bar coverage for all insureds when one insured commits such an act."[74] This conclusion disregards Texas law, which requires interpretations of exclusions as interpreted by the insured if they are reasonable, even if the insurance company's interpretation is more reasonable.[75] "An" and "any" insured are singular, so limiting the exclusion to only the acting CEO is reasonable, even if the court believes the plural urged by the insurance company is better. The issuer was not defined as an insured, so the Fifth Circuit had to engage in one more convoluted analysis. The limitation clause defined a single "claim" to include all claims arising from the same wrongful act or continuous acts. So, the claim against the company based on the CEO's acts was one claim, which was excluded. Again, this analysis ignores Texas law. Exclusions must be clear and unambigous.[76] Applying a second definition of claim appearing in the limitation clause to elsewhere in the insurance contract, when one would have thought that the definition of claim included in the definition section applied, does not satisfy the Texas standard.[77]

One wonders what the issuer paid to obtain this "errors and omissions" policy. The effect of these Fifth Circuit interpretations of exclusion clauses in standard securities claims endorsement is to exclude coverage liability under the TSA and TSFA when the primary perpetrator is included in the lawsuit.

### B. Class Actions Under the Texas Acts

The Securities Litigation Uniform Standards Act of 1998 ("SLUSA")[78] provides for the removal to federal court and dismissal of state law securities class actions involving misrepresentation, omission, or deception with respect to the purchase of the securities of public companies.

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mendation to invest in board member's company). The ability to rescind under the Texas Stock Fraud Act, satisfied the absence of legal entitlement. *See* Tex. Bus. & Com. Code Ann. § 27.01(b) (Vernon 2002) (actual damages); Scott v. Sebree, 968 S.W.2d 364, 368-69 (Tex. App.—Austin 1999, pet. denied) ("actual damages" in Texas Stock Fraud Act means damages for fraud at common law, which included rescission in lieu of monetary damages). These arguments would also apply to the Texas Securities Act. *See* Tex. Rev. Civ. Stat. Ann. arts. 581-33D (Vernon Supp. 2004) (rescission remedy).

74. *See* Coregis Ins. Co. v. Lyford, 21 F. Supp. 2d 695, 698 (S.D. Tex. 1998) (professional liability insurance policy for law firm).

75. *See* Nat'l Union Fire Ins. Co. of Pittsburgh v. Hudson Energy Co., Inc., 811 S.W.2d 552, 555 (Tex. 1991); TIG Specialty Ins. Co. v. PinkMonkey.com Inc., 375 F.3d 365, 373-74 (5th Cir. 2004) (dissent).

76. *See Hudson Energy Co.*, 811 S.W.2d at 555.

77. *See PinkMonkey.com Inc.*, 375 F.3d at 376-77 (Pickering, J., dissenting).

78. 15 U.S.C. §§ 77p, 78bb (2002); Pub. L. No. 105-353, 112 U.S. Stat. 3227, 3227-33 (1999).

SLUSA does not prevent the shareholders from suing individually under state law. In *Blaz v. Belfer*,[79] the Fifth Circuit confronted an attempt to circumvent SLUSA. The investors' lawyer brought a class action under the TSFA against Enron Corporation, cleverly defining the class period as ending shortly before the passage of SLUSA and three years and one day before the alleged discovery of the fraud. With this definition, the investors could not bring a federal action because the then applicable three-year limitations period had passed.[80] The investors could bring the Texas class action under its longer limitations period,[81] provided SLUSA did not apply to conduct before its passage. The issuer removed the state action to federal court under SLUSA and the district court dismissed. The Fifth Circuit affirmed and determined that the application of SLUSA to this state class action did not have an impermissible retroactive effect. Under the Supreme Court's standards, retroactive legislation is permitted if it does not impair a party's rights when he acted, increase a party's liability for past conduct, or impose new duties for transactions already completed.[82] Procedural rules fit this permission; class actions are procedural under Texas law.[83]

### C. Arbitration 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. Since securities transactions are "transactions involving commerce," the Federal Arbitration Act, rather than the Texas Arbitration Act, applies.[84] Since 1989, the Supreme Court has permitted arbitration of securities fraud actions under the federal act.[85] There were several arbitrations against brokers conducted by the NASD involving the TSA. Arbiters seldom explain their decisions as appellate courts do and need not follow the rules of law.[86] Yet, some trends are ascertainable.

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79. 368 F.3d 501 (5th Cir. 2004).

80. *See* 15 U.S.C. § 78i(e) (2002) (one year from discovery, but no more than three). The Sarbanes-Oxley Act, Pub. L. 107-204, § 804, 116 Stat. 745, 801 (2003) has since changed this to a five-year limitations period. *See* 28 U.S.C. § 1658(b) (2002) (two years from discovery, but no more than five).

81. The applicable statute of limitations for the Texas Stock Fraud Act is the residual four-year limitations period. *See* Pooley v. Seal, 802 S.W.2d 390, 393 (Tex. App.—Corpus Christi 1990, writ denied); Sullivan v. Hoover, 782 S.W.2d 305, 306 (Tex. App.—San Antonio 1989, no writ); Tex. Civ. Prac. & Rem. Code Ann. § 16.051 (1997).

82. *See* Landgraf v. USI Film Prods., 511 U.S. 244, 280 (1994).

83. *See* S.W. Ref. Co. v. Bernal, 22 S.W.3d 425, 437 (Tex. 2000).

84. 9 U.S.C. § 1 (2002); Tex. Civ. Prac. & Rem. Code Ann. § 171.001 (Vernon Supp. 2004). *See, e.g.*, *In re* Mony Sec. Corp., 83 S.W.3d 279, 282 (Tex. App.—Corpus Christi 2002, no pet.).

85. *See* Rodriguez de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477, 453 (1989) (under the Securities Act of 1933); Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 238 (1987) (under the Exchange Act of 1934).

86. *See, e.g.*, Wilko v. Swan, 346 U.S. 427, 435-37 (1952) (holding that arbiters are not required to explain their reasons; arbiters are reversed only for manifest disregard of the law).

Arbitrations almost invariably deal with investments that declined in value—typically more than $500,000. One broker complained against an investor for a debit balance in a margin account.[87] Investor complaints involved unsuitability,[88] wrongful recommendations,[89] recommendations

87. For investor recovery, *see* U.S. Bancorp Piper Jaffray, Inc. v. Woodward, No. 02-03779, 2004 WL 101801 (Jan. 6, 2004) (N.A.S.D. arb.) ($279,172 claim for debit amount resulting from refusal to cover margin call, countered with $500,000 for unsuitability under TSA and DTPA; settled with $50,000 for investor and $5,000 for attorney's fees).

88. For claimant recoveries, *see* Rogers v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 03-06582, 2004 WL 2093152 (Sept. 10, 2004) (N.A.S.D. arb.) ($500,000 claims for recommendations for mutual funds that did not meet broker's guidelines for people of investor's age and situation under DTPA; awarded $72,507 with $5,000 punitive damages, $28,717 attorney's fees, $4,000 costs, $3,835 expert fees, and $1,000 discovery sanctions); Pearlman v. Brookstreet Sec. Corp., No. 02-06622, 2004 WL 1837710 (July 27, 2004) (N.A.S.D. arb.) ($469,756 claim for option trades in technology stocks and margin trading in retirement account under the TSA, TSFA, and DTPA; awarded $358,400 with $100,000 attorney's fees and $35,000 costs); Hanson v. Morgan Stanley Dean Witter, Inc., No. 02-03174, 2003 WL 22951953 (Nov. 30, 2003) ($600,000 claim for selling high risk mutual funds for conservative investment objective under TSA, TSFA, and DTPA; awarded $86,500 with $33,974 attorney's fees and $10,000 witness fees); *see also* Cabanas v. A.G. Edwards & Sons, Inc., No. 02-05156, 2004 WL 2293463 (Sept. 30, 2004) (N.A.S.D. arb.) ($500,000 claim for unsuitable recommendations under TSA and DTPA; dismissed and expunged by settlement (amount unspecified)); George v. Sands Bros. & Co., No. 02-03737, 2004 WL 307215 (Feb. 2, 2004) (N.A.S.D. arb.) ($167,000 claims for safe representation while placing in unsuitable high risk technology stocks under TSA and DTPA; awarded $67,906 plus $1,250 attorney's fees).

For respondent dismissals, *see* Stovall v. Edward D. Jones & Co., No. 03-08482, 2004 WL 2029432 (Aug. 26, 2004) (N.A.S.D. arb.) ($800,000 claim for wholly unsuitable stocks, high risk technology stocks, for trust fund under TSA, TSFA, and DTPA); Broussard v. Citigroup Global Mkts., Inc., No. 03-01801, 2004 WL 1047872 (April 30, 2004) (N.A.S.D. arb.) ($200,000 claim for recommendations to purchase stocks for disabled investor lacking experience under TSA and TSFA); Bulko v. Morgan Stanley DW Inc., No. 02-10715, 2004 WL 726166 (Mar. 15, 2004) (N.A.S.D. arb.) ($18,000,000 claim for margin and unsuitable recommendations for a retiree recovering from brain surgery under TSA, TSFA, and DPTA); William Tiffany v. Wachovia Sec. Fin. Network, No. 02-04059, 2004 WL 726148 (Mar. 7, 2004) (N.A.S.D. arb.) ($350,000 claim for unsuitable investments in high tech stocks under TSA and TSFA); Briggs v. All-Tech Inv. Group, Inc., No. 99-02567, 2004 WL 583887 (Mar. 9, 2004) (N.A.S.D. arb.) ($100,000 claim for unsuitable accumulation of significant positions in stocks under TSA); Tiffany v. Wachovia Sec. Fin. Network, No. 02-039239, 2004 WL 527034 (Mar. 2, 2004) (N.A.S.D. arb.) ($250,000 claim for unsuitable investments in high tech stocks under TSA and TSFA); Tiffany v. Wachovia Sec. Fin. Network, No. 02-03425, 2004 WL 433803 (Feb. 11, 2004) (N.A.S.D. arb.) ($1,000,000 claim for unsuitable investments in high tech stocks under TSA and TSFA).

89. For claimant recoveries, *see* Messina v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 02-01201, 2004 WL 2191739 (Sept. 15, 2004) (N.A.S.D. arb.) ($531,855 claim for wrongful recommendations under TSA and DTPA; dismissed and expunged by settlement (amount unspecified)); Guidry v. Stephens, Inc., No. 01-05050, 2004 WL 1977486 (Aug. 19, 2004) (N.A.S.D. arb.) ($1,000,000 claim for wrongfully recommending unspecified technology stocks on margin under TSA and DTPA; dismissed and expunged by settlement (amount unspecified)).

For respondent dismissals, *see* Bodle v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 02-03977, 2004 WL 2029440 (Aug. 24, 2004) (N.A.S.D. arb.) ($500,000 claim for wrongful recommendation in volatile securities under the DTPA); Vanderham v. Brookstreet Sec. Corp., No. 03-01901, 2004 WL 1908063 (Aug. 5, 2004) (N.A.S.D. arb.) ($750,000 claim for recommending investment in fund writing puts and calls under the TSA and TSFA); Black v. A.G. Edwards & Sons, Inc., No. 03-01111, 2004 WL 1673717 (July 1, 2004) (N.A.S.D. arb.) (unspecified claim for recommendations in risky, volatile, undercapitalized, illiquid, and high-risk securities under TSA, DTPA, and TSFA); Small v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 03-00190, 2004 WL 785042 (Mar. 24, 2004) (N.A.S.D. arb.)

tainted by analysts' conflicts of interest,[90] unauthorized trades,[91] mismanagement of investments,[92] providing improper employee benefit information,[93] lack of broker supervision,[94] execution errors,[95] and aiding and

($2,021,628 claim for recommendations and subsequent decline in named stocks under TSA, TSFA, and DPTA); Smith v. Morgan Stanley DW, Inc., No. 02-07690, 2004 WL 583883 (Mar. 5, 2004) (N.A.S.D. arb.) ($1,000,000 claim for aggressive investment strategy in initial public offerings and using margin debt under TSA and DPTA).

90. For respondent dismissals, *see* Gilmore v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 03-01610, 2004 WL 1804100 (July 17, 2004) (N.A.S.D. arb.) ($1,291,557 claim for tainted stock recommendation under TSA, TSFA, and DTPA); Montgomery v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 03-04002, 2004 WL 1397579 (June 7, 2004) (N.A.S.D. arb.) ($356,187 claim for tainted stock recommendations under TSA, TSFA, and DTPA); Johnson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 02-07632, 2004 WL 1397535 (June 3, 2004) (N.A.S.D. arb.) ($433,990 claim for tainted recommendations under TSA, TSFA, and DTPA); Stirm v. Merrell Lynch, Pierce, Fenner & Smith, Inc., No. 02-07686, 2004 WL 835776 (April 2, 2004) (N.A.S.D. arb.) ($120,938 claim for tainted recommendations under TSA and TSFA).

The taint stems from the conflict of interest of full-service brokerage houses, whose research analysts compensation, designed to attract underwriting clients, favored coverage and buy recommendations for underwriting clients and potential underwriting clients. *See* George Lee Flint, Jr., *Securities Regulation*, 57 SMU L. REV. 1207, 1228 (2004) (substantial recoveries for the offense by the Texas State Securities Board).

91. For claimant recoveries, *see* Tipton v. Edward D. Jones & Co., No. 03-05587, 2004 WL 2093116 (Sept. 7, 2004) (N.A.S.D. arb.) ($75,000 claim for unauthorized sale of stock and purchase of municipal bonds under DTPA; awarded $92,388 with $29,740 attorney's fees and $2,500 expert witness fees); Harris v. Josephthal & Co., No. 01-07090, 2004 WL 1146454 (May 7, 2004) (N.A.S.D. arb.) ($606, 349 claim for unauthorized trading and transfer of funds to third parties by investor's son under the TSA; awarded with $86,162 in attorney's fees).

92. For respondent dismissals, *see* Foster v. Bank One Sec. Corp., No. 03-03796, 2004 WL 1445933 (June 16, 2004) (N.A.S.D. arb.) ($95,000 claim for mishandling of account, including high risk investments and use of margin under TSA and DTPA).

93. For claimant recoveries, *see* Lopez v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 02-04422, 2004 WL 306981 (Feb. 5, 2004) (N.A.S.D. arb.) ($3,000,000 claims for advising exercise of employee stock options and placement of resulting securities in margin account to pay exercise costs and tax under DTPA; awarded $5,391,000 less $21,507 counterclaim).

For respondent dismissals, *see* Knotts v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 02-02697, 2004 WL 1397573 (June 7, 2004) (N.A.S.D. arb.) ($83,880 claim for advising moneys from employer plan could not be rolled over into a brokerage account resulting in tax under DTPA).

94. For claimant recoveries, *see* Doherty v. Gruntal & Co., No. 00-03697, 2004 WL 1673573 (July 7, 2004) (N.A.S.D. arb.) ($5,000,000 claim for failure to supervise broker with discretion under DTPA; awarded $270,300 with $100,000 attorney's fees).

95. For claimant recoveries, *see* Anton v. Ferris, Baker Watts, Inc., No. 02-01659, 2003 WL 22999404 (Dec. 5, 2003) (N.A.S.D. arb.) ($1,000,000 claim for improper execution of trading naked put options and unauthorized trades under TSA, TSFA, and DTPA; awarded $220,829); Deprato v. Prudential Equity Group, Inc., No. 02-06293, 2003 WL 23104635 (Dec. 4, 2003) (N.A.S.D. arb.) ($150,000 claim for recommending annuities with a guaranteed retirement income benefit and subsequent purchase of annuities without this feature, but a stepped-up death benefit when investor had no heirs under the TSA, TSFA, and DTPA; awarded rescission for $345,000, $95,320 attorney's fees, and $9,340 witness fees).

For respondent dismissals, see Bondy v. Sanders Morris Harris, Inc., No. 02-02245, 2004 WL 383604 (Feb. 16, 2004) (N.A.S.D. arb.) ($500,000 claim for order execution of unspecified securities under DTPA); Eastwood v. Morgan Stanley DW, Inc., No. 02-01639, 2004 WL 307218 (Feb. 4, 2004) (N.A.S.D. arb.) ($1,357,688 claim for order execution of unspecified securities under TSA); S&R P'ship v. Lehman Bros., Inc., No. 02-07189, 2003 WL 23104663 (Dec. 17, 2003) (N.A.S.D. arb.) ($19,590 claim for not completing purchase of stock later subject to tender offer due to lack of documentation under the TSA).

abetting violations.[96] Other reported actions did not specify the offense.[97]

### D. Court Decisions Under the Federal Acts

The fraud provisions of the TSA are modeled on the federal statutes. As a result, Texas courts interpreting the TSA frequently look to the federal decisions. During the Survey period, the Fifth Circuit decided four cases concerning securities fraud, most under Rule 10b-5.[98] A private securities fraud claim under Rule 10b-5 has five elements in connection

96. For claimant recoveries, *see* Engelbrecht v. M.G. Sec. Group, Inc., No. 03-03668, 2004 WL 1672206 (July 12, 2004) ($28,550 claim for specific stock transaction under TSFA; awarded $32,852 with $18,000 attorney's fees).
For respondent dismissals, *see* Trefny v. Bear Stearns Sec. Corp., No. 00-01353, 2004 WL 433973 (Feb. 20, 2004) (N.A.S.D. arb.) ($9,858,422 claim for assisting president of introducing broker to make withdrawals from customer accounts through false statements and lending to in excess of margin requirements for purchase of worthless bonds placed in customer accounts under TSA, TSFA, and DPTA).

97. For claimant recoveries, *see* Mitchell v. Baird Mgmt. Corp., No. 03-05374, 2004 WL 2191795 (Sept. 14, 2004) (N.A.S.D. arb.) ($400,000 claim for concentrations in high risk, speculative technology funds under DTPA; awarded $300,000 with $50,000 attorney's fees and $15,000 costs); Kaufman v. Stephens, Inc., No. 03-04999, 2004 WL 1445940 (June 8, 2004) (N.A.S.D. arb.) ($500,000 claim under TSA, TSFA, and DTPA; dismissed and expunged by settlement (amount unspecified)); Miller v. Scott D. Ricketts Fin. Marketplace Group, LLC, No. 02-06986, 2004 WL 433769 (Feb. 6, 2004) (N.A.S.D. arb.) ($275,000 claim for converting diversified portfolio to risky and volatile stocks and options under DTPA; awarded $213,500 with $25,000 attorney's fees and $1,700 costs); *see also* Al-Adli v. Citigroup Global Mkts., Inc., No. 02-04043, 2004 WL 1496617 (June 1, 2004) (N.A.S.D. arb.) ($187,000 claims for unspecified stock under TSFA; denied by settlement (amount unspecified)).
For respondent dismissals, *see* Thompson v. Main Street Mgmt. Co., No. 03-04304, 2004 WL 2240052 (Sept. 23, 2004) (N.A.S.D. arb.) ($160,000 claim for purchase of unspecified mutual funds under the TSA, TSFA, and DTPA); Tanus v. United Am. Int'l, Inc., No. 00-01821, 2004 WL 1977524 (Aug. 23, 2004) (N.A.S.D. arb.) ($600,000 claim for purchase of volatile stock under DTPA; dismissed); Andretti v. Main Street Mgmt. Co., No. 03-02887, 2004 WL 1949309 (Aug. 20, 2004) (N.A.S.D. arb.) ($500,000 claim for purchase of various mutual funds under DTPA); K-Mo Props., Ltd. v. A.G. Edwards & Sons, Inc., No. 03-02526, 2004 WL 1908053 (Aug. 7, 2004) (N.A.S.D. arb.) ($521,266 claim for investments in science and technology funds under DTPA); Koach v. Wachovia Sec. LLC, No. 03-05589, 2004 WL 1774979 (July 21, 2004) (N.A.S.D. arb.) ($2,095,529 claim for purchase of unspecified stock and options under the TSA, TSFA, and DTPA); Betts v. Morgan Stanley DW, Inc., No. 02-06549, 2004 WL 1397574 (N.A.S.D. arb.) ($700,000 claim for investments in common stock and mutual funds under DTPA; dismissed); Freeman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 03-00585, 2004 WL 345705 (Feb. 10, 2004) (N.A.S.D. arb.) ($500,000 claim for unspecified stocks held in the account under TSA and TSFA); Allyn v. RLS & Assoc., No. 02-03901, 2003 WL 23104664 (Dec. 17, 2003) (N.A.S.D. arb.) ($1,937,367 claim for transactions in technology stock and options with margin under TSFA and DTPA).

98. *See* 17 C.F.R. § 240.10b-5 (2003).
Additionally, the Fifth Circuit considered a criminal case involving an aider of a Ponzi investment scheme. *See* United States v. Dale, 374 F.3d 321, 324, 326 (5th Cir. 2004). The aider allowed the perpetrator to transfer the victims' moneys through his company's bank accounts for a fee. The aider challenged his conviction claiming he lacked knowledge of the fraudulent nature of his co-defendant's activities and simply followed orders. But the aider had used the money that appeared in his company's accounts to purchase substantial personal luxuries, prepared investor marketing letters for the perpetrator containing lies about his company, and attended sales pitches made to the investors without correcting the lies told by the perpetrator. The Fifth Circuit affirmed the conviction.

with a sale or purchase of securities: "(1) a misstatement or an omission (2) of material fact, (3) made with scienter (4) on which plaintiff relied (5) that proximately caused plaintiff's injury."[99]

With respect to materiality, in *Kapps v. Torch Offshore, Inc.*,[100] the Fifth Circuit dealt with an omission from a registration statement for an initial public offering.[101] The omitted facts dealt regarded a sharp rise and fall in natural gas prices over four months, three months before the offering. The prospectus spoke of a substantial increase in gas prices over the last two years preceding the offer. The investors alleged that although these statements were true, they were nevertheless misleading due to the omission of the price drop and that the SEC regulations required inclusion of the omitted facts as a trend.[102] The trial court dismissed the complaint.[103] An omission is not material unless there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[104] The total mix includes cautionary statements contained in the prospectus[105] and publicly available information.[106] The suspect prospectus contained cautionary statements concerning the volatility of natural gas prices. The national newspapers quote natural gas prices daily. Therefore, the omissions were not material. With respect to the trend requirement, the standard is one of negligence with respect to the predictive value of the reported results.[107] The investors had three documents indicative of the issuer's knowledge of the trend. The subsequent year's quarterly report to the SEC indicated no meaningful decline in revenues. The press release issued two months after the offering described delays in the business, but also suggested they arose from the change from shallow drilling to deeper drilling. Caution-

99. *See* Nathenson v. Zonagen, Inc., 267 F.3d 400, 406-07 (5th Cir. 2001).

100. 379 F.3d 207 (5th Cir. 2004).

101. The action for a misstatement in a registration statement is a simplified fraud action. *See* 15 U.S.C. § 77k (2002) (lacking the scienter and reliance elements, and providing a defense of lack of knowledge). The materiality requirement, however, is the same as under Rule 10b-5. *See* Rosenzweig v. Azurix Corp., 332 F.3d 854, 873-74 (5th Cir. 2003); Klein v. General Nutrition Cos., 186 F.3d 338, 344 (3d Cir. 1999).

102. *See* 15 U.S.C. § 77k (2002) ("In case any part of the registration statement . . . omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading. . . ."); 17 C.F.R. § 229.303 (2004) (requiring disclosure of any known trends that impact net sales or revenue or income from continuing operations).

103. Actions under the Securities Act only require notice pleading, and not the detailed pleading mandated by FED. R. CIV. P. 9(b) for fraud. *See In re* Nations Mart Corp., Sec. Litigation, 130 F.3d 309, 315-16 (8th Cir. 1997) (as proof of fraud or mistake not a prerequisite to liability under the Securities Act of 1933, § 11; 15 U.S.C. § 77k (2002)).

104. *See* Basic Inc. v. Levinson, 485 U.S. 224, 232-33 (1988) (citing Rule 10b-5, 17 C.F.R. § 240.10b-5 (2004) (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)) (proxy)).

105. *See* Klein v. Gen. Nutrition Co., 186 F.3d 338, 342 (3d Cir. 1999); Olkey v. Hyperion 1999 Term Trust, Inc., 98 F.3d 2, 5-6 (2d Cir. 1996).

106. *See* United Paperworkers Int'l Union v. Int'l Paper Co., 985 F.2d 1190, 1199 (2d Cir. 1993).

107. *See* Oxford Asset Mgmt., Ltd. v. Jaharis, 297 F.3d 1182, 1191-92 (11th Cir. 2002).

ary language in the draft prospectus did not indicate knowledge of a trend. Therefore, the Fifth Circuit affirmed the dismissal.[108]

With respect to scienter, in *Southland Securities Corp. v. Inspire Insurance Solutions Inc.*, the Fifth Circuit rejected the group pleading doctrine for a class action under Rule 10b-5.[109] The Private Securities Litigation Reform Act of 1995 ("PSLRA") requires investors in class actions for misleading statements and omissions to specify in their pleading each statement made by the defendant alleged to be misleading, the reasons why it is misleading, and the facts giving a strong inference that the defendant acted with the required state of mind.[110] The federal rules for securities fraud additionally require the identity of the speaker, and the location and time where the statement occurred.[111] The group pleading doctrine allows investors to rely on a presumption that statements in prospectuses, registration statements, annual reports, and press releases are the collective work of the individuals involved in the everyday business of the issuer, the directors and executive officers. The Fifth Circuit had never adopted the group pleading doctrine.[112] The trial court dismissed the action for failure to state a claim because the group pleading doctrine used by the investors did not satisfy the PSLRA. The Fifth Circuit confirmed that the group pleading doctrine violates the PSLRA's scienter requirement as providing no strong inference concerning a particular officer's state of mind. Consequently, most of the investors' alleged misstatements failed the pleading requirements due to the group pleading doctrine, failure to explain the inaccuracies, failure to provide when and where, consisting of non-actionable puffery,[113] or consisting of analysts' forecasts without an allegation of entanglement by the issuer.[114] The investors also had other problems with the strong inference of scienter, providing only substantial insider sales during the year. The Fifth Circuit only accepts this evidence as a strong inference if the trades are made in "suspicious amounts or at suspicious times."[115] The participation of only some of the executive officers in the issuer's secondary offering lacked allegations that such sales were unusual. Other sales during times of no price volatility were not suspicious. Only sales near the all-time high

108. *Kapps*, 379 F.3d 221. *Kapps* arose in Louisiana, but reflects the Fifth Circuit's thoughts on materiality.

109. *See* 17 C.F.R. § 240.10b-5 (2004); *see also* Dunn v. Borta, 369 F.3d 421, 434 (4th Cir. 2004) (not reaching the issue); Schiller v. Physicians Res. Group, Inc., 342 F.3d 563, 569 n.4 (5th Cir. 2003) (same); *In re* Cabletron Sys., Inc., 311 F.3d 11, 40 (1st Cir. 2002) (same).

110. *See* 15 U.S.C. § 78u-4(b) (2002); Pub. L. No. 104-67, 109 U.S. Stat. 737, 758-62 (1996).

111. *See* FED. R. CIV. P. 9(b).

112. The doctrine comes from the Ninth and Second Circuits. *See* Wool v. Tandem Computers Inc., 818 F.2d 1433, 1440 (9th Cir. 1987); Lucy v. Edelstein, 802 F.2d 49, 55 (2d Cir. 1986).

113. *See* Rosenzweig v. Azurix Corp., 332 F.3d 854, 869 (5th Cir. 2003); Raab v. Gen. Physics Corp., 4 F.3d 286, 290 (4th Cir. 1993).

114. *See In re* Navarre Corp. Sec. Litig., 299 F.3d 735, 743 (8th Cir. 2002); Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 163 (2d Cir. 1980).

115. *See* Abrams v. Baker Hughes, Inc., 292 F.3d 424, 435 (5th Cir. 2002).

made the month before the press release containing the negative truthful information appeared suspicious. Consequently, the only actionable misrepresentation concerned the CEO's speaking to securities analysts, touting a contract and predicting future earnings therefrom without using cautionary language. The misrepresentation was coupled with the inference of scienter from his sales the following month followed by a press release revising the prediction downward due to lower expectations from the contract.[116] As to the issuer, the court will impute to the issuer misstatements and omissions made by a director or an executive officer with the requisite scienter, but not collectively, with one making the misstatement and another knowing its falsity. Consequently, the CEO's misrepresentation with the scienter from the sales also provides an actionable misrepresentation against the issuer. The Fifth Circuit affirmed in part, reversed in part, and remanded.[117]

With respect to reliance, in *Greenberg v. Crossroads Systems, Inc.*,[118] the Fifth Circuit opined on the application of the fraud-on-the-market theory to a Rule 10b-5 class action concerning a precipitous drop in an issuer's stock price before and after a press release containing much negative information. The trial court granted summary judgment to the issuer finding the price decline after the "truthful" announcement as statistically insignificant. In 1988, the Supreme Court eased the reliance requirement for class actions under Rule 10b-5 actions due to the unduly burdensome proof showing every class member's individual reliance by allowing, under the fraud-on-the-market theory, a rebuttable presumption of reliance if the investors show that the issuer made material misrepresentations, the issuer's shares were traded in an efficient market, and the investors traded shares between the time of the misrepresentations and the time of truthful disclosure.[119] Rebuttal information included situations such as market makers' knowledge of the matter, information leaked from issuer sources, or any unrelated investor concerns, that severed the link between the alleged misrepresentation or omission and the price received or paid by the investor. In 2001, the Fifth Circuit ruled that the investors must also show that the complained of misrepresentation or omission actually affected the price, such as manifesting an increase in price following release of false positive information or decrease in price following revelation of true negative information.[120] For this test, the trial court used a two-day window following the release of information, unchallenged by the investors. The trial court found statistical insignificance because the price drop during the six-month class period was so

116. The PSLRA has a safe-harbor rule for predictive statements accompanied by cautionary language. *See* 15 U.S.C. §§ 77z-2(i)(1), 78u-5(c)(1)(A) (2002).

117. Southland Sec. Corp. v. Inspire Ins. Solutions, Inc., 365 F.3d 353 (5th Cir. 2004).

118. 364 F.3d 657 (5th Cir. 2004).

119. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 247-49 n.27 (1988).

120. *See* Nathenson v. Zonagen, Inc., 267 F.3d 400, 414-15 (5th Cir. 2001) (case where price went in opposite direction, down over five months on false positive information and up over several months on true negative information).

much greater than the drops in the two-day periods.[121] The Fifth Circuit concluded that the test is the percentage of the drop following the release of the truthful information, not its comparison with some other percentages. Consequently, the sixty-three percent drop was statistically significant. This price drop, however, is not enough to trigger the presumption. The investors must also show that an earlier false, non-confirmatory statement also actually affected the price. The market has already digested information from confirmatory statements and therefore, they do not cause a change in stock price. Only three statements concerning the interoperability of the issuer's products and four earnings statements met this requirement. The investors could not show that the price drop came from the interoperability included within the truthful statement rather than the other negative matters contained within the truthful statement. But the Fifth Circuit accepted the earnings statements as satisfying the requirement. The Fifth Circuit affirmed in part, vacated in part, and remanded.[122]

With respect to damages, in *SEC v. United Energy Partners, Inc.*, the Fifth Circuit dealt with a fraud action brought by the SEC under Rule 10b-5 involving a disgorgement order. In a private placement of working interests in oil wells, the officers of a company raised double the amount of money needed for the wells, using one-half for the company's operations, contrary to statements in the private placement memoranda to spend all the funds on drilling. The trial court ordered the officers to disgorge $7.5 million, awarded pre-judgment interest of $2 million, and imposed civil penalties of $110,000 each. The officers wanted to offset the disgorgement by legitimate business expenses of the company because they did not have sufficient funds to disgorge. The Fifth Circuit affirmed, claiming that the overwhelming weight of authority lay against the offset, citing only two district court cases to one permitting the offset.[123]

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121. Such drops could be signs that insiders privy to the truth are bailing out or that bear-raiders are selling convinced of the falsehood of the issuer's statements.

122. *Greenberg*, 364 F.3d 670-71.

123. SEC v. United Energy Partners, Inc., 88 Fed. Appx. 744 (5th Cir. 2004). *See* SEC v. Kenton Capital, Ltd., 69 F. Supp. 2d 1, 16 (D.D.C. 1998); SEC v. Hughes Capital Corp., 917 F. Supp. 1080, 1086-87 (D.N.J. 1996) (overwhelming weight), *aff'd*, 124 F.3d 449 (3d Cir. 1997); SEC v. Great Lakes Equities Co., 775 F. Supp. 211, 214-15 (E.D. Mich. 1991); SEC v. Benson, 657 F. Supp. 1122, 1134 (S.D.N.Y. 1987); SEC v. World Gambling Corp., 555 F. Supp. 930, 935 (S.D.N.Y. 1983), *aff'd*, 742 F.2d 1440 (2d Cir. 1983), *cert. denied*, 465 U.S. 1112 (1984). *Contra* SEC v. Thomas James Assocs., Inc., 738 F. Supp. 88, 95 (W.D.N.Y. 1990). Other district courts agree with the Fifth Circuit.