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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, the author has attempted to limit the material to that involving state law,¹ only briefly touching federal securities law only when necessary.² The author does not intend this article to exhaust all aspects of securities regulation but rather to update the Texas-based securities practice with new developments of interest.

I. REGISTRATION OF SECURITIES

The basic rule of most securities laws is that securities need to be registered with the regulatory agency unless they fall within an exemption to registration. The State Securities Board (“Board”) amended several rules relating to registration and exemptions from registration to clarify cross-references³ and conform registrations coordinated with the Securities and Exchange Commission (“SEC”) to SEC changes concerning multi-jurisdictional (“foreign”) offerings.⁴

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1. Texas has two major statutes to combat securities fraud: the Texas Securities Act (“TSA”) and the Texas Stock Fraud Act (“TSFA”). See TEX. REV. CIV. STAT. ANN. art. 581, § 1 (Vernon Supp. 2006); TEX. BUS. & COM. CODE ANN. § 27.01 (Vernon 2002).

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 AND INVESTMENT BANKING OF THE SECTION ON BANKING AND BUSINESS LAW OF THE STATE BAR OF TEXAS, COMMENT—1977 Amendment, following TEX. REV. CIV. STAT. ANN. art. 581–33, § 1 (Vernon Supp. 2006).

3. 30 Tex. Reg. 6870 (2005), adopted 30 Tex. Reg. 8865 (2005) (codified as an amendment to 7 TEX. ADMIN. CODE § 109.15) (without comment, changing a reference to a section of the securities act to a reference to the TSA section labeled as an exemption from registration); 30 Tex. Reg. 6871 (2005), adopted 30 Tex. Reg. 8865 (2005) (codified as an amendment to 7 TEX. ADMIN. CODE § 113.5) (without comment, changing the rule number reference to an exemption and labeling it as an exemption from registration); 30 Tex. Reg. 6877 (2005), adopted 30 Tex. Reg. 8869 (codified as an amendment to 7 TEX. ADMIN. CODE § 139.14) (same, for non-issuer sales); 30 Tex. Reg. 6878 (2005), adopted 30 Tex. Reg. 8869 (2005) (codified as an amendment to 7 TEX. ADMIN. CODE § 139.16) (same, for sales to individual accredited investors)).

4. 30 Tex. Reg. 6872 (2005), adopted 30 Tex. Reg. 8866 (2005) (codified as 7 TEX. ADMIN. CODE § 113.13 for coordination of foreign offerings filed with the SEC) (without comment, adopting the model rule of the North American Securities Administrators Asso-

The Board took enforcement actions against several issuers and dealers who sold unregistered securities.⁵ The Board also used non-registration to terminate fraudulent sales. These sales dealt with misrepresenting a planned initial public offering for common stock,⁶ misrepresenting a guarantee for loan returns,⁷ omitting disclosure for oil and gas working interests,⁸ omitting disclosure for common stock coupled with a warning that the investor's failure to conduct due diligence is a defense to the issuer's liability for securities fraud,⁹ omitting a principal's disbarment, and misrepresenting fund investments contrary to the prohibition described in the offering materials.¹⁰ The Board also took action against issuers using misleading sales materials.¹¹

The staff of the Board issued three no-action letters dealing with registering securities in connection with reorganizations. One request dealt with the merger of mutual funds organized as Massachusetts business trusts, where the holders of the funds had voted to allow mergers without a holder vote.¹² The staff noted this transaction did not comply with the Texas exemption from registration for mergers with a shareholder vote,¹³ since the entities were not corporations, but would recommend no action

ciation reducing the review period from seven days to three days, the timeframe of Canadian jurisdictions and clarifying the reference to the current SEC release); *see also* 30 Tex. Reg. 8866 (2005) (repealing the old rule).

5. *See, e.g., In re Robert Hevel*, No. ENF-06-CDO-1615, 2006 WL 1970206 (Tex. State Sec. Bd. July 5, 2006) (cease-and-desist order); *In re George Stephen Yenko*, No. ENF-06-CDO-1606, 2006 WL 451957 (Tex. State Sec. Bd. Feb. 12, 2006) (same, covered currency calls); *In re Richard August Lowrance*, No. ENF-06-CDO-1605, 2006 WL 451955 (Tex. State Sec. Bd. Feb. 7, 2006) (same, covered currency calls); *In re Sandra K. Brooks*, No. ENF-06-CDO-1604, 2006 WL 451956 (Tex. State Sec. Bd. Feb. 7, 2006) (same, covered currency calls); *In re Jerry Dwight Adams*, No. ENF-06-CDO-1603, 2006 WL 451954 (Tex. State Sec. Bd. Feb. 2, 2006) (same, covered currency calls).

6. *See, e.g., In re Homeland Commc'ns Corp.*, No. ENF-06-CDO-1621, 2006 WL 2984784 (Tex. State Sec. Bd. Oct. 12, 2006) (emergency cease-and-desist order against an issuer that sold common stock and warrants, claiming the issuer would make a public offering in May 2007, when subject to other states' cease-and-desist orders for claiming the public offering would occur since, at least, August 2005).

7. *See, e.g., In re Dawnstar Alliance, LLC*, No. ENF-06-CDO-1614, 2006 WL 1563243 (Tex. State Sec. Bd. May 16, 2006) (emergency cease and desist against an issuer that sold evidences of indebtedness through ads in newspapers claiming expertise in financial markets without naming the experts, their relation to the promoters, or the contractual relationship).

8. *See, e.g., In re Maxim Energy Inc.*, No. ENF-06-CDO-1613, 2006 WL 1230648 (Tex. State Sec. Bd. Apr. 27, 2006) (emergency cease-and-desist against an issuer selling unregistered working interests in an oil and gas field without any disclosure).

9. *See, e.g., In re Chelsea Mgmt. Group, Inc.*, No. ENF-06-CDO-1611, 2006 WL 900536 (Tex. State Sec. Bd. Mar. 29, 2006) (emergency cease-and-desist order).

10. *See, e.g., In re Brazos Valley Capital LLC*, No. ENF-06-CDO-1607, 2006 WL 451958 (Tex. State Sec. Bd. Feb. 14, 2006) (emergency cease-and-desist order for describing law degree but concealing subsequent disbarment, and for describing fund's private-placement prohibition when fifty percent of fund is so invested).

11. *See, e.g., In re Power Station, LLC*, No. ENF-06-CDO-1608, 2006 WL 451959 (Tex. State Sec. Bd. Feb. 14, 2006) (cease publication order for sales materials claiming installation of, or contracts for, kiosks at three locations when there were no installations or contracts).

12. *See, e.g., In re Fid. Mgmt. & Research Co.*, 2006 WL 2038692 (Tex. State Sec. Bd. June 1, 2006) (no-action letter).

13. TEX. REV. CIV. STAT. ANN. art. 581-5(G) (Vernon Supp. 2006).

to require registration of the fund shares. The staff also recommended no action to require registration for a demutualization of an insurance company, and its concurrent reorganization, into a holding company approved by the Arkansas Insurance Commissioner.¹⁴ The third no-action letter dealt with an exchange tender offer by a foreign private company for a foreign issuer with American Depositary Receipts listed on NASDAQ.¹⁵ The exchanged shares would be restricted, not transferable unless registered or exempt. The tender offering materials had been filed with the Autorite des Marches Financiers, the French stock market authority. Again the staff recommended no action to require registration of the exchange shares.¹⁶

II. 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.¹⁷ Registration infractions generally surface when applying or reapplying for registration.

A. DEALERS

The Board amended several rules relating to dealer and agent registration to conform to the National Association of Securities Dealers ("NASD") Form BR, approved by the SEC, for registration of branch offices¹⁸ and to streamline the registration process by eliminating the requirement to file assumed name certificates with an application for registration.¹⁹ The Board also amended and added to the dealer and agent registration rules to provide for a restricted registration as a finder for individuals that introduce accredited investors to issuers, provided they engage in no other dealer activities;²⁰ those registered as general dealers

14. *In re Farmers Home Holding Co.*, 2006 WL 2038690 (Tex. State Sec. Bd. Feb. 24, 2006) (no-action letter).

15. *In re Gemalto N.V.*, 2006 WL 2038694 (Tex. State Sec. Bd. June 14, 2006) (no-action letter).

16. *Id.*

17. TEX. REV. CIV. STAT. ANN. art. 581-13 (Vernon Supp. 2006).

18. 30 Tex. Reg. 8866 (2005) (codified as an amendment to 7 TEX. ADMIN. CODE §§ 115.1, 115.2, 115.4 & 115.10) (for dealer registration) (without comment, accommodating SEC's Form BR, Uniform Branch Office Form, replacing the definition of branch office and branch manager to conform with the terminology of the National Association of Securities Dealers, conforming other terminology, providing for filing of Form BR through the Central Registration Depository, and shortening the period for a registration application to be considered automatically withdrawn); *see also* 30 Tex. Reg. 6877 (2005), *adopted* 30 Tex. Reg. 8869 (2005) (codified as an amendment to 7 TEX. ADMIN. CODE § 133.33) (for registration forms) (without comment, authorizing substitution of the SEC's Form BR for Texas forms). For the SEC approval, *see* Approval of Form BR Amendments, Release No. 52544, Securities Act Release No. 34-52544, 2005 WL 3750328 (proposed Sept. 30, 2005).

19. 31 Tex. Reg. 364 (2006), *adopted* 31 Tex. Reg. 2846 (2006) (codified as an amendment to 7 TEX. ADMIN. CODE § 115.2) (for dealer registration) (without comment).

20. 31 Tex. Reg. 6709 (2006) (codified as an amendment to 7 TEX. ADMIN. CODE § 115.1) (for dealer registration) (with comment); 31 Tex. Reg. 6712 (2006) (codified as an

may engage in finder activities. The idea is to insulate issuers from the potential loss of a securities registration exemption for using unregistered agents and to provide additional protection to investors through the application review process that would reveal the finders' regulatory and criminal histories. Finders will keep certain records and be exempt from the examination requirements.

The Board had several enforcement actions against dealers and selling agents. Dealer infractions included failure to register,²¹ failure to have branch offices registered,²² failure to supervise an agent's private securities transactions with others,²³ failure to disclose changed information,²⁴ failure to have a registered and qualified designated officer,²⁵ failure to identify order takers on the order memoranda,²⁶ and failure to sell through a registered agent.²⁷ Agent infractions included falsifying

amendment to 7 TEX. ADMIN. CODE § 115.3) (for dealer registration) (without comment); 31 Tex. Reg. 6713 (2006) (to be codified as 7 TEX. ADMIN. CODE § 115.11) (for finder registration) (with comment).

21. See, e.g., *In re* Tex. Ret. Plans, Inc., No. ENF-06-CDO-1612, 2006 WL 1175862 (Tex. State Sec. Bd. Apr. 10, 2006) (cease-and-desist order against company accepting investment instructions and relaying them to brokerage custodians under retirement plans for higher-education institutions for a one percent annual fee); *In re* Alejandro C. Gonzalez, No. ENF-06-CDO-1609, 2006 WL 707735 (Tex. State Sec. Bd. Feb. 27, 2006) (cease-and-desist order against seller of deposits of personal investment of a Honduras company, universal leases in Mexico coupled with management contracts, and fractionalized interests in life-settlement policies); *In re* Douglas Leon Ellis, No. ENF-066-CDO-1610, 2006 WL 707736 (Tex. State Sec. Bd. Feb. 7, 2006) (cease-and-desist order against seller of universal leases in Mexico coupled with management agreements).

22. Board rules require registration of branch offices, that keep records. 7 TEX. ADMIN. CODE § 115.1 (2006). For the actions, see *In re* Dealer and Inv. Adviser Registration of Huckin Fin. Group, Inc., No. IC06-CAF-42, 2006 WL 2793969 (Tex. State Sec. Bd. Sept. 25, 2006); *In re* Dealer Registration of Prospera Fin. Servs., Inc., No. IC06-CAF-02, 2006 WL 563059 (Tex. State Sec. Bd. Feb. 24, 2006).

23. NASD Rule 3040 requires members to record on their books the private securities transactions their agents have with others as if those transactions were executed on behalf of the member. NASD Manual, Conduct Rules, Rule 3040 (2006) (private-securities transactions of an associated person). For the Board action, see *In re Dealer Registration of Lehman Bros. Inc.*, No. IC06-CAF-25, 2006 WL 2250900 (Tex. State Sec. Bd. July 31, 2006), reprimanding and ordering an administrative fine of \$15,000 for failing to detect an agent's private-securities transaction when notified that the agent was engaged in outside-business activity, a violation of the duty to supervise agents.

24. Board rules require updating of registrations within thirty days of the event. 7 TEX. ADMIN. CODE § 115.9 (2006). For the Board action, see *In re Dealer Registration of Linsco/Private Ledger Corp.*, No. IC06-CAF-19, 2006 WL 1930000 (Tex. State Sec. Bd. June 28, 2006), reprimanding and ordering an administrative fine of \$10,000 for not disclosing other names and locations used for securities activities.

25. See, e.g., *In re* Dealer Registration of N.Y. Global Sec., Inc., No. IC06-CAF-06, 2006 WL 1309952 (Tex. State Sec. Bd. May 2, 2006) (reprimanding and ordering an administrative fine of \$500 for failing to file for registration of a new designated officer within thirty days of resignation of the old officer).

26. See, e.g., *In re* Dealer Registration of the (Wilson) Williams Fin. Group, No. IC06-CAF-04, 2006 WL 1175859 (Tex. State Sec. Bd. Apr. 7, 2006) (reprimanding and ordering an administrative fine of \$65,000 for not identifying order takers, not registering branch offices, not reporting changes within thirty days, not disclosing outside business activities, and allowing two agents to supervise each other).

27. See, e.g., *In re* Dealer Registration of Riverstone Wealth Mgmt., Inc., No. IC06-CEN-03, 2006 WL 707737 (Tex. State Sec. Bd. Mar. 7, 2006) (reprimand).

records to conceal diversion of client moneys to the agent,²⁸ failing to disclose a misdemeanor conviction and fine for promoting gambling,²⁹ and failing to report the sale of securities to outsiders to employing dealers, as required by written dealer supervisory policies, or to the Board.³⁰ The Board also participated in several multi-state prosecutions with the SEC against conflicts of interests in full-service brokerage houses.³¹ 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.

B. INVESTMENT ADVISERS

The Board amended several rules relating to investment advisor and investment-advisor representative registrations to conform to the SEC's Form BR³² and to streamline the registration process by eliminating the requirement to file assumed name certificates with an application for registration.³³

The Board had numerous enforcement actions against investment advisors and investment-advisor representatives. These actions involved investment advisors and investment-advisor representatives rendering compensated service without registration,³⁴ several whose registrations

28. See, e.g., *In re* Application for the Agent Registration of Corey Dwayne Minor, No. IC06-DOR-26, 2006 WL 2250902 (Tex. State Sec. Bd. Aug. 2, 2006) (denying the registration for refusing to allow the staff to inspect records and denoting on a check register that client money went to investments while bank records indicated agent control of the money).

29. See, e.g., *In re* Agent Registration of Robert Harold Hanley Jr., No. IC06-CAF-22, 2006 WL 1970209 (Tex. State Sec. Bd. July 3, 2006) (reprimanding and ordering an administrative fine of \$3,000 for not disclosing a gambling conviction on an earlier Form U-4).

30. See, e.g., Agent and Inv. Adviser Representative Registrations of Christine Nicole Parma, No. IC06-SUS-09, 2006 WL 1677890 (Tex. State Sec. Bd. June 5, 2006) (suspending registrations for five days and ordering disgorgement of ten percent commissions to investors for sale of designated hotel units for a specific week with a property-management agreement believing the time-units were not securities).

31. See, e.g., *In re* Dealer Registration of Thomas Weisel Partners, LLC, No. IC06-CDO/FIN-13, 2006 WL 1677894 (Tex. State Sec. Bd. June 7, 2006) (awarding a \$321,332 administrative fine to Texas in a multi-state fine of \$12,500,000); *In re* Dealer Registration of Deutsche Bank Sec., Inc., No. IC06-CDO-07, 2006 WL 1580322 (Tex. Sec. State Bd. May 31, 2006) (awarding a \$1,847,656 administrative fine to Texas in a multi-state fine of \$28,750,000). For earlier cases, see George Lee Flint, Jr., *Securities Regulation*, 57 SMU L. REV. 1207, 1228 (2004).

32. 30 Tex. Reg. 6875 (2005), adopted 30 Tex. Reg. 8868 (2005) (codified as an amendment to 7 TEX. ADMIN. CODE §§ 116.1, 116.2, and 116.4) (for investment-advisor registration) (without comment, accommodating SEC's Form BR, Uniform Branch Office Form, replacing the definition of branch office and branch manager to conform with the terminology of the NASD, conforming other terminology, providing for filing of Form BR through the Central Registration Depository, shortening the period for a registration application to be considered automatically withdrawn, and eliminating outdated information).

33. 31 Tex. Reg. 365 (2006), adopted 31 Tex. Reg. 2846 (2006) (codified as an amendment to 7 TEX. ADMIN. CODE § 116.2) (for investment-advisor registration, without comment).

34. Those rendering compensated investment advice must register. TEX. REV. CIV. STAT. ANN. art. 581-12(B) (Vernon Supp. 2006). See *In re Inv. Adviser Representative Re-*

lapsed when they failed to transition into the electronic filing system of the NASD³⁵ as a result of failing to amend their registration to reflect a

gistration of John Alan Braden, No. IC06-CAF-48, 2006 WL 2989280 (Tex. State Sec. Bd. Oct. 11, 2006) (reprimanding and ordering an administrative fine of \$1,000 for providing services for compensation before registration discovered on staff inspection of branch office); *In re Application for Inv. Adviser Representative Registration of William Anthony Richter*, No. IC06-CAF-46, 2006 WL 2929570 (Tex. State Sec. Bd. Oct. 6, 2006) (reprimanding and ordering an administrative fine of \$3,500 for providing compensated services before registration); *In re Application for Inv. Adviser Representative Registration of Keith Murellhuber, Jr.*, No. IC06-CAF-35, 2006 WL 2355986 (Tex. State Sec. Bd. Aug. 10, 2006) (granting the registration, reprimanding, and ordering an administrative fine of \$25,000 for providing compensated services after lapse of registration); *In re Agent Registration of John Clauge Husbands*, No. IC06-CDO-34, 2006 WL 2337252 (Tex. State Sec. Bd. Aug. 8, 2006) (reprimanding, ordering an administrative fine of \$2,000, and ordering a cease and desist for providing compensated service after lapse and while registered as a dealer); *In re Inv. Adviser Registration of Carroll, Caton & Greenway*, No. IC06-CAF-27, 2006 WL 2250905 (Tex. State Sec. Bd. Aug. 2, 2006) (reprimanding and ordering an administrative fine of \$1,000 for providing compensated service after lapse of registration); *In re Inv. Adviser Representative Registration of David Todd Machemehl*, No. IC06-CAF-24, 2006 WL 2233203 (Tex. State Sec. Bd. July 24, 2006) (reprimanding and ordering an administrative fine of \$8,500 for providing compensated service without registration); *In re Application for Inv. Adviser Representative Registration of David George Moring*, No. IC06-CAF-21, 2006 WL 1970208 (Tex. State Sec. Bd. July 3, 2006) (granting registration, reprimanding, and ordering an administrative fine of \$1,500 for compensated service after lapse of registration); *In re Inv. Adviser Registration of Briner Capital*, No. IC06-CDO/FIN-10, 2006 WL 1677891 (Tex. State Sec. Bd. June 7, 2006) (reprimanding and ordering an administrative fine of \$1,500 for using an unregistered representative, and ordering a cease and desist against the representative); *In re Application for Inv. Adviser Registration of Briggs Mgmt. and Research Co.*, No. IC06-CAF-08, 2006 WL 1622331 (Tex. State Sec. Bd. June 1, 2006) (granting registration, reprimanding, and ordering an administrative fine of \$1,000 for providing compensated service after lapse of registration); *In re James Charles Lennon*, No. 06-IC01, 2006 WL 563058 (Tex. State Sec. Bd. Feb. 21, 2006) (cease-and-desist order and ordering an administrative fine of \$30,000 for providing compensated service after lapse of registration).

35. *See, e.g., In re Application for Inv. Adviser Representative Registration of George Murphy Davis Jr.*, No. IC06-CEN-36, 2006 WL 2426157 (Tex. State Sec. Bd. Aug. 18, 2006) (granting the registration and reprimanding for rendering compensated investment advice during the lapse); *In re Application for Inv. Adviser Representative Registration of Nileymonroe Church*, No. IC06-CEN-37, 2006 WL 2426158 (Tex. State Sec. Bd. Aug. 18, 2006) (same); *In re Application for Inv. Adviser Representative Registration of Paul Alan Stotts*, No. IC06-CEN-33, 2006 WL 2384150 (Tex. State Sec. Bd. Aug. 4, 2006) (same); *In re Application for Inv. Adviser Representative Registration of Ralph Heffelman*, No. IC06-CEN-28, 2006 WL 2250907 (Tex. State Sec. Bd. Aug. 2, 2006) (same); *In re Application for Inv. Adviser Representative Registration of Richard Don Jordan*, No. IC06-CEN-29, 2006 WL 2250909 (Tex. State Sec. Bd. Aug. 2, 2006) (same); *In re Application for Inv. Adviser Representative Registration of Daniel Sholom Frishberg*, No. IC06-CEN-30, 2006 WL 2250911 (Tex. State Sec. Bd. Aug. 2, 2006) (same); *In re Application for Inv. Adviser Representative Registration of Karl Joseph Eggerss*, No. IC06-CEN-31, 2006 WL 2250912 (Tex. State Sec. Bd. Aug. 2, 2006) (same); *In re Application for Inv. Adviser Representative Registration of Daniel Martin Stewart*, No. IC06-CEN-32, 2006 WL 2250914 (Tex. State Sec. Bd. Aug. 2, 2006) (same); *In re Application for Inv. Adviser Representative Registration of Larry Dale Stamps*, No. IC06-CEN-15, 2006 WL 1734360 (Tex. State Sec. Bd. June 15, 2006) (same); *In re Application for Inv. Adviser Representative Registration of Ian Gordon Manson Cardono*, No. IC06-CEN-16, 2006 WL 1734361 (Tex. State Sec. Bd. June 15, 2006) (same); *In re Inv. Adviser Representative Registration of John Hart Keene*, No. IC06-CEN-11, 2006 WL 1677892 (Tex. State Sec. Bd. June 7, 2006) (same); *In re Inv. Adviser Representative Registration of Barry Curtis Richardson*, No. IC06-CEN-12, 2006 WL 1677893 (Tex. State Sec. Bd. June 7, 2006) (same); *see also In re Inv. Adviser Representative Registration of Gary J. Shalhoob*, No. IC06-CEN-18, 2006 WL 1893995 (Tex. State Sec. Bd. June 20, 2006) (reprimanding); *In re Inv. Adviser Representative Registra-*

federal felony fraud indictment,³⁶ engaging in the inequitable practice of not following client contracts,³⁷ misrepresenting Certified Financial Planner status,³⁸ and misrepresenting performance data to clients.³⁹

III. 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 removed the most difficult elements to prove in a common-law fraud action, namely scienter and privity.

A. COURT DECISIONS UNDER THE TEXAS ACTS

One Texas court of appeals considered an investment situation where the issuer concocted unusual arguments to void the securities it had sold. The opinion dealt with an issuer who granted overly favorable returns to investors under litigation funding agreements and then found various ways to renege on paying those returns, including some under the Texas Securities Act ("TSA"). In contrast, the Fifth Circuit considered a legitimately presented issue concerning inquiry notice necessary for the Texas statute of limitations for securities fraud.

1. *The In Pari Delicto Defense for Unregistered Securities*

In *Anglo-Dutch Petroleum International, Inc. v. Haskell*,⁴⁰ the Houston Court of Appeals for the First District considered litigation-funding

tion of Robert Gibson Gunn III, No. IC06-CEN-14, 2006 WL 1734359 (Tex. State Sec. Bd. June 13, 2006) (same).

36. Board rules require updating of registrations within thirty days of the event. 7 TEX. ADMIN. CODE § 116.9 (2006). For the Board action, see *In re Inv. Adviser Representative Registration of Ira Klein*, No. IC06-REV/FIN-44, 2006 WL 2869562 (Tex. State Sec. Bd. Oct. 4, 2006) revoking registration and ordering an administrative fine of \$15,000 for not reporting a federal grand-jury indictment for felony fraud.

37. The TSA permits the Board to revoke or suspend registrations for inequitable practices. See TEX. REV. CIV. STAT. ANN. art. 581-14A(3) (Vernon Supp. 2006); *In re Inv. Adviser Registration of Seniors Only Fin.*, No. IC06-SUS-38, 2006 WL 2469174 (Tex. State Sec. Bd. Aug. 23, 2006) (suspending registration fifty days for obtaining client acknowledgment of receipt of nonexistent privacy policies and withdrawing fees from accounts when the client contract called for a invoicing procedure); *In re Inv. Adviser Registration of Crabtree Capital Mgmt.*, No. IC06-CAF-17, 2006 WL 1893994 (Tex. State Sec. Bd. June 20, 2006) (reprimanding and ordering an administrative fine of \$2,500 for obtaining client acknowledgment of receipt of nonexistent privacy policies).

38. See, e.g., *In re Inv. Adviser Registration of JCM Capital Mgmt.*, No. IC06-SUS-23, 2006 WL 2040060 (Tex. State Sec. Bd. July 12, 2006) (reprimanding and ordering suspension of registration for ten days for claiming on Form ADV that an investment-adviser representative was a Certified Financial Planner after the representative's status had been revoked for failure to meet continuing education requirements; ordering an administrative fine of \$5,000 for representative).

39. See, e.g., *In re Inv. Adviser Registration of MDK Fin. Group*, No. IC06-CAF-05, 2006 WL 1175864 (Tex. State Sec. Bd. April 19, 2006) (reprimanding and ordering an administrative fine of \$10,000 for sending to clients performance data on their accounts after fees, when the data related to the adviser's model portfolio, without first deducting client commissions).

40. 193 S.W.3d 87 (Tex. App.—Houston [1st Dist.] 2006, pet. denied).

agreements entered into with investors. The issuer needed to raise money to fund both a lawsuit and fund operations to avoid bankruptcy. The underlying lawsuit involved the misappropriation of trade secrets and breaches of confidentiality agreements by a large oil-field-service company during the development of an oil and gas field. The issuer alleged damages of \$650 million as lost profits, was unable to obtain commercial bank loans due to a lack of sufficient collateral, and solicited \$560,000 from the investors through the litigation funding agreements. Although each funding agreement differed, suggesting a bargaining process, the agreements uniformly provided an interest in any cash recovery in the lawsuit contingent upon the existence of a cash recovery. The amount of the interest in the cash recovery varied between 300%, 200%, and 185% of the amount invested plus an additional return proportional to the number of days from the time of the investment to the date of the disposition of the lawsuit.

The issuer recovered only \$81 million, which was substantially less than expected. The issuer, therefore, attempted to renege on its own security and sent letters to the investors claiming the litigation-funding agreements were unenforceable and against Texas public policy. The issuer also sent amounts considerably below the amounts called for in the litigation-funding agreements to the investors along with a statement stating that the deposit of the check released the issuer from further liability under the litigation-funding agreements. The investors sued for breach of contract, fraud, breach of fiduciary duty, conspiracy, and conversion. They also sought a temporary injunction to prevent the disbursement of the cash recovery. The trial court granted the investors' summary-judgment motion on the breach of contract claim.⁴¹

The Houston Court of Appeals for the First District affirmed the summary judgment.⁴² But neither the trial court nor the court of appeals decided the issue of whether the litigation-funding agreements constituted securities, since the investors agreed to this for purposes of the summary judgment.⁴³ The securities issues involved two ridiculous arguments that the investors could not enforce the contract.⁴⁴ First, does the issuer of securities sold in violation of the TSA have the right to void the contract of sale as violative of the TSA? The issuer could cite no case so holding. The litigation-funding agreements allegedly violated the TSA, since the issuer had not registered them with the Board.⁴⁵ The

41. *Id.* at 90.

42. *Id.* at 105.

43. *Id.* at 102.

44. The issuer also opposed the motion for summary judgment, claiming fact issues on two other nonsecurities grounds: (1) litigation-funding agreements constituted usurious loans, despite evidence clearly indicating the investments were subject to risk at the time entered into; and (2) litigation-funding agreements were champertous, preying on financially desperate plaintiffs, despite evidence clearly indicating the issuer had solicited the investors. These half-baked grounds fared no better than the securities grounds.

45. One would think that this approach to a violation of the TSA would also require proof of not complying with an exemption from registration. The opinion contains no

court of appeals noted that the whole purpose of the TSA, as well as the Securities Act of 1933,⁴⁶ was to protect investors, not issuers.⁴⁷ Consequently, both Texas courts for the TSA⁴⁸ and the federal courts for the Securities Act⁴⁹ have determined that contracts for the purchase of securities are not void but voidable only at the option of the purchasers. Second, could this issuer use the *in pari delicto* defense to thwart enforcement of the contract?⁵⁰ The issuer depicted itself as a victim preyed upon by the litigation-funding industry, based on allegations that one investor's sole purpose was to invest in lawsuits and that other investors were sophisticated investors or owners of oil and gas businesses.⁵¹ The elements for the cause of action specified under the Securities Act of 1933⁵² are: (1) the buyer had at least equal responsibility in the violation; (2) preclusion of the buyer's recovery would not interfere with enforcement of the securities laws; and (3) the role of the buyer was more of a promoter than an investor.⁵³ Using these elements, the court of appeals found no evidence that the role of the investors was more of a promoter than an investor.⁵⁴ The issuer had solicited the investors, had made the presentation to the investors, and had provided the litigation funding agreements modeled after an agreement of one of the issuer's previous

discussion of exemptions. The issuer, however, to explain away the risk for usury purposes, provided testimony that the issuer described details of the lawsuit being funded and the relevant evidence discovered to date with the potential investors. The issuer, to argue its *in pari delicto* defense, described one investor as an investor whose sole purpose was to invest in lawsuits and other investors as sophisticated investors or owners of oil and gas businesses. Both of these claims, if true, might establish a private-placement exemption, and hence no violation of the securities laws.

46. 15 U.S.C.A. §§ 77a et seq. (West Supp. 2006).

47. 193 S.W.3d at 102-03.

48. The TSA states that a party who made or performed a contract in violation of the TSA or a rule thereunder cannot enforce the contract. *See* TEX. REV. CIV. STAT. ANN. art. 581-33(K) (Vernon Supp. 2006). Under the Texas Securities Act of 1935, the predecessor of the TSA, a Texas court of appeals held that a promoter's failure to comply with the securities act did not render royalty contracts being promoted automatically void, but instead made them voidable and subject to being set aside by purchasers. *Smith v. Fishback*, 123 S.W.2d 771, 778 (Tex. Civ. App.—Texarkana 1938, writ ref'd).

49. The federal Securities Act has no provision voiding contracts. *But see* 15 U.S.C.A. § 78cc (West Supp. 2006) (Exchange Act provision declaring contracts made in violation of the Exchange Act void with respect to the rights of the violator). The Supreme Court has refused to void contracts in violation of the Securities Act on public policy grounds, declaring that they are voidable at the option of the investor. *A.C. Frost & Co. v. Coeur D'Alene Mines Corp.*, 312 U.S. 38, 43 (1941).

50. TEX. REV. CIV. STAT. ANN. art. 581-33(K) (Vernon Supp. 2006) (no person knowingly making or performing a contract in violation of the securities laws may base a lawsuit on the contract).

51. Brief of Appellants at 11-14, *Anglo-Dutch Petroleum Int'l, Inc., v. Haskell*, 193 S.W.3d 87 (Tex. App.—Houston [1st Dist.] 2006, pet denied) (No. 01-05-00129-CV).

52. The federal courts first applied the defense for tippers sued under the Exchange Act by their tippees, found liable to investors, *see Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985) (under Rule 10b-5), and later extended it to actions against issuers sued under the Securities Act by investors who assist the issuer with unregistered securities. *Pinter v. Dahl*, 486 U.S. 622, 633-39 (1988).

53. 193 S.W.3d at 103.

54. *Id.*

lenders who had furnished funds for the litigation.⁵⁵

2. *Inquiry Notice for the Texas Statutes of Limitations for Securities Fraud*

In *Margolies v. Deason*,⁵⁶ the Fifth Circuit dealt with shareholders who sold their company in exchange for the buyer's common stock. The buyer subsequently went bankrupt leaving the shareholders with worthless stock. Four-and-a-half years after the exchange, the bankruptcy trustee filed actions against the management of the bankrupt company alleging that self-dealing and fraud resulted in the company's collapse. Within five years of the exchange, the shareholders filed suit against these managers alleging violations of the TSA, the Securities Act of 1933, and the Exchange Act of 1934, and common-law fraud. The trial court dismissed all the claims as time-barred, claiming the disclosures by the issuer amounted to a "storm warning" to the investors long before the time periods specified in the statute of limitations.⁵⁷

The statute of limitations for TSA claims⁵⁸ is three years, but no more than five years, from the time of the discovery.⁵⁹ So the issue for these claims was whether the shareholders should have discovered the fraud more than three years before filing their lawsuit. The matter of inquiry notice ordinarily is a fact question for a jury, unless reasonable people would not differ on the evidence provided.⁶⁰ The issuer's disclosures listed some sales of property to management on which the issuer took losses, but there was no indication the issuer made them at below-market value, as alleged in the fraud complaint. Disclosures of other sales to management did not include any details. And disclosures of management's compensation did not suggest any sales of property at below-market value to them. Consequently, the Fifth Circuit concluded that there was insufficient information for a reasonable person to conclude the investors were on inquiry notice prior to the bankruptcy filing, and, therefore, the dismissals of these actions on summary judgment was in error.⁶¹

As to the common-law fraud claim, the statute of limitations is four years.⁶² The issue for this claim was whether the fraudulent concealment of the action by the alleged misrepresentations tolled the statute of limitations. Again, this ordinarily is a fact question for the jury. The Fifth Circuit likewise concluded that the dismissal of this action on summary judgment was in error.⁶³

55. *Id.*

56. 464 F.3d 547 (5th Cir. 2006).

57. *Id.* at 554.

58. See TEX. REV. CIV. STAT. ANN. arts. 581-33(A)(2) (Vernon Supp. 2006) (for misrepresentations and omissions); TEX. REV. STAT. ANN. art. 581-33(F) (Vernon Supp. 2006) (for controlling-person liability).

59. TEX. REV. CIV. STAT. ANN. art. 581-33(H) (Vernon Supp. 2006).

60. 464 F.3d at 553.

61. *Id.* at 554-55.

62. TEX. CIV. PRAC. & REM. CODE ANN. § 16.004(a) (Vernon 2002).

63. 464 F.3d at 555.

B. COURT DECISIONS UNDER THE FEDERAL ACTS

The fraud provisions of the TSA are modeled on the federal statutes.⁶⁴ As a result, Texas courts interpreting the TSA frequently look to federal decisions. Just as one Texas court of appeals wrestled with less than stellar securities arguments, the Fifth Circuit had its own rash of weak arguments. During the Survey period, only one investor adequately raised the issue of whether the Sarbanes-Oxley Act extended the federal limitations period for expired federal actions.⁶⁵ The one Private Securities Litigation Reform Act (“PSLRA”) of 1995⁶⁶ petition did not even try to comply with the specific factual-allegation requirements.⁶⁷ Another investor lacked standing as neither a seller nor a purchaser of securities.⁶⁸ A defendant concocted half-baked arguments that the court lacked jurisdiction for his attempted fraud.⁶⁹ One criminal court could not calculate damages for a sentencing enhancement in a securities fraud case.⁷⁰ And one investor failed to raise the issue of the court’s authority to ignore state-liquidation statutes in the disgorgement remedy for securities fraud.⁷¹

1. *Limitation Periods for Securities Fraud Under the Sarbanes-Oxley Act*

The court in *Margolies*⁷² also confronted the limitations for the action under the federal securities acts as well as the Texas statutes. For the federal Securities Act claim (misrepresentations in a registration statement and prospectus)⁷³ and the Exchange Act claim (fraud in the sale of a security violating Rule 10b-5),⁷⁴ the statute of repose⁷⁵ is one year from the time of discovery but no more than three years from the time of the sale.⁷⁶ This means that after the period expires, the right to the action ceases, and there is no tolling. But the Sarbanes-Oxley Act extended the statute of repose for fraud actions under the federal securities laws to *two* years from the time of discovery but no more than five years from the

64. See *Anglo-Dutch Petroleum Int’l, Inc. v. Haskel*, 193 S.W.3d 87, 103 n.13 (Tex. App.—Houston [1st Dist.] 2006, pet. denied).

65. *Margolies*, 464 F.3d 547, 550 (5th Cir. 2006).

66. 15 U.S.C.A. § 78u-4 (West Supp. 2006).

67. *Fin. Acquisition Partners v. Blackwell*, 440 F.3d 278, 285–86 (5th Cir. 2006).

68. *Holland v. GEXA*, 161 F. App’x 364, 365 (5th Cir. 2005).

69. *SEC v. Res. Dev. Int’l*, 160 F. App’x 368, 370 (5th Cir. 2005).

70. *United States v. Olis*, 429 F.3d 540, 548 (5th Cir. 2005).

71. *SEC v. Great White Marine & Recreation, Inc.*, 428 F.3d 553, 556 (5th Cir. 2005).

72. 464 F.3d 547 (5th Cir. 2006).

73. See 15 U.S.C.A. §§ 77k–l (West Supp. 2006).

74. See 17 C.F.R. § 240.10b–5 (2006).

75. A statute of repose extinguishes both the right and the remedy after a period of time, while a statute of limitations merely extinguishes the remedy. See, e.g., *Kaplan v. Shure Bros., Inc.*, 153 F.3d 413, 422 (7th Cir. 1998). The federal limitations period in the Securities Act and Exchange Act are statutes of repose. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 360 (1991).

76. For the Securities Act, see 15 U.S.C.A. § 77m (West Supp. 2006). For the court-implied action under Rule 10b-5 action, see *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 (1991).

time of the sale.⁷⁷ The issue was whether the Sarbanes-Oxley Act, passed after the federal securities law statute of repose had run against the shareholders' action but before their lawsuit filing, revived their action.⁷⁸ The Fifth Circuit followed the Second, Third, Fourth, Seventh, and Eighth Circuits⁷⁹ in deciding that the Sarbanes-Oxley Act did not revive an expired claim.⁸⁰ The Fifth Circuit found the Sarbanes-Oxley provision ambiguous.⁸¹ The Act states that it applies to all actions filed after the passage of the Act but also says it does not create new, private rights of action. This language might not only revive expired claims, but could also extend the limitations period to those actions not expired when the Act was passed. The legislative history contains nothing to resolve this ambiguity. Consequently, the presumption that a statute does not apply retroactively meant the shareholders' federal securities claims were time-barred.⁸²

2. *Pleading Misrepresentation and Scienter under the PSLRA*

The Fifth Circuit considered one case involving the pleading requirements of the PSLRA. The PSLRA requires pleadings for private securities fraud actions under the federal statutes to apprise each defendant as to his particular part in the fraud. The PSLRA accomplishes this task by requiring the petition to specify each misleading statement, the reasons the statement is misleading, if the misstatement or omission is based on information and belief, facts on which the belief is formed, and facts giving rise to a strong inference that the perpetrator acted with the required state of mind.⁸³ The federal rules of civil procedure similarly require particular allegations of the circumstances constituting the fraud,⁸⁴ which the Fifth Circuit has determined includes the time, place, and identity of the speaker of the misstatement.⁸⁵ These pleading requirements as to misstatements and scienter are regarded as difficult and are designed to rid the court of time-consuming fishing expeditions using the federal discovery rules, since the PSLRA requires dismissal for pleading errors prior to discovery.⁸⁶

77. 28 U.S.C.A. § 1658(b) (West Supp. 2006).

78. 464 F.3d 547, 550–51 (5th Cir. 2006).

79. See *In re* Enter. Mortgage Acceptance Co. Sec. Litig. v. Enter. Mortgage Acceptance Co., 391 F.3d 401, 411 (2d Cir. 2005); *Lieberman v. Cambridge Partners*, 432 F.3d 482, 490–91 (3d Cir. 2006); *Glaser v. Enzo Biochem, Inc.*, 126 F. App'x 593, 598 (4th Cir. 2005); *Foss v. Bear, Stearns & Co.*, 394 F.3d 540, 542 (7th Cir. 2005); *In re* ADC Telecomms., Inc. Sec. Litig., 409 F.3d 974, 978 (8th Cir. 2005). *Contra* *Tello v. Dean Witter Reynolds, Inc.*, 410 F.3d 1275, 1281–82 (11th Cir. 2005).

80. 464 F.3d at 550–51.

81. *Id.* at 552.

82. *Id.* at 553.

83. 15 U.S.C.A. § 78u-4(b)(1) & (2) (1997).

84. FED. R. CIV. P. 9(b).

85. See *Williams v. WMX Techs., Inc.*, 112 F.3d 175, 177 (5th Cir. 1997).

86. See 15 U.S.C.A. § 78u-4(b)(3)(A) (1997).

In *Financial Acquisition Partners LP v. Blackwell*,⁸⁷ the Fifth Circuit dealt with another failure to plead securities fraud for a class action under the PSLRA.⁸⁸ The issuer made loans to middle-market businesses and bundled those loans for sale to third parties, retaining a subordinated interest in the bundled loans. The value of the issuer's assets and cash flow depended on assumptions concerning the projected credit loss from those loans and the present-value discount of future income from those loans. The issuer suffered successive annual losses and became bankrupt. The shareholders sued the officers for violation of Rule 10b-5,⁸⁹ for misrepresenting that the issuer would obtain warehouse financing, for overstating assets, and for failing to disclose the default of a major loan, the retention of a restructuring firm, and the adoption of an executive compensation plan. The shareholders also sued the accountants for failing to issue a going-concern qualification. The district court dismissed the lawsuit as not meeting the pleading requirements of the PSLRA. The Fifth Circuit affirmed.⁹⁰

The investors had difficulty identifying the spokesmen of the warehouse financing misstatement. The misrepresentation occurred at a shareholders' meeting. Generally, the spokesperson is liable for the misstatement, and the remaining officers are liable for failing to correct the misstatement. When there are only two defendants present, the Fifth Circuit has not required pleadings to specify which officer made the statement and which remained silent.⁹¹ But when several officers are present, the Fifth Circuit requires the identification of the speaker.⁹² Since this pleading did not identify which defendant made the statement at the shareholders' meeting and which defendants remained silent, the district court properly dismissed it.⁹³

The investors also had difficulty explaining why a particular misstatement or omission was fraudulent. The investors plead no facts suggesting that the credit-loss or discount assumptions were erroneous, describing

87. 440 F.3d 278 (5th Cir. 2006) (from the Northern District of Texas). The other three issues dealt with collateral estoppel, an expert's affidavit, and leave to amend. The district court correctly denied collateral estoppel, which requires the same legal standards, since the earlier court, the Northern District of Oklahoma, had used group pleading for the securities fraud, a practice permissible in the Tenth Circuit, but, subsequent to the Oklahoma court's opinion, rejected in the Fifth Circuit. See *Southland Sec. Corp. v. Inspire Ins. Solutions, Inc.*, 365 F.3d 353, 363 (5th Cir. 2004); see also George Lee Flint, Jr., *Securities Regulation*, 58 SMU L. REV. 1135, 1155 (discussing *Southland Sec. Corp.*). The district court correctly ignored the opinion portion of the expert's report attached to the pleading since the PSLRA requires pleading of facts, not opinions. See 15 U.S.C.A. § 78u-4(b) (West 1997). The district court also properly denied leave to amend, since the investors had failed to explain why they were unable to obtain the information before filing their second amended petition.

88. 15 U.S.C.A. § 78u-4 (West 1997).

89. 17 C.F.R. § 240.10b-5 (2006).

90. 440 F.3d at 282, 292.

91. See *Barrie v. Intervoice-Brite, Inc.*, 397 F.3d 249, 263 (5th Cir. 2005), *modified and reh'g denied*, 409 F.3d 653 (5th Cir. 2005); see also Flint, *supra* note 87, at 1557-58.

92. *Id.* at 288-89.

93. 440 F.3d at 292.

the major loan and how it led to the issuer's demise, explaining how the retention of a restructuring firm rendered the recovery plan fraudulent, or describing the value of the compensation plan and how it exceeded the issuer's market capitalization.

The investors also failed to allege facts supporting a scienter allegation. For the officers, the investors only alleged that a job-retention goal motivated the officers. In the Fifth Circuit, this is insufficient.⁹⁴ Similarly, the investors did not plead with sufficiently particularized facts how the accountants were remiss in failing to discern that the issuer's plan to deal with its financial problems would be ineffective.⁹⁵

3. *Standing to Sue for Corporate Mismanagement*

In *Holland v. GEXA*,⁹⁶ the Fifth Circuit dealt with a private placement where the investor's lawyer lacked the ability to draft understandable trial petitions and appellate briefs. The investor complained of a fraudulent transaction that occurred after the sale to him. The trial court dismissed the claims. The Fifth Circuit affirmed.⁹⁷ The Rule 10b-5 fraudulent-sale action failed since the investor, at the time of the alleged fraud, was not a purchaser or seller as required by the rule, but rather a shareholder complaining of issuer mismanagement.⁹⁸ The claim for a misleading prospectus under Securities Act section 12(a)(2) failed since it applies only to public offerings.⁹⁹ The investor did not allege a violation of Securities Act section 12(a)(1) for failure to register. Since the district court dismissed the federal causes of action before trial, dismissal without prejudice of the state law claims, including ones under the TSA, did not amount to abuse of discretion.¹⁰⁰

4. *False Claims of Lack of SEC Jurisdiction*

In *SEC v. Resource Development International LLC*,¹⁰¹ the Fifth Circuit dealt with an SEC action against promoters for violating the registration and anti-fraud provisions of the federal securities laws in a scheme to raise \$100 million. The SEC sought appointment of a receiver and a preliminary injunction, freezing the promoters' assets and seeking an accounting. The district court granted a temporary injunction appointing a receiver, requiring the promoters to deliver assets to the receiver, enjoining the promoters from interfering with the receiver or filing bankruptcy, and ordering the promoters to produce an accounting. The promoters, pro se, filed documents labeled "Response by Special Visitation." The district court granted the SEC's motion for default judgment.

94. See *Melder v. Morris*, 27 F.3d 1097, 1102 (5th Cir. 1994).

95. 440 F.3d at 290-91.

96. 161 F. App'x 364 (5th Cir. 2005) (from the Western District of Texas).

97. *Id.* at 365-66.

98. *Id.* at 365.

99. See *Lewis v. Fresne*, 252 F.3d 352, 357 (5th Cir. 2001); 161 F. App'x at 366.

100. 161 F. App'x at 366.

101. 160 F. App'x 368 (5th Cir. 2005), *cert. denied* 127 S. Ct. 248 (2006).

One promoter withdrew money from his bank account, another changed the locks on his office, which the receiver had seized, and the third filed for bankruptcy in Wisconsin. The district court held all three in contempt of court. The Fifth Circuit affirmed.¹⁰²

The promoters contended the district court lacked jurisdiction of the case for a variety of reasons. First, Congress's 1948 act creating the "United States District Court" was unconstitutional, since the Constitution uses the language "district courts of the United States." Second, the SEC lacked standing, since it failed to first hold an administrative hearing. But the Securities Act and Exchange Act allow the SEC to bring actions in the first instance.¹⁰³ Third, Rule 10b-5 was invalid since the SEC had not published it in the Federal Register. But the SEC had.

5. *Enhancement of Sentence for Securities Fraud Under the Federal Sentencing Guidelines*

In *United States v. Ollis*,¹⁰⁴ the Fifth Circuit considered the sentencing of an issuer's financial officer for securities fraud. The scheme involved depicting loan proceeds as positive cash flow from operations. The issuer's bank lenders owned a special-purpose entity that would borrow money from the banks, purchase gas at market prices, and sell the gas to the issuer at a discount. The issuer then sold the gas at market prices, generating the cash flow. In subsequent years, the special-purpose entity would buy gas at market prices and sell the gas to the issuer at above-market prices. The issuer's payments would enable the banks to recover their principle and interest. The desired accounting characterization required that the special-purpose entity be sufficiently independent of the issuer and that its owners, the banks, be at risk. The issuer, however, to ensure the banks would not lose any money, entered into side agreements with the banks and the special-purpose entity. In order to get the desired accounting treatment, the financial officer, and his co-defendants, concealed these agreements from the outside accountants.¹⁰⁵ The SEC reviewed this transaction in its second year and required the issuer to restate the cash flow as derived from financing, rather than from operations. The issuer's stock price dropped. The Justice Department indicted the financial officer for securities fraud, among other counts. The district court convicted the officer and gave him an enhanced sentence due largely to the loss suffered by one shareholder. The Fifth Circuit affirmed the conviction but reversed and remanded the sentence enhancement.¹⁰⁶

Federal sentencing guidelines provide for enhanced jail time for significant losses caused by perpetrators of securities fraud. The district court should use the greater of actual loss or intended loss, thus incorporating a

102. *Id.* at 371.

103. *See* 15 U.S.C.A. §§ 77t(b), 78u(d)(1) (West Supp. 2006).

104. 429 F.3d 540 (5th Cir. 2005).

105. *Id.* at 592.

106. *Id.*

causation standard.¹⁰⁷ The Fifth Circuit analogized this calculation to the corresponding calculation of civil damages under the securities laws where losses caused by factors other than the fraudulent act are not included in compensable loss.¹⁰⁸ The district court, in determining the enhancement factor, calculated the loss as the total loss by one large shareholder, who had bought at the top of the market. Two-thirds of this shareholder's loss had occurred before the disclosure of the fraudulent scheme and more than a week after the announcement of the fraud, due to both a general decline in the gas industry and the issuer's failed attempt to acquire another company.¹⁰⁹

6. *The Court's Authority to Avoid State Statutes of Liquidation for the Disgorgement Remedy*

In *SEC v. Great White Marine & Recreation, Inc.*,¹¹⁰ the Fifth Circuit dealt with an attempt to circumvent an SEC disgorgement proceeding by filing bankruptcy against the issuer. The SEC filed its proceeding in Texas against the issuer and its chief executive officer. The district court appointed an agent to collect, liquidate, and disburse assets. The district court also ordered a stay of all claims against the issuer. The SEC, the issuer, and the chief executive officer settled; the officer paid \$3 million to the agent. Shortly thereafter, a \$1 million creditor filed an involuntary bankruptcy action against the issuer in Illinois. The district court found that the creditor had violated the stay and ordered the creditor to file an order transferring the bankruptcy proceeding to the district court, which the district court dismissed. The agent recommended the equitable subordination of the creditor's debt to the defrauded investors, who received \$.08 per share, and to the other creditors, with this creditor receiving nothing. The district court accepted the recommendation due to the "knowing and willful" violation of the district court's order that resulted in substantial costs to defend the lawsuit. The creditor appealed. The Fifth Circuit affirmed.¹¹¹

The creditor obfuscated a legitimate issue over the SEC's authority to ignore state-liquidation statutes and order subordination of the creditor's debt. The creditor's counsel conceded that it was aware of the stay at the time of the bankruptcy filing. The agent had also indicated to the creditor's accountant before the bankruptcy filing that there were stay orders in the case. There was no release of the stay, so the district court's action was within its discretion.¹¹²

107. U.S. SENTENCING GUIDELINES MANUAL § 2B1.1, cmt. n 3(A) and cmt. background ("Reason for Amendment of Nov. 1, 2001," definition of loss). The federal sentencing guidelines are advisory, not mandatory. *See United States v. Booker*, 543 U.S. 220 (2005).

108. *See, e.g.*, 15 U.S.C.A. §§ 77k(e), 77l(b) (West Supp. 2006).

109. 429 F.3d at 548-49.

110. 428 F.3d 553 (5th Cir. 2005).

111. *Id.* at 557.

112. *Id.*

The dissenting opinion¹¹³ challenged the district court's "knowing and willful" finding based on the creditor's obfuscation.¹¹⁴ Upon the settlement, the district court entered a final judgment closing the case. This action would not alert someone that the stay remained in effect. Additionally, the district court initially found the creditor was only on inquiry notice of the pendency of the stay. Moreover, all parties treated the bankruptcy as a viable proceeding. The dissent also noted that the creditor might not recover much, since most of the assets to distribute to the investors came from the chief executive officer, not the issuer. So, a court reconsidering the matter might not reach the novel issue of whether the deference granted a receiver appointed at the request of the SEC can ignore state law priorities in the winding-up of an issuer.

IV. CONCLUSION

The Board had the opportunity to lead both the state and federal securities regulatory bodies with respect to easing registration requirements through rule changes for finders, those who assist issuers in finding purchasers. The Board also issued no-action letters for nonregistration of securities issued in connection with various reorganizations involving a Massachusetts business trust, a demutualization of an insurance company, and an exchange of private shares for public American Depositary Receipts.

Other than considering the availability of the *in pari delicto* defense for litigation-funding agreements, the courts generally avoided the interesting issues, such as whether a seller's fraud tolls the statute of limitations under the TSA for securities fraud and whether the SEC has authority to ignore state statutes of liquidation when formulating disgorgement orders against perpetrators of securities fraud.

113. *Id.*

114. *Id.* at 557-59.

