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# Texas Annual Survey: Securities Regulation

George Lee Flint Jr
*St. Mary's University School of Law*, gflint@stmarytx.edu



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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. This article focuses on securities regulation in Texas,[1] and touches on federal securities law when necessary.[2] This article is not, however, intended to exhaust all aspects of securities regulation, instead it is meant to update Texas-based securities practitioners with new developments of interest.

## I. COVERAGE OF THE SECURITIES ACTS

The definitions—especially those relating to what constitutes a security, who may recover, and the territorial reach—determine the scope of the securities acts. The Fifth Circuit narrowed the types of fraud that are covered by the Texas Securities Act ("TSA") by holding that the TSA did not cover fraud in connection with interest rate swaps.[3] In contrast, the Texas Supreme Court, in dicta, expanded the scope of the TSA by finding that the TSA does have extra-territorial reach for those victimized by Texas-based sales.[4] The importance of these scope questions is that the TSA allows recovery of attorney's fees and provides for liability for situations not permitted under other states' securities laws.

### A. DEFINITION OF SECURITY

The Fifth Circuit, in a non-precedential decision, narrowed the types of fraud that the TSA covers by limiting the definition of "security."[5] Many purported fraud victims assert a claim under the Texas Securities Act in

* H. Andy Professor of commercial Law, St. Mary's University School of Law, San Antonio, Texas; B.A., 1966, B.S., 1966, M.A., 1969, University of Texas at Austin; Nuc. E. 1969, Massachusetts Institute of Technology; Ph.D. (Physics), 1973, J.D. 1975, University of Texas at Austin.

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. art. 581 (Vernon Supp. 2008) (TSA); TEX. BUS. & COM. CODE ANN. § 27.01 (Vernon 2002 & supp. 2008) (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* TEX. REV. CIV. STAT. ANN. art. 581-33 cmt. to 1977 Amendment (Vernon Supp. 2008).

3. K3C Inc. v. Bank of Am., N.A., 204 F. App'x 455, 465 (5th Cir. 2006).

4. Citizens Ins. Co. of Am. v. Daccach, 217 S.W.3d 430 (Tex. 2007), *rev'd* 105 S.W.3d 712 (Tex. App.—Austin 2003).

5. *K3C Inc.*, 204 F. App'x at 465.

order to recover attorney's fees.[6] The Fifth Circuit faced a case involving an alleged fraudulent omission with respect to an interest rate swap under the TSA, along with numerous other claims.[7] The Securities and Exchange Commission ("SEC") had enforced federal securities laws against those engaged in fraudulent interest rate swaps, contending the swaps involved securities.[8] But more recently, Congress specifically excluded interest rate swaps from the definition of "security" in both the Securities Act of 1933 ("SA") and the Exchange Act of 1934 ("EA").[9] Although the TSA defines "security" similarly, it does not contain this exclusion. In *K3C Inc. v. Bank of America, N.A.*,[10] a bank entered into a hedging plan with a borrower which involved interest rate swaps that reduced the customer's interest rate risk and generated fees for the bank. In addition to paying its normal interest payments during each pay period, the borrower would receive payments from the bank if interest rates went above a set fixed interest rate. On the other hand, the borrower would pay additional amounts if interest rates went below the set fixed interest rate. The plan also had a ceiling provision; if interest rates rose above a specified level above the fixed interest rate, no payments would be due by the bank during such period. The borrower made several payments under the plan, then cut its losses by terminating the interest rate swap and paid off its loans to the bank, but refusing to pay the interest rate swap termination fee. The borrower then sought to recover the monies paid under the interest rate swap alleging several causes of action including one under the TSA. The trial court ruled against the borrower on all its claims and in favor of the bank on its contractual counterclaim. The Fifth

6. *See* TEX. REV. CIV. STAT. ANN. art. 581-33D(7) (Vernon Supp. 2008) (allowing injured investors to recover attorney's fees if a court finds that such recovery would be equitable).

7. *K3C Inc.*, 204 F. App'x at 465.

8. The Securities and Exchange Commission [hereinafter SEC] has obtained settlement agreements from a broker and its agent for selling treasury-linked interest rate swaps with cap options at values that the broker's sophisticated calculations significantly understated potential losses. *See* Vazquez, Exchange Act Release No. 33-7269 (Feb. 29, 1996); BT Secs. Corp., Exchange Act Release No. 33-7124 58 SEC Docket 1145 (Dec. 22, 1994). Consequently, the Securities and Exchange Commission at that time viewed interest rate swaps as securities, subject to the anti-fraud rules of the Exchange Act of 1934.

9. After the interest rate swap transaction involved in the Fifth Circuit's case, Congress passed the Commodity Futures Modernization Act of 2000, Pub. L. 106-554, Appendix E, 114 Stat. 2763 (2000), to promote innovation of various derivatives by removing federal regulation. The act amended both the SA and the EA, to exclude swap agreements from the definition of "security" contained in those two acts. *See* 15 U.S.C.A. § 78c cmt. (West Supp. 2008) (explaining the definitions of "swap agreement," "security based swap agreement," and "non-security based swap agreement"); 15 U.S.C.A. § 77b-1 (West Supp. 2008) (the exclusion from the SA); 15 U.S.C.A. § 78c-1 (West Supp. 2009) (the exclusion from the EA). The idea is to remove interest rate swaps, among other types of swaps, from the registration requirements and regulations of the SEC, yet retain application of the EA's anti-fraud provisions to "security based swap agreements." *See* 15 U.S.C.A. § 78j(a)(2) (West Supp. 2008) (subjecting "security based swap agreements" to the anti-fraud rules of the SEC).

10. 204 F. App'x 455 (5th Cir. 2006) (non-precedential except in limited circumstances).

Circuit affirmed.[11]

The Fifth Circuit held that interest rate swaps were not securities under the TSA, and therefore no cause of action arose under the TSA.[12] Although there were no prior decisions under the TSA,[13] the Fifth Circuit found one federal case under the federal securities acts' old definition of "security" which established that interest rate swaps were not securities.[14] Consequently, the Fifth Circuit decided that these interest rate swaps were not securities.[15]

## B. Extra-Territorial Extent

The Texas Supreme Court, in dicta, finally made a pronouncement on the extra-territorial reach of the TSA.[16] The Act at least applies to registration of issuers and dealers as sellers of securities for offers and sales originating in Texas. This confirms some positions taken by the State Securities Board (the "Board') and the Texas Appellate Courts calling for the registration of securities and selling agents when offers and sales are made from Texas.[17] Specifically, the case involved the certification of a

11. *See id.* at 467.
12. *See id.* at 465.
13. Since the Texas Legislature based portions of the TSA on the federal securities statutes, Texas courts rely on federal decisions to interpret the corresponding sections of the TSA. *See, e.g.*, Tex. Rev. Civ. Stat. Ann. art. 581-33 cmt. to 1977 Amendment (Vernon Supp. 2008). The definition of "security" is one of those corresponding sections. *See, e.g.*, First Mun. Leasing Corp. v. Blankenship, Potts, Aikman, Hagin & Stewart, P.C., 648 S.W.2d 410, 414 (Tex. App.—Dallas 1983, writ ref'd n.r.e.) (the decisions under the SA serve as a guide to the definition of "security" under the TSA because of the almost identical wording of the two statutes).
14. A district court found that the interest rate swap did not satisfy the requirements for the most likely portions of the definition of "security" under the SA for "investment contracts; . . . notes; . . . evidence of indebtedness; . . . options on securities; and . . . instruments commonly known as securities"). *See* Lehman Bros. Commercial Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co., 179 F. Supp. 2d 159, 164, 167 (S.D.N.Y. 2001) (following *Proctor & Gamble* without analysis for the New York securities act); *see also* Proctor & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270, 1277-83 (S.D. Ohio 1996). *Proctor & Gamble* used horizontal commonality (a promoter and several pooled investors) for the investment contract analysis, while the Fifth Circuit itself permits vertical commonality (one promoter and one investor), *see, e.g.*, Long v. Shultz Cattle Co., 881 F.2d 129, 140 (5th Cir. 1989), as do Texas courts. *See, e.g.*, Searsy v. Commercial Trading Corp., 560 S.W.2d 637, 640 (Tex. 1977). *Proctor & Gamble* found no investment contract in an interest rate swap since there was only one customer. Had the Fifth Circuit considered vertical commonality for the investment contract analysis for the interest rate swap, the Fifth Circuit would not likely change its conclusion, since for vertical commonality the Fifth Circuit also requires that the profit come from the promoter's efforts, not market forces affecting the interest rate.
15. *See* 204 F. App'x at 465.
16. Citizens Ins. Co. of Am. v. Daccach, 217 S.W.3d 430, 430 (Tex. 2007), *rev'd* 105 S.W.3d 712 (Tex. App.—Austin 2003).
17. *See* 7 Tex. Admin. Code § 139.7 (2008) (exempting offers and sales from Texas by issuers and selling agents to non-residents outside of Texas from securities registration, but providing that such issuers and selling agents are dealers required to register unless otherwise exempt from registration, only take the selling materials outside Texas themselves, only receive money sent to Texas from the non-resident purchasers, or only perform clerical functions in Texas with respect to the closing of the sale). The exemption for securities registration implies that, unless under the exemption, securities must also be registered

class action securities lawsuit. The court had to determine whether questions of law or fact common to the members outweighed any such questions affecting only individual members of the class. In *Citizens Insurance Co. of America v. Daccach,*[18] the issuer, an out-of-state corporation, had its principal place of business in Texas. The issuer's subsidiary sold life insurance policies through foreign insurance agents exclusively to persons outside of the United States. The policies allowed the policyholders to assign their policy dividends to offshore trusts that used them to purchase common stock of the issuer, which was listed on an American exchange. The issuer had not registered any of its sales force anywhere as securities dealers. The issuer asserted that the life insurance policies were not subject to regulation in any of the countries in which the policyholders lived. Two foreign shareholders that had acquired their shares through their life policies filed a class action in Texas, alleging, *inter alia*, a violation of the TSA because the securities had been sold from Texas through unregistered dealers and agents.[19] One of the shareholders sought class certification with himself as the class representative but only for the TSA violation cause of action. The trial court granted the certification without analyzing the law of other jurisdictions. On an interlocutory appeal, the appellate court, with a one-word modification, upheld the class certification.

The Supreme Court decertified the class on non-securities law grounds,[20] rendering its pronouncement on the securities law aspect dicta.[21] The issuer claimed error from the trial court's failure to analyze the laws of other jurisdictions in determining whether there were common questions of law for the class. The issuer misunderstood the law.

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when the offer and sale is made from Texas to non-resident investors. In the late 1970s the State Securities Board's rules so provided.

For the court positions, *see* Enntex Oil & Gas Co. v. State, 560 S.W.2d 494, 495-96, 498 (Tex. Civ. App.—Texarkana 1977, writ ref'd n.r.e.) (found violation of the Texas Securities Act for selling unregistered securities, namely oil and gas interests, through unregistered selling agents to non-Texas residents by mailing material from Texas and making telephone calls from Texas); Rio Grande Oil Co. v. State, 539 S.W.2d 917, 918, 921 (Tex. Civ. App.—Houston [1st Dist.] 1976, writ ref'd n.r.e.) (found violation of the Texas Securities Act for selling unregistered securities, namely oil and gas interests, to non-Texas residents by mailing material from Texas, making telephone calls from Texas, and making glowing reports of the program to non-residents visiting Texas).

For more recent pronouncements, *see, e.g.*, Greenberg Traurig of N.Y., P.C. v. Moody, 161 S.W.3d 56, 63, 67, 102 (Tex. App.—Houston [14th Dist.] 2004, no pet.) (out-of-state aider and abetter of fraud); Grant Thornton L.L.P. v. Suntrust Bank, 133 S.W.3d 342, 361 (Tex. App.—Dallas 2004, pet. denied) (out-of-state victims of instate fraud); George Lee Flint, Jr., *Securities Regulation*, 58 SMU L. REV. 1135, 1139-42 (2005) (discussing *Greenberg Traurig* and *Grant Thornton*).

18. *Daccach*, 217 S.W.3d at 430; *see also* George Lee Flint., Jr., *Securities Regulation*, 58 SMU L. REV. 1135, 1139 n.24 (2005) (discussing Citizens Ins. Co. of Am. v. Daccach, 105 S.W.3d 712 (Tex. App.—Austin 2003), *rev'd* 217 S.W.3d 430 (Tex. 2007)).

19. *See* TEX. REV. CIV. STAT. ANN. art. 581-12(A) (Vernon Supp. 2008) (prohibiting "person[s], firm[s], corporation[s], or dealer[s]," directly or through agents from offering or selling securities in this state without first registering).

20. The class representative did not adequately represent the class since he abandoned the other issues in the lawsuit.

21. *See* 217 S.W.3d at 460.

An action for failure to register as a dealer of or selling agent for securities does not result in a conflict of laws analysis. Securities laws generally operate concurrently meaning that the laws of multiple jurisdictions may apply to a transaction.[22] For offers made from Texas to nonresidents, the Texas dealer registration requirements of the TSA apply,[23] providing the commonality of questions of laws to all members of the class regardless of the laws of other jurisdictions. So the only issue remaining is whether the application of the TSA for dealer registration for offers and sales to nonresidents violated constitutional limits. The need for the state to protect its own securities industry from a fraudulent reputation and its TSA-compliant dealers from unlawful competition satisfied constitutional requirements.

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22. *See, e.g.*, Unif. Sec. Act of 2002, § 610(c) ("[Offers in this State.] For the purpose of this section, an offer to sell or to purchase a security is made in this State, whether or not either party is then present in this State, if the offer: (1) originates from within this State; or (2) is directed by the offeror to a place in this State and received at the place to which it is directed."); *id.* cmt. 3 ("Section 610(c) provides that an offer which originates in State B and is directed to State A is made in both states. The securities act of State A would apply under Section 610(c)(2). The act of State B would apply also, under Section 610(c)(1). The intent is to prevent a seller in State B from using that state as a base of operations for defrauding person in other states.").

Before 1996, the federal securities laws and the state securities laws applied concurrently. *See, e.g.*, 48 Stat. 74, 85 (1934) (Section 18: "Nothing in this title shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person."). Congress modified this concurrency, starting in 1996, by preempting state securities laws for certain securities matters. The National Securities Markets Improvements Act of 1996 preempted some broker regulations by the states. *See* 15 U.S.C.S. § 78o(h) (LEXIS 2008) (states can not regulate extension of credit by dealers or impose capital or recordkeeping requirements). The subject action falls outside of that proscription. The Securities Litigation Uniform Standards Act of 1998 barred most class actions involving fraud for publicly traded securities. *See, e.g.*, 15 U.S.C.A. § 77p(b) (West Supp. 2008) (barring class actions involving more than fifty persons for fraud claims under state law with respect to covered securities); *id.* § 77r(b) (covered securities include those on the exchanges). The subject class action dealt with dealer registration, not fraud under the TSA.

23. The TSA has this same "in this state" language as does the Uniform Securities Act. *See* TEX. REV. CIV. STAT. ANN. art. 581-12(A) (Vernon Supp. 2008) ("Except as provided in Section 5 of this Act, no person, firm, corporation or dealer shall, directly or through agents, offer for sale, sell or make a sale of any securities in this state without first being registered as in this Act provided. No agent shall, in behalf of any dealer, sell, offer for sale, or make sale of any securities within the state unless registered as an agent for that particular registered dealer under the provisions of this Act."). The Texas State Securities Board has made it clear, under its authority to make exemptions from this statutory section, TEX. REV. CIV. STAT. ANN. art. 581-12(C) (Vernon Supp. 2008), that this covers offers and sales made from Texas to non-residents. *See* 7 TEX. ADMIN. CODE § 139.7(b) (2008) ("Sale of Securities to Nonresidents. . . . An issuer or selling agent who makes an offer or sale from Texas, by any means, including use of the mail or telephone, is a dealer and must comply with the dealer registration requirements of the Securities Act. . . . An offer is not deemed to be made from Texas merely because offering material is prepared in Texas, if such material is still in the possession of the issuer or its selling agent when it leaves the state. . . .").

## II. ORGANIZATION OF THE STATE SECURITIES BOARD

The TSA created the Board to handle the registrations required by the TSA and to serve as an enforcement agency. The Board views the major threats to Texas investors to be Ponzi schemes, unlicensed securities sellers, unregistered investment products, promissory notes issued by those unable to deliver promised returns, fraudulent or unsuitable opportunities targeted toward certain demographic groups, high-yield investments, internet fraud, variable annuity sales practices, and oil and gas scams.[24]

The Board made two changes to facilitate its record-keeping function. The Board amended its form for requesting reduced fees for certain persons registered in multiple capacities by updating cross references to the rules setting out the criteria and procedures for using the form.[25] The Board also updated its rule covering charges for copying public records to reflect the relocation of state copy charges rules from the Texas Building and Procurement Commission to the Office of the Attorney General.[26]

## III. REGISTRATION OF SECURITIES

The basic rule of most securities laws is that securities need to be registered with their corresponding regulatory agency unless they fall within an exemption. With respect to exemptions from registration, the Board amended one exemption rule and issued two no-action letters. The Board's enforcement actions focused on issuers failing to register their securities and those making misleading statements to aid their sales.

The Board amended its rule exempting listed securities to reflect the 2001 statutory amendments recognizing the name change of the Midwest Stock Exchange to the Chicago Stock Exchange, and to include a definition of the statutory "national market system of the NASDAQ stock market" to reflect recent changes in that market to include certain submarkets.[27]

The staff of the Board issued two no-action letters with respect to exemptions from registration. One dealt with the conversion of a Texas corporation into a Delaware corporation to operate as a cooperative

24. *See, e.g.*, Press Release, Texas State Secs. Board, Secs. Comm'r Identified Top 10 Treaty to Texas Investors Governor Perry Proclaims, "April Savings and Investing Month" (Apr. 6, 2005); Meena Thiruvengadam, *Scammers Drilling for Oil Investors*, SAN ANTONIO EXPRESS-NEWS, Apr. 7, 2005, at 1E (discussing the press release).

25. *See* 31 Tex. Reg. 8671 (Oct. 20, 2006) (repealing 7 TEX. ADMIN. CODE § 133.36, without comment); *see also* 31 Tex. Reg. 6440 (Aug. 18, 2006) (the proposal to repeal); 31 Tex. Reg. 8671 (Oct. 20, 2006) (adopting a new form); 31 Tex. Reg. 6440 (Aug. 18, 2006) (the proposal to adopt the new form).

26. *See* 32 Tex. Reg. 2135 (Apr. 13, 2008) (amending 7 TEX. ADMIN. CODE § 101.5, without comment); *see also* 32 Tex. Reg. 14 (Jan. 5, 2007) (the proposal to amend).

27. 32 Tex. Reg. 43 (Jan. 5, 2007) (amending 7 TEX. ADMIN. CODE § 111.2, without comment); *see also* 31 Tex. Reg. 8603 (Oct. 20, 2006) (the proposal). The Texas Securities Act exempts from registration securities listed on national exchanges. *See* TEX. REV. CIV. STAT. ANN. art. 581-6(F) (Vernon Supp. 2007). The legislature amended the statute to reflect the name change of the Chicago Stock Exchange in 2001. *See* 2001 TEX. SESS. LAW. SERV. 2409 (West).

under the Internal Revenue Code.[28] The company operated in bulk transactions to obtain lower prices for its members. All members owned ten shares of non-transferable, non-hypothecable Class A common stock, purchased for $100 per share and sold back upon withdrawal for the same price. The members additionally owned transferable Class B common stock and preferred stock based on each member's warehouse purchases. The company remitted the rebates as dividends on the preferred stock. There was no market for any of the shares. In the conversion, the preferred stock would be converted to Class B shares, and then the Class B and Class A shares would be exchanged for new Class B and Class A shares. The resulting Delaware company would have Class C shares issued to those members underinvested based on their warehouse purchases. The Delaware company would additionally issue notes to withdrawing members and pay rebates to alleviate cash flow problems. The officers would receive no extra compensation for the conversion work or for otherwise aiding the sale of the Delaware company's securities. The staff recommended no-action with respect to the registration of the securities involved in the conversion and also the registration of the officers as dealers.[29]

The second no-action letter considered a common stock purchase plan offering securities to employees and current shareholders.[30] The company, a New York corporation, was entirely owned by employees and retired former employees. The company sold its shares to employees for $20 per share, subject to a thirty-day buy-back option at the issue price. Additionally, the company paid annual dividends of two dollars per share.[31] The officers would receive no extra compensation for aiding the sale. The staff recommended no-action with respect to registration of the shares to current employees,[32] retired former employees who were shareholders,[33] and the one former employee. The staff further recommended no-action with respect to registration of the officers as dealers.[34]

The Board also took several enforcement actions against issuers. Is-

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28. *See* Handy Hardware Wholesale, Inc., SEC No-Action Letter, 2006 WL 4783596, at *1 (Dec. 15, 2006).

29. *Cf.* Tex. Rev. Civ. Stat. Ann. art. 581-5(G) (Vernon Supp. 2008) (exempting from registration of securities those offers and sales made pursuant to mergers with shareholder vote under state corporate statutes); *see also id.* art. 581-5 (those selling exempt securities are not dealers).

30. *See* Graybar Elec. Co., SEC No-Action Letter, 2006 WL 4783595, at *1 (Oct. 25, 2006).

31. Without the dividend, this transaction becomes an interest free loan to the company, not exactly what the employees expected.

32. *See* Tex. Rev. Civ. Stat. Ann. art. 581-5(F) (Vernon Supp. 2008) (exempting from registration of securities those offers and sales of securities made to employees pursuant to employee benefit plans).

33. *See id.* art. 581-5(E) (exempting from registration of securities those offers and sales made to current shareholders provided no commission is paid).

34. *See id.* art. 581-5 (Vernon Supp. 2008) (those selling exempt securities are not dealers).

suer violations included failure to register their securities,[35] some with additional misrepresentations such as omitting convictions against the principals and omitting financial data.[36] Many involved the Board's identified threats to investors, namely oil and gas scams,[37] internet fraud,[38]

35. *See* Sun City Market, L.L.C., No. ENF-07-CDO-1636, 2007 WL 2361310, at *1-2 (Tex. St. Sec. Bd. Aug. 14, 2007) (agreed cease and desist order for selling shares of partnership to pay expenses of operation of partnership's gas station, convenience store, and restaurant without registering the securities or selling agents); From Mex., L.L.C., No. ENF-07-CDO-1632, 2007 WL 2161513, at *1-2 (Tex. St. Sec. Bd. July 20, 2007) (agreed cease and desist order for selling membership units in a Nevada entity without registering the securities or selling agents); Automated Vending Techs., Inc., No. ENF-07-CDO-1630, 2007 WL 1959120, at *1-2 (Tex. St. Sec. Bd. June 28, 2007) (agreed cease and desist order for selling convertible debentures and common stock in a Delaware entity without registering the securities or selling agents).

36. *See, e.g.*, Nelsen, No. ENF-07-CDO-1631, 2007 WL 2050404, at *1-3 (Tex. St. Sec. Bd. July 12, 2007) (agreed cease and desist order for selling pooled funds to be traded overseas without registering the securities or selling agents, and failing to disclose a California judgment for breach of contract against the principals); NCL Dev. L.L.C., No. ENF-07-CDO-1628, 2007 WL 1366150, at *1-3 (Tex. St. Sec. Bd. May 2, 2007) (emergency cease and desist order for selling convertible notes without registering the securities or selling agents, and failing to disclose, among other omissions, defaults on previous guaranteed promissory notes by the principals, judgments rendered against the principals for such defaults, evictions from business premises by the principals, the intended use of the monies, the losses in the businesses previously operated by the principals, the indebtedness of the principals, and forfeited charters of businesses previously operated by the principals, including the charter of the issuer); Global Partners Capital, No. ENF-07-DCO-1626, 2007 WL 951805, at *1 (Tex. St. Sec. Bd. Mar. 20, 2007) (emergency cease and desist order for selling treasury shares of an issuer engaged in oil and gas exploration without registering the securities or selling agents and failing to disclose the risks associated with oil and gas exploration or the financial data with respect to the issuer, not incorporated in Texas nor authorized to do business in Texas).

37. *See, e.g.*, Always Consulting, Inc., No. ENF-C7-CDO-1635, 2007 WL 2317197, at *1-3 (Tex. St. Sec. Bd. Aug. 8, 2007) (order affirming emergency cease and desist order for offering participation units in an Oklahoman oil and gas lease without disclosing numerous guilty pleas of the principals for theft, counterfeiting, securities fraud, mail fraud, and assault causing bodily injury from 1989 to 2004); Sundance Res., Inc., No. ENF-06-CDO-1623, 2006 WL 3891516, at *1 (Tex. St. Sec. Bd. Dec. 22, 2006) (agreed cease and desist order for selling working interests in oil and gas drilling projects without registering the securities or selling agents); *see also* Always Consulting, Inc., No. ENF-06-CDO-1622, 2006 WL 3223649, at *1 (Tex. St. Sec. Bd. Oct. 25, 2006) (the emergency cease and desist order).

38. *See* Homeland Commc'ns Corp., No. ENF-06-CDO-1621, 2006 WL 2984784, at *1-2 (Tex. St. Sec. Bd. Oct. 12, 2006) (emergency cease and desist order for offering common stock and warrants over the Internet without registration of the securities or the selling agents, and failing to disclose the financial statements of the issuer and securities sanctions against the principal in Pennsylvania, Kansas, Illinois, Indiana, and Wyoming, and misrepresenting a forthcoming public offering in light of the same statement made two years before); Home Shopping Latino, Inc., No. ENF-C6-CDO-1620, 2006 WL 2984782, a *1-2 (Tex. St. Sec. Bd. Oct. 11, 2006) (emergency cease and desist order for offering common stock through a newspaper ad referring to a website, requiring investors to represent that they learned about the offer through private channels rather than the newspaper ad, requiring investors to represent that there is no public market while the promoters claim to shortly take the company public, misrepresenting the chief financial officer as a member of the California bar when he had been suspended from the practice twice and had agreed with another to commit conspiracy to structure currency transactions, and misrepresenting the chief executive officer as experienced in leading startup companies to NASDAQ listings when he has been subject to a Missouri prosecution for engaging in illegal practices relating to the offer of that company's securities).

and guaranteed notes.[39]

## IV. REGISTRATION OF MARKET OPERATORS

One common feature of state regulation of securities is the usual requirement to register as a seller of securities before beginning sales in the state, and to register as an investment advisor before rendering investment advice.[40] Registration infractions generally surface when applying or reapplying for registration.

### A. Dealers

During the Survey period, the Board prosecuted several enforcement actions against dealers and selling agents. Dealer infractions included failing to comply with a prior agreed undertaking with the Board,[41] failing upon inspection to give the Board access to certain required records, failing to provide requested documents, failing to update filings,[42] offering to engage in a restriction removing resale of securities through misrepresentations,[43] and allowing unregistered investment advisors to access the dealer's customers' accounts even after learning about their lack of registration.[44]

Selling agent violations included selling unregistered securities while

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39. *See* Jaxtrece Exclusive Invs., L.L.C., No. ENF-07-CDO-1625, 2007 WL 631149, at *1-2 (Tex. St. Sec. Bd. Feb. 26, 2007) (emergency cease and desist order for representing principal guaranteed without disclosing information on what funds were reserved for the guarantee, failing to disclose compensation fees and costs charged to investors in the offering materials, and misrepresenting professional degrees of principal).

40. *See* Tex. Rev. Civ. Stat. Ann. art. 581-13(D) (Vernon Supp. 2008) (stating the requirements for registration).

41. *See* Dealer Registration of Advanced Planning Sec., Inc., No. IC07-CAF-20, 2007 WL 2464230, at *1-3 (Tex. St. Sec. Bd. Aug. 24, 2007) (administrative fine of $1000 for not timely disclosing within ten days NASD arbitration complaint against dealer for breach of fiduciary duty and deceptive practices against senior citizens discovered by Board eight months later, but disclosing within one month churning and unsuitability parts of complaint).

42. *See* Dealer Registration of One Fin. Sec., Ltd., No. IC07-REV-18, 2007 WL 2296408, at *2, *4-5 (Tex. St. Sec. Bd. Aug. 6, 2007) (revoking a dealer's and agent's license for refusal to provide access and requested documents, and failing to amend registrations to reflect applicant's subjection to a regulatory proceeding that could result in a finding of regulatory and statutory violations); *see also* 7 Tex. Admin. Code §§ 115.5(F) (Vernon supp. 2008) (requiring Board access to records); *id.* 115.7(a), (e) (authorizing unannounced inspections and requiring submission of records to Board within forty-eight hours).

43. *See* Phoenix Acquisitions, No. ENF-07-CDO-1633, 2007 WL 2317195, at *1-3 (Tex. St. Sec. Bd. Aug. 6, 2007) (emergency cease and desist order for offering owners of shares to remove legends in a sale regulated by the "U.S. Commission of Equities" under the "International U.S. Securities Act").

44. *See* Dealer Registration of Ameritrade, Inc., No. IC07-CAF-03, 2007 WL 460605, at *1-3 (Tex. St. Sec. Bd. Feb. 7, 2007) (disciplinary order for not prohibiting access to broker's customers' accounts by unregistered investment advisors when advised by an independent contractor of the lack of registration, and not directing employees to investigate the report of the independent contractor; imposing an administrative fine of $200,000 and requiring written procedures to monitor the investment advisors and reasonable steps to enforce such procedures).

not registered as a dealer or agent,[45] making materially misleading statements when offering securities,[46] being subject to an order issued within the last five years by a state securities commissioner and the NASD,[47] engaging in the inequitable business practice of violating its principal's supervisory procedures,[48] and failing to disclose a filed tax lien, a felony conviction for driving while intoxicated, and a felony possession of cocaine charge on the selling agent's filings.[49]

### B. Investment Advisors

The Board engaged in numerous enforcement actions against investment advisors during the Survey period. These actions involved render-

45. *See* Ginsberg, No. ENF-07-CDO-1629, 2007 WL 2762808, at *1-2 (Tex. St. Sec. Bd. Sept. 18, 2007) (cease and desist order for selling the National Foundation of America Tax Deductible Installment Plan for a fixed return with tax savings, and requiring a refund of commissions to investors of $81,000); Heuermann, No. ENF-07-CDO-1637, 2007 WL 2361311, at *1-2 (Tex. St. Sec. Bd. Aug. 14, 2007) (cease and desist order for selling the National Foundation of America Tax Deductible plans for a fixed return with tax savings misrepresenting that the entity was tax-exempt organization); Marks, No. ENF-07-CDO-1634, 2007 WL 2317196, at *1-2 (Tex. St. Sec. Bd. Aug. 6, 2007) (cease and desist order for selling National Foundation of America Tax Deductible Installment Plan for a fixed return with tax savings; *see also* Nat'l Found. of Am., No. ENF-07-CDO-1629, 2007 WL 1514023, at *1 (Tex. St. Sec. Bd. May 18, 2007) (emergency cease and desist order that was modified by the orders).

46. *See* Wilson, No. ENF-07-CDO-1639, 2007 WL 2762802, at *1 (Tex. St. Sec. Bd. Sept. 17, 2007) (emergency cease and desist order for representing a guaranteed thirty percent return, negating stated risks, and contradicting accredited investors requirements to unaccredited investors seeking secure investments where offering documents described risky shares of an issuer in a competitive business with no operational history); McAdams, No. ENF-07-CDO-1638, 2007 WL 2689936, at *1 (Tex. Sec. Bd. Sept. 11, 2007) (cease and desist order for representing principal guaranteed without disclosing information on what funds were reserved for the guarantee and failing to disclose compensation fees and costs charged to investors in the offering materials).

47. *See* Application for the Agent Registration of James Robert Brown, No. IC07-SUS-11, 2007 WL 1663087, at *1 (Tex. St. Sec. Bd. May 25, 2007) (disciplinary order for being suspended for twenty days and fined $5000 by the NASD for excessive mark-ups and mark-downs on six transactions and denial of application as a salesperson by State of Illinois; granting the application, reprimanding the selling agent, and suspending the selling agent for 30 days); *see also* TEX. REV. CIV. STAT. ANN. art. 581-14(A)(9) (Vernon Supp. 2008) (authorizing the suspension for agents subject to an order of another securities regulatory body).

48. *See* Agent and Inv. Adviser Representative Registrations of John Hutchison Arnette, No. 312-06-3016, 2007 WL 1202858, at *1-4, *6 (Tex. St. Sec. Bd. Apr. 19, 2007) (default order for inequitable practices of selling securities labeled "universal lease agreements" and "residence club memberships" on his own behalf and receiving commissions therefore without obtaining prior permission of his principal investment advisor, failing to update his registration to reflect the transactions, fraudulently representing to his principal that he had not sold any securities, and fraudulently misrepresenting to the NASD the amount of his commissions for the sales; revoking the investment advisor representative's registration with an administrative fine of $100,000); *see also* TEX. REV. CIV. STAT. ANN. art. 581-14(A)(3) (Vernon Supp. 2008) (authorizing the revocation of an agent's registration for engaging in inequitable practices or fraudulent business practices).

49. *See* Agent Registration of Christopher Anthony Corso, Sr., No. IC07-REV/FIN-05, 2007 WL 852376, at *1-2, *5 (Tex. St. Sec. Bd. Mar. 5, 2007) (default order for failing to disclose a filed tax lien in 2002, a 2004 felony conviction for driving while intoxicated, and a 2003 felony cocaine possession charge, within thirty days to the Board; revoking the registration with an administrative fine of $15,000).

ing compensated service without registration,[50] rendering compensated service after registration lapsed and before renewal,[51] failing to establish a written supervisory policy and thereby allowing an investment advisor

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50. *See* Applications for Inv. Adviser Registration of Rock Ridge Capital, L.P., No. ICC7-CAF-19, 2007 WL 2348529, at *1-2 (Tex. St. Sec. Bd. Aug. 14, 2007) (granting application while reprimanding and ordering fines of $2500); Inv. Adviser Registration of First Western Sec., Inc., No. IC07-CAF-17, 2007 WL 2161514, at *1-4 (Tex. St. Sec. Bd. July 23, 2007) (disciplinary order for failing to file amended forms, failing to supervise, and using three unregistered investment advisors to give advice for compensation; reprimanding the registered investment advisor with an administrative fine of $8000 and fines of $500, $4600 and $1900 for the unregistered investment advisors); Application for the Inv. Adviser Registration of Mark Anthony Miller, No. IC07-CAF-08, 2007 WL 1109070, at *1-2 (Tex. St. Sec. Bd. Apr. 2, 2007) (disciplinary order for rendering compensated investment advice without registration for six years, granting the registration and reprimanding the investment advisor with an administrative fine of $6000); Application for Inv. Adviser Representative Registration of Oscar Jackson III, No. IC06-CAF-51, 2006 WL 3338641, at *1-2 (Tex. St. Sec. Bd. Nov. 10, 2006) (disciplinary order for rendering compensated investment advice without registration for three years; granting the registration and reprimanding the investment advisor representative with an administrative fine of $6000); Inv. Adviser Representative Registration of John Alan Braden, No. IC06-CAF-48, 2006 WL 2989280, at *1-2 (Tex. St. Sec. Bd. Oct. 11, 2006) (disciplinary order for rendering compensated investment advice without registration for one year and reprimanding the investor advisor representative with an administrative fine of $1000); Application for Inv. Adviser Representative Registration of William Anthony Richter, No. IC06-CAF-46, 2006 WL 2929570, at *1-2 (Tex. St. Sec. Bd. Oct. 6, 2006) (disciplinary order for rendering compensated investment advice without registration for three years; granting the application and reprimanding the investor advisor representative with an administrative fine of $3500).

51. *See* Budge, No. IC07-CDO-15, 2007 WL 1959119, at *1-2 (Tex. St. Sec. Bd. June 28, 2007) (cease and desist order until registered and administrative fine of $34,750 for rendering compensated service as investment advisor representative, after registration lapsed in 2002); Applications for the Inv. Adviser Registration of Sundial Capital Mgmt., L.P., No. IC06-CAF-49, 2006 WL 3051520, at *1-2 (Tex. St. Sec. Bd. Oct. 24, 2006) (disciplinary order for rendering compensated investment advice after registration lapsed in 2002; granting registration and reprimanding with an administrative fine of $5000); Inv. Adviser Registration of Mendelovitz & Urban Advisors, L.L.C., No. IC05-CAF-45, 2006 WL 2879776, at *1-2 (Tex. St. Sec. Bd. Oct. 5, 2006) (disciplinary order for rendering compensated investment advice, after registration lapsed from 2003 to 2004; reprimanding with an administrative fine of $2500); *see also* Inv. Adviser Registration of Mark Lee Westerman, No. IC07-CEN-14, 2007 WL 1813672, at *1-2 (Tex. St. Sec. Bd. June 19, 2007) (disciplinary order for rendering compensated service as investment advisor representative after failing to transition to electronic registration in 2003; reprimanding the investment advisor representative and granting the registration); Inv. Adviser Representative of Lynn Marie Miori, No. IC07-CEN-12, 2007 WL 1727567, at *1-2 (Tex. St. Sec. Bd. June 11, 2007) (same, except registration was granted in 2006); Inv. Adviser Representative Registration of Cadmus Kilgore Lawson II, No. IC07-CEN-04, 2007 WL 708557, at *1-2 (Tex. St. Sec. Bd. Mar. 5, 2007) (same); Application for Inv. Adviser Representative Registration of Fadi Boury, No. IC06-CEN-55, 2006 WL 3907770, at *102 (Tex. St. Sec. Bd. Dec. 29, 2006) (same, except also granting registration); Application for Inv. Adviser Representative Registration of Larry Saunders, No. IC06-CEN-56, 2006 WL 3907771, at *1-2 (Tex. St. Sec. Bd. Dec. 29, 2006) (same); Application for Inv. Adviser Representative Registration of Stephen Anthony Engro, No. IC06-CEN-54, 2006 WL 3891514, at *1-2 (Tex. St. Sec. Bd. Dec. 27, 2006) (same, but registration was previously granted); Application for Inv. Adviser Representative Registration of Mark Diamond, No. IC06-CEN-53, 2006 WL 3891515, at *1-2 (Tex. St. Sec. Bd. Dec. 27, 2006) (same); Inv. Adviser Representative Registration of Eugen Kurt Schluter, No. IC06-CEN-52, 2006 WL 3907769, at *1-2 (Tex. St. Sec. Bd. Dec. 18, 2006) (same, except also granting registration); Application for Inv. Adviser Representative Registration of William Robert Allbright, No. I&C06-CEN-50, 2006 WL 3255437, at *1-2 (Tex. St. Sec. Bd. Nov. 6, 2006) (same); Application for Inv. Adviser Representative Registration of John William Byrd, Sr., No. IC06-CEN-47, 2006 WL 2929571, at *1-2 (Tex. St. Sec. Bd. Oct. 6, 2006) (same).

representative to copy client signatures on documents,[52] failing to follow a written supervisory policy prohibiting the rendering of investment advice by unregistered investment advisor representatives for compensation,[53] failing to disclose employment as an investment advisor representative on a selling agent application,[54] failing to disclose a sub-business of an investment advisor representative on both the investment advisor's filings and the investment advisor representative's filings,[55] engaging in fraudulent misrepresentation as a certified advisor to senior citizens,[56] and failing to amend filings to reflect indictments for felony fraud.[57]

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52. *See* Inv. Adviser Registration of Windward Partners L.L.C., No. IC07-SUS-16, 2007 WL 1952731, at *1-2 (Tex. St. Sec. Bd. June 29, 2007) (disciplinary order suspending investment advisor for fifteen days and imposing administrative fine of $10,000 for letting representative copy signature from documents and paste the signature on client documents although no client was harmed); *see also* 7 TEX. ADMIN. CODE § 116.10 (2008) (requiring investment advisors to maintain a written supervisory system to supervise the activities of its representatives).

53. *See* Inv. Adviser Registration of Titan Wealth Mgmt., L.L.C., No. IC 07-CAF-13, 2007 WL 1813660, at *1-2 (Tex. St. Sec. Bd. June 19, 2007) (disciplinary order for failing to follow written supervisory policy by using unregistered investment advisor representative; reprimanding the investment advisor with an administrative fine of $9000); Dealer Registration of Butler Freeman Tally Fin. Group, L.L.C., No. IC07-CAF-10, 2007 WL 1459299, at *1-2 (Tex. St. Sec. Bd. May 11, 2007) (disciplinary order for failing to follow written supervisory policy by allowing an investment advisor representative also to render compensated investment advisor services to another investment advisor without registration, knowing of such investor advisory representative arrangement; reprimanding the dealer with an administrative fine of $20,000).

54. *See* Inv. Adviser Registration of Crescent Advisor Group, Inc., No. IC07-CDO-07, 2007 WL 852378, at *1-3 (Tex. St. Sec. Bd. Mar. 13, 2007) (disciplinary order for rendering compensated investment advice when not registered as an investment advisor representative, but registered as a selling agent of the investment advisor, and failing to denote the advisor status on the selling agent filings, discovered on Board inspection; reprimanding the investment advisor and the selling agent, and assessing an administrative fine of $1500 and a cease and desist order on the selling agent); *see also* Dealer and Inv. Adviser Registrations of Dillon Gage Sec., Inc., No. IC07-CAF-06, 2007 WL 852377, at *1-3 (Tex. St. Sec. Bd. Mar. 8, 2007) (same; reprimanding the investment advisor and the selling agent with an administrative fine of $2500 and a cease and desist order on the selling agent).

55. *See* Inv. Adviser Registration of IAAS, Inc., No. IC07-CAF-02, 2007 WL 437327, at *1-2 (Tex. St. Sec. Bd. Feb. 6, 2007) (disciplinary order for failure to disclose on the investment advisor's filings and the investment advisor representative's filings the investment advisor representative's sole proprietorship in selling subscriptions to an analysis and reporting service from 2004 through 2006).

56. *See* Inv. Adviser Representative Registrations of Richard Allen Alford, No. IC07-CAF-01, 2007 WL 98087, at *1-3 (Tex. St. Sec. Bd. Jan. 9, 2007) (disciplinary order for displaying certificates as senior advisors in the office and on business cards, customer brochures, and website and targeting senior citizens by claiming it operated a foundation to help senior citizens and specialization in financial planning for senior citizens, all at a time when the certifications had lapsed; reprimanding with administrative fines of $12,500 each on the two investment advisors, a cease and desist order, and requiring destruction of all documents used with customers containing the fraudulent practice).

57. *See* Inv. Adviser Representative Registration of Ira Klein, No. IC06-REV/FIN-44, 2006 WL 2869562, at *1, *3-4 (Tex. St. Sec. Bd. Oct. 4, 2006) (default order for failing to amend filing to reflect indictment by the federal grand jury for felony fraud, revoking registration with an administrative fine of $15,000).

## V. SECURITIES FRAUD

One of the major reasons legislatures passed securities acts was to facilitate investors' actions to recover their monies through a simplified fraud action by eliminating 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 Appeals Court narrowed the secondary parties that would become liable for a perpetrator's fraud by finding that merely preparing the transactional documents did not satisfy the requisite scienter for secondary party liability.[58] Another Texas Appeals Court determined that the Board's standard certifications of process were insufficient to support a default judgment.[59]

#### 1. *Aider and Abetter Liability*

Injured investors continue to hunt for lucrative sources of recovery when investments sour. One such source lies in third parties who may have enabled the alleged perpetrator of fraud to sell the securities. But to hold these individuals liable for the investment loss under the TSA requires more than just the enablement. Injured investors must prove sufficient scienter by the alleged aider and abetter to recover.[60] This year's case involves a lawyer, and his law firm through respondeat superior principles. Under what circumstances does a lawyer preparing the transactional documents run the risk of liability to the investors when the promoter client may have engaged in securities fraud?

In *Kastner v. Jenkens & Gilchrist, P.C.*,[61] a limited partner sought recovery against the attorney that represented the promoter in establishing a limited partnership to purchase and operate an apartment complex. According to the Dallas Court of Appeals, the lawyer merely prepared the transactional documents for a client who may or may not have been involved in securities fraud. The lawyer formed the limited partnership and the corporate general partner based upon information supplied by the promoter. The lawyer represented the limited partnership, the general partner, and the promoter at the closing of the apartment complex. The lawyer's representation ceased after the closing. The partnership later fell into financial difficulties and filed for bankruptcy. The suing limited partner brought this action against a number of parties, including the promoter, the general partner, the company managing the apartment complex, and the lawyer and his law firm. The suit was based on several grounds, one being violation of the TSA. Due to non-suits, settlements, and other motions for summary judgment, the lawsuit was reduced to the

58. 231 S.W.3d 571 (Tex. App.—Dallas, 2007, no pet.).
59. 218 S.W.3d 126, 126 (Tex. App. Ct.—Houston [14th Dist.] 2007, pet. denied).
60. Sterlingtrust Co. v. Adderly, 168 S.W.3d 835, 842 (Tex. 2005).
61. 231 S.W.3d 571 (Tex. App.—Dallas 2007, no pet.).

actions against the lawyer and his firm. The trial court granted a summary judgment for the lawyer and his firm. The limited partner appealed.

The securities law claim involved a misrepresentation. If successful, the suing limited partner would recover its contributions with interest.[62] The alleged securities misrepresentation involved the calculation of the partnership interests. The partnership agreement required the limited partners to contribute cash. The lawyer's cover letter submitted to the limited partners indicated that the final partnership interests would be determined at the closing based on the aggregate contributions of the partners. Unfortunately, some limited partners contributed non-cash items, rather than cash, and so the partnership percentages recorded in the partnership agreement were incorrect. Moreover, due to the lack of sufficient cash contribution at closing, the seller of the apartment complex had to finance a portion of the purchase of the apartment complex. Liability for an aider and abetter under the TSA requires liability of the primary perpetrator of the fraud, plus material aid and an "intent to deceive or defraud or reckless disregard for the truth or the law" by the alleged aider and abetter.[63] While the summary judgment motion evidence might raise fact issues with respect to the liability of the primary perpetrator—the promoter—the investor failed to offer any evidence of scienter by the lawyer. The evidence showed that the lawyer believed the calculated partnership interests to be accurate, and that the shortfall of cash at the closing resulted from inaccurately estimating the funds needed for the purchase rather than the failure to bring in sufficient cash subscriptions. Consequently, the appellate court affirmed.[64]

### 2. *Substitute Service*

For out-of-state issuers, dealers, and investment advisors, the TSA provides a method of serving substitute process on the Board.[65] Injured investors who avail themselves to this method of service hope that such service would support a subsequent default judgment against the perpetrator. After all, the semi-analogous substitute service provision for the Secretary of State under the Texas Business Corporation Act[66] does support a later default judgment if the Secretary of State provides a certificate satisfying certain conditions imposed by the Texas Supreme Court.[67]

62. *See* TEX. REV. CIV. STAT. ANN. art. 581-33(A)(2), (D) (Vernon Supp. 2008) (seller liability for misrepresentation or omission; buyer's right to rescission).

63. *See id.* art. 581-33(F)(2) (Vernon Supp. 2008).

64. *Kastner*, 231 S.W.3d at 587.

65. *See id.* art. 581-8 (Vernon Supp. 2008) (when commissioner is served with process as agent for dealer, commissioner must forward the process to the dealer's last known address).

66. The corporate law provision covers the situation when the agent for process cannot be located or was not appointed. *See* TEX. BUS. CORP. ACT ANN. art. 2.11 (Vernon Supp. 2008); *see also* TEX. BUS. ORGS. CODE ANN. § 5.251 (Vernon 2008) (not appointed).

67. *See* Capitol Brick, Inc., v. Fleming Mfg. Co., 722 S.W.2d 399, 401 (Tex. 1986) (provided the Secretary of State's certificate shows it received process as agent of the defendant and forwarded the service as required by the statute).

This year, a Texas appellate court, on a case of first impression, concluded that the Texas Securities Commissioner's procedures for substitute process did not satisfy the Texas Supreme Court's requirements for default judgment. Consequently, out-of-state dealers might avoid fraud liability by dodging personal service. In *Harvestons Securities, Inc. v. Narnia Investments, Ltd.*,[68] the injured investor served the petition on the Texas Securities Commissioner, who sent the petition to the dealer by both regular mail and certified mail.[69] The dealer did not answer the lawsuit. After severing the action from the other defendants, the injured investor obtained a default judgment against the dealer. The dealer brought the current action to set aside the default judgment alleging invalid service of process. In support of its default judgment, the injured investor had submitted two certificates from the Texas Securities Commissioner. In both certificates, the Texas Securities Commissioner certified that the attached records were true copies of a record filed with the Texas Securities Commissioner.[70] One record was the letter forwarding the petition to the dealer, addressed to the dealer with the cause number and court, stating "[t]he Securities Commissioner has received process in the above-referenced lawsuit. Since [dealer] is named as a defendant, we are forwarding process to you."[71] The second record was the dealer's power of attorney appointing the Securities Commissioner as agent for service of process. The trial court upheld the default judgment, but the Houston Court of Appeals reversed and remanded.[72]

The majority reasoned that the Texas Supreme Court has spelled out two requirements before a government official's certificate could support a default judgment. First, the statute must require courts to accept the certificate as sufficient evidence, although rebuttable, of the facts as stated. Comparing the Texas Business Corporation Act provision with the Texas Securities Act provision, the majority concluded the latter statute was deficient of this requirement.[73] The corporate provision provides

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68. 218 S.W.3d 126, 126 (Tex. App.—Houston [14th Dist.] 2007, pet. denied).

69. This procedure went beyond that required by the TSA. At the time of the lawsuit, the TSA had no requirement to forward the process to the dealer. *See* Tex. Rev. Civ. Stat. Ann. art. 581-8 (Vernon Supp. 1999) (only forward for issuer). The current version does not require certified mail. *See* Tex. Rev. Civ. Stat. Ann. art. 581-8 (Vernon Supp. 2008).

70. The standard language of the Texas Securities Commissioner was:

> I, ———, Securities Commissioner of the State of Texas, do hereby certify that I have caused to be made a careful examination of the records of the State Securities Board, which records are kept under my supervision and control under the provision of [the Texas Securities Act] and from such examination, I do further certify that the attached [number of attached pages] pages constitute a true and correct record of information filed with the Securities Commissioner.

*Harvestons Sec.*, 218 S.W.3d at 131.

71. *See id.* at 132.

72. *See id.* at 135.

73. *Compare* Tex. Rev. Civ. Stat. Ann. art. 9.05 (Vernon 2003 & Supp. 2008) ("All certificates issued by the Secretary of State in accordance with the provisions of this Act, and all copies of documents filed in his office in accordance with the provisions of this Act, when certified by him, shall be taken and received in all courts, public offices, and official

that the Secretary of State's certificate is *prima facie* evidence of the facts therein stated, but the securities provision merely states the certificate is some evidence, provided the original constituted some evidence. However, the minority argued that this statutory distinction lacked real meaning.

The second requirement related to the language of the certificate. The certificate must state that the Secretary of State received the citation as an agent of the respective defendant and that the Secretary of State forwarded the citation and petition to the correct address. The Secretary of State's certificates for substituted process generally so state.[74] The Securities Commissioner's certificates in this case, however, merely certified that the document was a true and correct record of what was on file with the Securities Commissioner.[75] Since these certificates did not say whether the Commissioner was served with citation or petition in the case, or that the documents accurately reflected the actions or events stated, the majority found that the certificates did not support the default judgment.[76] On the other hand, the minority felt that the forwarding letters, subject to one of the Securities Commissioner's certificates, satisfied the requirement even though they failed to indicate that the Commissioner received the petition as agent for that defendant (there were several), failed to include a copy of the petition (or identify which one), and contained no information with respect to the receipt (or attempted receipt) of the letter by the defendant.[77]

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bodies as *prima facie* evidence of the facts therein stated. . . .") *and* TEX. BUS. ORGS. CODE ANN. § 4.005 (Vernon Supp. 2008) ("A court, public office, or official body shall accept a certificate issued as provided by this code by the secretary of state or a copy of a filing instrument accepted by the secretary of state for filing as provided by this code that is certified by the secretary of state as prima facie evidence of the facts stated in the certificate or instrument.") *with* TEX. REV. CIV. STAT. ANN. art. 581-30 (Vernon Supp. 2008) ("Copies of all papers, instruments, or documents filed in the office of the Commissioner, certified by the Commissioner, shall be admitted to be read in evidence in all courts of law and elsewhere in this state in all cases where the original would be admitted in evidence . . .").

74. *See* InsureSuite, Inc. v. MJS Mktg., L.P., No. 03-05-00822-CV, 2006 WL 2080684, at *2-4 (Tex. App.—Austin July 26, 2006) (the certificate dated April 4, 2005, states "(1) the citation and MJS's original petition were received by his office on March 17, 2005; (2) his office forwarded the citation and the petition to InsureSuite on March 22, 2005, by certified mail, return receipt requested to 'InsureSuite Inc,' 600 N Brand Blvd, Glendale, CA 91203-4207; and (3) the Secretary of State received the return receipt, bearing the signature of addressee's (InsureSuite's) agent on March 28, 2005.).

75. The certificates stated

> I, [ ] Securities Commissioner of the State of Texas, do hereby certify that I have caused to be made a careful examination of the records of the State Securities Board, which records are kept under my supervision and control under the provisions of [the Texas Securities Act] and from such examination, I do further certify that the attached [number of attached pages] constitute a true and correct record of information filed with the Securities Commissioner.

*Harvestons Sec.*, 218 S.W.3d at 131.

76. *See id.* at 134.

77. The cover letter merely stated: "[t]he Securities Commissioner has received process in the above-referenced lawsuit. Since Harveston Securities, Inc. [sic] is named as a defendant, we are forwarding process to you." *See id.* at 132.

## B. Court Decisions Under the Federal Acts

The fraud provisions of the TSA are modeled on the federal statutes.[78] As a result, Texas courts interpreting the TSA frequently look to federal decisions. Congress has designed the federal securities laws to rely on SEC enforcement against the perpetrators of fraud, including aiders and abetters, rather than private class actions so as not to siphon off some of the investors' recovery to litigious plaintiff's lawyers.

The Fifth Circuit continued the federal effort to eliminate frivolous petitions alleging securities fraud within private class actions. One investor failed to allege sufficient facts to infer the scienter required under the Private Securities Litigation Reform Act of 1995 ("PLSRA"). Those facts need some connection to the misstatements or omissions.[79] Two other investors failed to obtain class certification due to the inappropriateness of the fraud-on-the-market theory to satisfy the reliance requirement of a securities fraud situation.[80] The Fifth Circuit imposed burdensome requirements for class certification in such cases after considering some merits at the class certification stage of the lawsuit. It also required a negative market reaction to the disclosure of corrective announcements before fraud-on-the-market theory could be employed.[81] The United States Supreme Court has confirmed their efforts.[82]

### 1. *Scienter under the PSLRA*

Congress drafted the PSLRA with the intent of reducing the number of private actions brought under the antifraud provisions of the federal securities laws. Before the PLSRA, some investors had used such antifraud actions to extort settlements in lieu of substantial litigation costs from issuers and individuals whose conduct actually conformed to the federal securities laws. The PSLRA accomplishes its intended goal through heightened pleading requirements coupled with a bar to discovery during motions to dismiss a complaint for pleading errors.[83] In particular, the complaint must state the facts "giving rise to a strong inference" that the perpetrator of the fraud possessed the requisite intent or scienter.[84] Congress did not, however, define what it meant by a "strong inference." Although the Supreme Court recently provided some guidance as to the

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78. *See* Tex. Rev. Civ. Stat. Ann. art. 581-33 cmt. to 1977 Amendment (Vernon Supp. 2008).

79. Cent. Laborers' Pension Fund v. Integrated Elec. Servs., Inc., No. Civ. A. 4:04-CV-3342, 2006 WL 54021, at *1-5 (S.D. Tex. Jan. 10, 2006), *aff'd*, 497 F.3d 546 (5th Cir. 2007).

80. Regents of Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372 (5th Cir. 2007); Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261 (5th Cir. 2007).

81. 487 F.3d. at 262.

82. *See Regents*, 482 F.3d 372, 387-90 (adopting the position of the Eighth Circuit that was subsequently affirmed by the Supreme Court, *In re* Charter Communications, Inc. Securities Litigation, 443 F.3d 987 (8th Cir. 2006), *aff'd sub. nom.*, Stonebridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008)).

83. *See* 15 U.S.C.A. § 78u-4(b)(3)(B)(3) (West 1997).

84. *See* 15 U.S.C.A. § 78u-4(b)(2) (West 1997).

meaning,[85] the Fifth Circuit continues to confront pleadings that lack even minimal inferences. In *Central Laborers' Pension Fund v. Integrated Electrical Services, Inc.*,[86] the issuer had published a series of stock touting documents to increase the issuer's visibility and make it more attractive to investors.[87] These documents routinely omitted information unfavorable to the issuer. Over the next year, the issuer's stock rose, only to decline when the independent auditors reported weakness in the issuer's internal controls that resulted in erroneous accounting practices in the issuer's subsidiaries, necessitating restatements.[88] The district court dismissed the lawsuit. The Fifth Circuit affirmed.[89] The investor's factual allegations in support of the scienter requirement consisted of GAAP violations, confidential sources reporting pervasive knowledge of accounting problems, insider trading, and false Sarbanes-Oxley certifications. The Fifth Circuit found that much of the investor's scienter allegations lacked any connection with the alleged fraud. With respect to the GAAP violations, the pleadings lacked any factual allegations as to what was known, who knew it, when that person knew it, or how that knowledge related to any of the alleged misstatements.[90] For the confidential

85. When certain facts became susceptible to more than one inference, the circuits differed on whether the court should consider only the investor's inference or require the most compelling inference. The Sixth Circuit had the stiffest position and sought to judge the complaint on the basis of the most "plausible" inference. *See* Helwig v. Vencor, Inc., 251 F.3d 540, 553 (6th Cir. 2001). The First, Fourth, and Ninth Circuits required the investor's inference to be more convincing than the other inferences. *See, e.g.*, Brown v. Credit Suisse First Boston L.L.C., 431 F.3d 36, 49 (1st Cir. 2005), *vacated* Tellabs, Inc. v. MakOr Issues & Rights, Ltd, 127 S. Ct. 2499 (2007) (complaint does not pass where "there are legitimate explanations for the behavior that are equally convincing"); Ottmann v. Hanger Orthopedic Group, Inc., 353 F.3d 338, 349 (4th Cir. 2003) (complaint does not pass where facts are "more consistent with negligence than with recklessness or intent"); Gompper v. VISX, Inc., 298 F.3d 893, 897 (9th Cir. 2002) (must consider all inferences and conclude on balance). The Tenth Circuit evaluated the investor's inference in the context of other inferences, but refuses to weigh them. *See* Pirraglia v. Novell, Inc., 339 F.3d 1182, 1188 (10th Cir. 2003). The Seventh Circuit had the weakest position and would only consider the investor's inference. *See* Makor Issues & Rights, Ltd. v. Tellabs, Inc., 437 F.3d 588, 602 (7th Cir. 2006), *vacated* 127 S. Ct. 2499 (2007).

The Supreme Court resolved this difference by specifying a middle ground. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 127 S. Ct. 2499, 2510 (2007). The court must consider opposing inferences and, for the complaint to satisfy the requirement, the inference of scienter must be "at least as compelling as any opposing inference one could draw from the facts alleged." *See id.*

86. 497 F.3d 546 (5th Cir. 2007). The Fifth Circuit's opinion lacks sufficient detail to comprehend its conclusions. For a more complete rendition of the factual situation, see *In re* Integrated Elec. Servs., Inc., No. Civ. A. 4:04-CV-3342, 2006 WL 54021, at *1-5 (S.D. Tex. Jan. 10, 2006), *aff'd*, 497 F.3d 546 (5th Cir. 2007); Brief of Appellees at 12, Central Laborers' Pension Fund v. Integrated Elec. Servs., Inc., No. 06-20135 (5th Cir. Oct. 15, 2006); Brief of Appellant at 20, Central Laborers' Pension Fund v. Integrated Elec. Servs., Inc., No. 06-20135 (5th Cir. Sept. 5, 2006).

87. *See Central Laborers' Pension Fund*, 2006 WL 54021, at *1, *3-4.

88. *See id.* at *1.

89. *See* 497 F.3d at 556. The Fifth Circuit also affirmed the district court's refusal to allow amendments to the petition since the proposed amendments would not cure the defects in the petition outlined by the Fifth Circuit. *See id.*

90. *See id.* at 552 ("GAAP violations, without more, do not establish scienter."); *see* Brief of Appellees at 32, Central Laborers' Pension Fund v. Integrated Elec. Servs., Inc., No. 06-20135, 497 F.3d 546 (5th Cir. Oct. 15, 2006); *see also* Abrams v. Baker Hughes, Inc.,

sources, the pleadings failed to allege facts concerning the witnesses' job descriptions, responsibilities, and dates of employment so the Fifth Circuit could not discern whether the witnesses' statements amounted to speculative gossip or concrete knowledge of their statements' veracity.[91] The sale of the issuer's stock by the chief executive officer, being less than four percent of his holdings, was too negligible to support an inference of scienter. But the sale of most of the issuer's stock held by the former chief financial officer during the period prior to his resignation did support an inference of scienter. The Sarbanes-Oxley certifications, signed by the chief financial officer and former chief financial officer, attesting to the adequacy of the issuer's internal controls in the absence of factual allegations that the certifying officers participated in any of the issues that lead to the restatement or to the identification of weaknesses in the controls, did not support an inference of scienter.[92]

### 2. *Reliance by the Fraud-on-the-Market Theory*

One of the elements of a securities fraud action under Rule 10b-5 is reliance.[93] To maintain a commonality of reliance among all members of a class, class action investors frequently invoke presumptions to establish the reliance element of the cause of action. The *Affiliated Ute* doctrine provides that a court may presume reliance in a Rule 10b-5 action based primarily on a failure to disclose, while the fraud-on-the-market theory presumes reliance where the securities trade in an efficient market since the market price reflects all material, public information and the investor is presumed to rely on the integrity of the market place.[94] In two recent opinions, the Fifth Circuit joined those circuit courts by placing stringent requirements invoking these presumptions when certifying a class. The earlier opinion required class action investors seeking liability of aiders and abetters of the fraud committed by the issuer to provide evidence of a duty to disclose, or the making of a public and material misrepresenta-

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292 F.3d 424, 432 (5th Cir. 2002) (publication of inaccurate accounting figures without facts showing the misstaters knew of the inaccuracies does not establish scienter).

91. *Central Laborers' Pension Fund*, 497 F.3d at 552 (the "confidential source statements lack sufficient detail to credit them as bases for a strong inference of scienter"); Brief of Appellees at 36, Central Laborers' Pension Fund v. Integrated Elec. Servs., Inc., 497 F.3d 546, No. 06-20135 (5th Cir. Oct. 15, 2006); *see also* Barrie v. Intervoice-Brite, Inc., 397 F.3d 249, 264, *modified*, 409 F.3d 653 (5th Cir. 2005).

92. *Central Laborers' Pension Fund*, 497 F.3d at 555 (the petition did "not clearly explain the link between these statements about the internal controls and the actual accounting and reporting problems that arose").

93. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341-42 (2005) (setting out the elements of the cause of action as: (1) a material misrepresentation (or omission), . . . (2) scienter, . . . (3) a connection with the purchase or sale of a security, . . . (4) reliance, . . . (5) economic loss, . . . (6) and loss causation).

94. *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 152-54 (1972) (presumptive reliance for improper omissions); Basic Inc. v. Levinson, 485 U.S. 224, 241-47, 250 (1988) (adopting fraud-on-the market theory of reliance under certain circumstances).

tion by the aider and abetter.[95] The later opinion required evidence of "loss causation," which is one of the other elements of the cause of action, to invoke the fraud-on-the-market presumption of reliance.[96]

The earlier opinion, *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*,[97] dealt with several financial institutions purchasing assets of an issuer, while agreeing also to sell the assets back to the issuer later for a premium. This enabled the issuer to misstate its financial condition by recording these transactions as sales rather than loans. According to the class action investors, these financial institutions knew they were aiding and abetting the insurer's long-term scheme to defraud the investors. Since the Supreme Court has foreclosed secondary liability against aiders and abetters through the more usual cause of action under Rule 10b-5(b) proscribing misrepresentations,[98] the class action investors sought primary liability for these aiders and abetters under (1) Rule 10b-5(a), which forbids deceptive devices, schemes, and artifices; and (2) Rule 10b-5(c), which prohibited deceptive acts, practices, and courses of business. The district court adopted the SEC's proposed test for defining a deceptive act, namely "a transaction whose principal purpose and effect is to create a false appearance of revenues."[99] Then the district court concluded that the class action investors were entitled to a presumption of reliance under the *Affiliated Ute* doctrine and the fraud-on-the-market theory, and certified the class.[100]

Disposing of two procedural issues,[101] the Fifth Circuit determined that

95. Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372 (5th Cir. 2007), *cert. denied*, 128 S. Ct. 1120 (U.S. Jan. 22, 2008) (Smith, J., majority opinion).

96. Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261 (5th Cir. 2007) (Higginbotham, J.). Judge Higginbotham served as a visiting professor in 2007, and is so serving in 2008, at the same institution as the author.

97. 482 F.3d at 372.

98. *See* Central Bank, N.A. v. First Interstate Bank, N.A., 511 U.S. 164, 183-85 (1994).

99. *See* Enron Corp. Sec., Derivative & "ERISA" Litig., 236 F.R.D. 313, 316; *see also* Enron Corp. Sec., Derivative & "ERISA" Litig., 439 F. Supp. 2d 692, 714, 714-15 n.27 (S.D. Tex. 2006) (spelling out the test contained in an amicus curiae brief in another case).

The Supreme Court recently rejected this definition of scheme liability. *See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 770 (2008) (mentioning *Enron Corp.*). This theory is based on the idea that, in an efficient market, investors not only rely on statements but also upon the transactions those statements reflect. If adopted it would reach the whole marketplace in which the issuer does business. There is no authority for this rule since it is not in connection with a purchase or sale of a security. It seeks to impose securities fraud liability beyond the securities markets, the realm of financing a business, to purchase and supply contracts, the realm of ordinary business operations.

100. *See* Enron Corp. Sec., Derivative & "ERISA" Litig., 236 F.R.D. 313, 317 ("under *Affiliated Ute* and/or the fraud-on-the-market theory").

101. The Fifth Circuit determined that the interlocutory appeal of the class certification was proper since Fed. R. Civ. P. 23(f) permits leave to appeal when certification may force a defendant to settle rather than incur the costs of defending the class action. The "settlement pressure appears to be particularly acute" for these financial institutions since the class action investors seek to hold them "liable for nearly the entirety of securities losses stemming from the Enron collapse." *See* 482 F.3d at 379.

The Fifth Circuit also determined that, although Fed. R. Civ. P. 23(f) limits the appeal to issues needed for class certification, the appellate court could consider an issue that relates to both the class certification and the merits. *See id.* at 380-81.

the district court erred in presuming reliance and reversed, decertified the class, and remanded.[102] The court held that the *Affiliated Ute* doctrine only applies to cases involving non-disclosure where the perpetrator owed a duty of disclosure to the class action investors. The financial institutions were not fiduciaries of the class action investors and were not otherwise obligated to them, and so owed no duties to the class action investors. The duty not to break the law, as the district court reasoned,[103] is insufficient to raise the *Affiliated Ute* presumption. Since investors cannot expect financial institutions to provide them with information, the investors cannot be deemed to have relied on their candor. With respect to the fraud-on-the-market presumption, the district court used an overly broad interpretation of the definitions of a deceptive act. The Fifth Circuit noted that the Supreme Court had foreclosed secondary liability for secondary actors, but not primary liability for deceptive acts. The various circuit courts had developed two standards to determine the deceptive acts leading to primary liability of secondary actors. The Ninth Circuit follows the SEC's broad approach and attaches primary liability to secondary actors if they engage in a transaction whose principal purpose and effect is to create the false appearance of revenue.[104] The district court followed this approach. In contrast, the Eighth Circuit limited the deceptive act giving rise to primary liability of secondary actors to making a fraudulent statement or directly engaging in manipulative securities trading practices.[105] The United States Supreme Court has subsequently confirmed the Eighth Circuit's approach.[106] The Fifth Circuit in turn adopted the Eighth Circuit's approach.[107] The Supreme Court had determined that liability for fraudulent nondisclosure requires a duty to speak,[108] and for fraudulent misrepresentation there must be a practice, "such as wash sales, matched orders, or rigged prices, that are intended to

102. *See id.* at 394.

103. *See* Enron Corp. Sec., Derivative & "ERISA" Litig., No. H-01-3624, 2006 WL 4381143, at *27 (S.D. Tex. June 5, 2006).

104. *See* Simpson v. AOL Time Warner, Inc., 452 F.3d 1040, 1048 (9th Cir. 2006), *vacated sub. nom.*, Avis Budget Group, Inc. v. Cal. State Teachers' Ret. Sys., 128 S. Ct. 1119 (2008).

105. *See In re* Charter Commc'ns, Inc., Sec. Litig., 443 F.3d 987, 992 (8th Cir. 2006), *aff'd sub. nom.* Stonebridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008). The scheme in *Charter Communications* was similar to the *Enron Corp.* scheme. *See* Stonebridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761, 766 (2008). The issuer overpaid for cable boxes (capitalized thus reducing reportable expenses for the reporting period) and received the overpayment refund as advertising (revenue). Neither the *Affiliated Ute* nor the fraud-on-the-market presumptions apply. There is no duty to disclose and the deceptive acts were not communicated to the public. No member of the investing public had knowledge of the deceptive acts of the secondary actors during the relevant times. The investors can not show reliance on any of the perpetrators' acts "except in an indirect chain the [Supreme Court] find[s] too remote for liability." *See id.* at 769.

106. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008).

107. *See* 482 F.3d at 387-90 (adopting the Eighth Circuit's position rather than the Ninth Circuit's position).

108. *See* Chiarella v. United States, 445 U.S. 222, 230-31 (1980).

mislead investors by artificially affecting market activity."[109] In the present situation, the financial institutions lacked any duties to the class action investors and did not engage in activity affecting market activity. The market was not entitled to rely on the financial institutions conduct and so the fraud-on-the-market presumption was inapplicable.[110]

*Oscar Private Equity Investments v. Allegiance Telecom, Inc.*[111] involved alleged misrepresentations of an issuer providing telephone service and equipment that overstated the issuer's line-installation count by twelve percent during the first, second, and third quarters, resulting in a fourth quarter adjustment by the auditors. Share prices for the telecom industry declined significantly during the year, with the issuer's share price plunging ninety percent. After each of the first three quarterly announcements, the share price would rise nine percent to twenty-nine percent, but then resume declining. On the fourth quarter's announcement, the share price fell twenty-eight percent the next trading day. The class action investors sued the bankrupt issuer, the chief executive officer, and the vice president of sales. The district court certified the class relying on the fraud-on-the-market presumption for class commonality of reliance. The issuer's officers filed an interlocutory appeal.

The Fifth Circuit vacated the certification and remanded.[112] The Fifth Circuit had to consider whether class action investors had to prove their entitlement to the fraud-on-the market presumption at the class certification stage.[113] The presumption requires proof of (1) the loss causation prerequisite, that is that the corrective statement actually moved the market down, and (2) the sufficiency of the evidence to establish the prerequisite. The Fifth Circuit had previously required examination of evidence for the efficient market prerequisite at the class certification stage for use

109. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977).

110. The concurring opinion would take a radically different approach. *See* 482 F.3d at 394 (Dennis, J., concurring). The concurring justice would accept the broad definition of "deceptive act" of the Ninth Circuit since the court should interpret statutes broadly to effectuate their remedial purposes. But the district court defined the class too broadly. Primary liability for securities fraud requires that the investor be harmed by the perpetrator's acts. Consequently, a financial institution could not be liable to those investors that purchased the issuer's stock (the price of which may have already been inflated by the fraudulent acts of other defendants) before that financial institution's transactions. The concurring justice would remand to consider whether class certification was appropriate in light of his clarification of the applicable legal standard.

Imposing requirements on class action investors before they could use the reliance presumptions also disturbed the concurring justice. Such actions reversed the burden of proof required by the reliance presumption from the defendants to the plaintiffs. This was contrary to the Supreme Court's creation of the fraud-on-the-market presumption and early Fifth Circuit precedent. *See* Basic Inc. v. Levinson, 485 U.S. 224, 246-48 (1988); Fine v. Am. Solar King Corp., 919 F.2d 290, 299 (5th Cir. 1990). The concurring justice traced this development from an opinion in which the plaintiff's complaint contained the rebutting material on the lack of a price impact, *see* Nathenson v. Zonagen Inc., 267 F.3d 400, 414, 417-18 (5th Cir. 2001), to an opinion imposing a requirement on the plaintiff to show an impact on the stock price. *See* Greenberg v. Crossroads Sys., Inc., 364 F.3d 657, 663, 665 (5th Cir. 2004).

111. 487 F.3d. 261 (5th Cir. 2007).

112. *See id.* at 271.

113. *See* Greenberg v. Crossroads Sys., Inc. 364 F.3d 657, 663, 665-66 (5th Cir. 2004).

of the fraud-on-the-market presumptions.[114] It also previously required proof of the loss causation prerequisite at the summary judgment stage for use of the fraud-on-the-market presumption for class actions.[115] The Fifth Circuit decided here only to impose the loss causation prerequisite at the class certification stage to permit use of the fraud-on-the-market presumption in class action suits. The court found that this was appropriate, in light of the 2003 amendments to the class action rule authorizing limited merit inquiry on those aspects necessary to class certification,[116] and the purpose of the PSLRA to eliminate the previous trend to avoid litigation costs to settling. Specifically, the Fifth Circuit rejected the class action investors' assertion that materiality satisfied the loss causation prerequisite since (1) material information of a particular type is sometimes ignored by analysts and market makers thereby not moving the share price, and (2) insider trading can move the share price before disclosure of the material information likewise not moving the market. Further, the Fifth Circuit determined that the loss causation prerequisite must be established by a preponderance of all admissible evidence.[117] These class action investors failed this requirement since they presented only analyst commentary.[118] The problem for the class action investors lied in the negative statements made at the time of the corrective disclosure. The Fifth Circuit requires that the class action investors show that it is more probable than not that it was the corrective statement, "and not other unrelated negative statements, that caused a significant amount of the decline."[119] This requires some sort of empirically-based damage model, not mere well-informed speculation from analysts.[120]

## VI. CONCLUSION

Many courts have rendered opinions during the Survey period affecting the reach of the TSA. The Texas Supreme Court acknowledged its reach

114. *See* Unger v. Amedisys Inc., 401 F.3d 316, 322-23 (5th Cir. 2005) (raised on class certification interlocutory appeal).

115. *See Greenberg*, 364 F.3d at 665.

116. *See* Fed. R. Civ. P. 23 Advisory Committee Notes to the 2003 Amendments.

117. *See* 487 F.3d at 270.

118. Although the class action investors had the better of the analysts statements, some analysts made no mention of the corrective statement, described the management as the best in the business, or indicated there was no change in the fundamentals of the issuer.

119. *See Greenberg*, 364 F.3d at 666.

120. The dissenting opinion would affirm. *See* Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 271 (5th Cir. 2007) (Dennis, J., dissenting). As he stated in his concurring opinion for *Regents of the Univ. of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 401 (5th Cir. 2007), *cert. denied*, 128 S. Ct. 1120 (2008), the loss causation prerequisite violates the fraud-on-the-market presumption of the Supreme Court by changing the burden of proof from the issuer to the class action investors. Secondly, the requirement of *Greenberg* can be satisfied by evidence that the share price moved up immediately following the release of positive information, which happened for these class action investors, rather than only by a decline on the disclosure of the truthful statement. Thirdly, the Supreme Court regards reliance and loss causation as two separate elements of the securities fraud cause of action and should not be intertwined. Fourthly, the majority dramatically expands the scope of class certification review by effectively requiring mini-trials on the merits to determine class certification.

over registration of securities sold and dealers selling from Texas to non-residents. In contrast, the Fifth Circuit continued Congress's campaign to limit regulation of interest rate swaps to federal regulatory bodies by defining "security" in the TSA to not include interest rate swaps. A Texas appellate court determined that lawyers merely preparing the transactional documents for perpetrators of fraud are not subject to liability for aiding and abetting.

The courts also narrowed the ability of private litigants to use the securities laws as a basis for legal action. A Texas appellate court determined that the Board's certificates would not support a default judgment. The Fifth Circuit, continuing Congress's efforts to reduce frivolous securities fraud class actions, determined that the factual allegations of scienter relate to the perpetrator's misstatements. The Fifth Circuit also limited the use of the fraud-on-the-market theory to establish a presumption of reliance by considering some merit questions at the class certification stage, litigation and by requiring a perceptible market reaction to corrective disclosure.