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Texas Annual Survey: Securities Regulation

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SECURITIES REGULATION

George Lee Flint, Jr.*

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SECURITIES regulation deals primarily with the laws preventing and providing remedies for fraud in the sale of stocks and bonds. Although this Article includes Fifth Circuit cases under federal law, the author has attempted to limit the material to that involving state law,

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and only briefly touch federal securities law when necessary. The author does not intend this Article to exhaust all aspects of securities regulation but rather to update the Texas-based securities practitioner with new developments of interest.

I. COVERAGE OF THE SECURITIES ACTS

Preemption of state law by federal law narrows the scope of state law. The Fifth Circuit twice confronted lawsuits brought in the Enron Corporation (Enron) litigation under both the Texas Securities Act (TSA) and what is referred to here as the Texas Stock Fraud Act (TSFA),¹ both of which were deviously crafted to avoid preemption by the Securities Litigation Uniform Standards Act of 1998 (SLUSA).² The importance of these scope questions is that both TSA and TSFA provide for aider and abetter liability not permitted under federal securities laws unless brought by the SEC.³ TSFA also allows for punitive damages not permitted under federal securities laws.⁴

The Fifth Circuit found that SLUSA barred several state securities law actions, operated in cookie-cutter fashion by one law firm, after consolidation in federal court. In contrast, the Fifth Circuit found potential actions, not yet operated in cookie-cutter fashion or consolidated in state court, as not yet preempted by SLUSA.

A. FEDERAL PREEMPTION DETERMINED AFTER CONSOLIDATION

The Enron lawsuits arose from the actions of Enron, a seller of natural gas products.⁵ During the late 1990s, Enron falsely inflated its income and concealed losses in its securities reports, causing a "meteoric rise" in Enron's stock price and allowing insiders to reap windfall profits. The subsequent corrective statements made in late 2001, caused Enron's stock price to fall precipitously and led to the bankruptcy of Enron and the indictment of many of its senior officers.⁶ A single law firm, representing hundreds of former Enron investors, brought both lawsuits involving preemption.

1. Texas has two major statutes to combat securities fraud: The Texas Securities Act and the Texas Stock Fraud Act. See TEX. REV. CIV. STAT. ANN. art. 581-1 (Vernon Supp. 2008); TEX. BUS. & COM. CODE ANN. § 27.01 (Vernon 2008). TSFA is included in a statute that also covers real estate fraud, so many of the cases dealing with TSFA's statutory fraud deal with real estate. See § 27.01.

2. See 15 U.S.C. §§ 77p(b), (d), 78bb(f) (2006); Securities Uniform Standards Act of 1998, 15 U.S.C. § 78a (2006).

3. See TEX. REV. CIV. STAT. ANN. art. 581-33(F)(2); TEX. BUS. & COM. CODE ANN. § 27.01(d); Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 176-78 (1994) (no private action for aiding and abetting under Federal Rule 10b-5).

4. See 15 U.S.C. § 78bb(a) (Exchange Act damages limited to actual damages); TEX. BUS. & COM. CODE ANN. § 27.01(c), (d) (punitive damages against the primary perpetrator and punitive damages against the aider and abetter); see also Stone v. Kirk, 8 F.3d 1079, 1093 (6th Cir. 1993) (punitive damages unavailable under Rule 10b-5).

5. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 535 F.3d 325, 331 (5th Cir. 2008).

6. *Id.* at 331-32.

In the first of these lawsuits, the law firm filed ten cases on behalf of former Enron investors, in several different state courts and one federal court, alleging securities fraud only under Texas law, including the TSA and the TSFA, against former management of Enron, members of Enron's former accounting firm, and certain financial institutions, but not Enron itself.⁷ Each case claimed damages for fewer than fifty investors, not denominated a class, in an attempt to avoid preemption by SLUSA.⁸ In order to preserve the strict requirements on pleading under the Private Securities Litigation Reform Act of 1995 (PSLRA),⁹ SLUSA bars most class actions by private individuals for securities fraud based on state law.¹⁰ Class actions under SLUSA include those with more than fifty investors.¹¹ The defendants removed the state court actions to federal court as relating to bankruptcy.¹² Those actions not in the Southern District of Texas were transferred to the Southern District under federal statutes and consolidated with the cases already in the Southern District. The plaintiff investors in the ten cases thereafter acted in unison, using the same attorneys, alleging nearly identical state law claims, jointly scheduling discovery, filing joint motions, providing nearly identical discovery responses, identifying the same experts, and relying on the same expert reports. The district court dismissed the consolidated lawsuit as preempted by SLUSA.¹³ The Fifth Circuit affirmed.¹⁴

The key issue dealt with the timing of the application of preemption mandated by SLUSA.¹⁵ The law firm contended that the federal court should use the time of removal from state court to determine preemption, when each case involved less than fifty investors, rather than some time after consolidation in federal court, when the consolidated cases involved considerably more than fifty investors.¹⁶ SLUSA preempts private state securities fraud actions for "covered class action[s]" where

- (1) the suits are "pending in the same court,"
- (2) the suits involve "common questions of law or fact,"
- (3) "damages are sought on behalf of more than 50 persons," and
- (4) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.¹⁷

The law firm focused on the first and last requirements. The law firm claimed the provision in SLUSA, which ensures the act does not interfere with a state court's discretion whether to consolidate cases, means that the covered class actions have to be pending in a state court.¹⁸ The Fifth

7. *Id.* at 330-31, 333.

8. *Id.* at 332.

9. *See* 15 U.S.C. § 78u-4(b)(1)-(3) (2006).

10. *See* 15 U.S.C. § 78bb(f)(1) (2006).

11. 15 U.S.C. § 78bb(f)(5)(B)(ii).

12. *In re Enron*, 535 F.3d at 333.

13. *Id.*

14. *Id.* at 331.

15. *Id.* at 333.

16. *Id.* at 336.

17. *Id.* at 339 (quoting 15 U.S.C. § 78bb(f)(5)(B) (ii) (2006)).

18. *Id.* at 392 (citing 15 U.S.C. § 78bb(f)(5)(F)).

Circuit rejected this idea as contrary to the plain meaning rule.¹⁹ The requirement had no language limiting the court to a state court.²⁰ With respect to the last requirement, the law firm claimed that if the preemption occurred after consolidation, the federal court could manufacture its own preemption.²¹ The Fifth Circuit avoided this interpretation by focusing on proceedings rather than consolidation.²² The law firm had conducted the proceedings jointly, thereby causing the preemption itself.²³ The Fifth Circuit also noted that the Supreme Court had recognized that a court can determine SLUSA preemption at the time of the motion to dismiss, a time subsequent to consolidation.²⁴

B. ABILITY TO AVOID PREEMPTION PRESERVED

The second lawsuit²⁵ involved the law firm's misunderstanding²⁶ of an injunction entered by the federal district court to curtail the law firm's devious practices. The district court entered the injunction to prevent the law firm from obtaining ex parte temporary restraining orders in state court against the defendants' destruction of documents at a time when the federal district court had already entered such restraining orders against the same defendants, who at the time were opposed in federal court by the law firm. The Fifth Circuit upheld the injunction, which enjoined the law firm from filing any new Enron-related actions without leave of the federal district court, regarding the behavior of the law firm as an unjustified attempt to harass parties to a federal case.²⁷ Three days short of four years after the disclosure of Enron's fraudulent securities reports, the law firm moved for leave to file thirty-four state actions on behalf of twelve hundred clients.²⁸ Since the bankruptcy proceedings against Enron had ended, the defendants could not remove these new state actions to federal court under the guise of a federal cause of action as they had done before.²⁹ Therefore, these lawsuits might not be consol-

19. *Id.*

20. *Id.*

21. *Id.* at 348.

22. *Id.*

23. *Id.*

24. *See id.* (citing *Merrill Lynch, Pierce, Fenner, & Smith, Inc. v. Dabit*, 547 U.S. 71, 87-89 (2006)).

25. *Newby v. Enron Corp. (IV)*, 542 F.3d 463, 467, 471 (5th Cir. 2008). *Newby v. Enron Corp. (III)*, 394 F.3d 296, 298 (5th Cir. 2004), dealt with a partial settlement.

26. The Fifth Circuit does not think highly of the law firm, describing their performance as "less than exemplary." *See In re Enron Corp. Sec., Derivative & ERISA Litig.*, 535 F.3d 325, 332 (5th Cir. 2008).

27. *Newby (IV)*, 542 F.3d at 467; *Newby v. Enron Corp. (I)*, 302 F.3d 295, 298 (5th Cir. 2002), *cert. denied* 537 U.S. 1191 (2003); *see also Newby v. Enron Corp. (II)*, 338 F.3d 467, 475 (5th Cir. 2003) (upholding another injunction against the same law firm as an attempt to taunt the parties and undermine the district court's ability to control the consolidated cases).

28. *Newby (IV)*, 542 F.3d at 467.

29. *See In re Enron*, 535 F.3d at 332, 335 (stating that Enron's debtors' plan was effective on November 17, 2004, and determining that a federal court is not divested of removed actions upon termination of the bankruptcy proceedings).

idated, might not involve more than fifty investors seeking damages each, and so might not be preempted by SLUSA. By the time the law firm made the motion, the three year statute of limitations had run for TSA violations,³⁰ but not the four-year statute of limitations for TSFA.³¹ The district court denied the motion because under its local court rules it would take twenty days before the court could render a decision. By that time, all the limitations periods would have elapsed.³² The Fifth Circuit affirmed with respect to the three-year limitations period, but reversed and remanded with respect to the four-year limitations period.³³

Dispensing with tolling arguments that would have allowed all the lawsuits to proceed, the Fifth Circuit concluded that a Texas court might deem a late state filing as dating back to the filing of the motion for leave to file, thereby allowing the lawsuits subject to a four-year limitations period to proceed.³⁴ The federal district court should not have prevented the Texas court from ruling on the matter.³⁵ With respect to preemption, the Fifth Circuit preserved the ability of the plaintiffs' bar to shape their lawsuits so as to avoid SLUSA preemption.³⁶ The defendants claimed that SLUSA would preempt even the lawsuits subject to the four-year limitations period. The Fifth Circuit disagreed.³⁷ Congress intended to permit bona fide individual actions, even if more than fifty persons brought separate actions in the same court against the same defendant.³⁸ It is only when the lawsuits are "joined, consolidated, or otherwise proceed as a single action" that SLUSA preempts them.³⁹ There was no indication that Texas courts would consolidate the actions. Notions of federalism dictate that Texas courts should decide how to proceed with their own multiple actions, not the federal courts.

II. ORGANIZATION OF THE STATE SECURITIES BOARD

TSA created a regulatory body, the State Securities Board (Board), to handle the registrations required by TSA as well as to serve as an en-

30. See TEX. REV. CIV. STAT. ANN. art. 581-33(H) (Vernon Supp. 2008).

31. *Newby (IV)*, 542 F.3d at 468; TEX. CIV. PRAC. & REM. CODE ANN § 16.004 (Vernon Supp. 2008) (statute of limitations for fraud).

32. *Newby (IV)*, 542 F.3d at 463.

33. *Id.* at 474.

34. See *id.* at 470-72. The 2002 injunction did not toll the limitations period since it merely required an additional step, the motion for leave to file, to the filing in state court. *Id.* at 471. The 2002 scheduling order did not toll the limitations period since it only applied to amending and responsive filings. *Id.* The tolling doctrine of *American Pipe & Construction v. Utah*, 414 U.S. 538, 552-53 (1974), where the filing of a class action tolls the statute of limitations for all purported members of the class to prevent numerous protective motions to intervene or join in the event the court denied class certification, did not apply since Texas courts have refused to adopt the doctrine for federal class actions. See *Bell v. Showa Denko K.K.*, 899 S.W.2d 749, 757-58 (Tex. App.—Amarillo 1995, writ denied).

35. *Newby (IV)*, 542 F.3d at 470.

36. *Id.* at 474.

37. *Id.* at 473-74.

38. *Id.* at 474.

39. *Id.* at 473 (citing 15 U.S.C. § 78bb(f)(5)(B)(ii) (II) (2006)).

forcement mechanism.⁴⁰ The Board updated its form for requesting open records by referring to “public information” rather than “open records,” and by denoting the Attorney General’s authority over the charges for copies.⁴¹

III. REGISTRATION OF SECURITIES

The basic rule of most securities laws is that securities must be registered with the regulatory agency unless they fall within an exemption to registration. Enforcement actions generally focus on issuers failing to register their securities and making misleading statements to aid the sale.

The Board adopted a new revised chapter concerning its registration guidelines for real estate programs operated in the form of limited partnerships to bring them in line with those adopted by the North American Securities Administrators Association, Inc. (NASAA).⁴² NASAA intends to have many states adopt their guidelines to achieve national uniformity in forms as well as consistency in standards to facilitate nationwide registration.⁴³ The Board also amended its securities registration application to eliminate a corporate applicant’s certification of franchise tax payments since Texas no longer requires certification to obtain permits or licenses.⁴⁴

Board enforcement actions against issuers dealt with failure to register securities and selling agents,⁴⁵ and some with additional misrepresentations by omitting judgments against the principals,⁴⁶ projecting future val-

40. TEX. REV. CIV. STAT. ANN. art. 581-1 (Vernon Supp. 2008).

41. 33 Tex. Reg. 8991, *adopted* 33 Tex. Reg. 1320 (2008) (codified at 7 TEX. ADMIN. CODE § 133.1) (adopting new form and repealing old form without comment).

42. *See* 33 Tex. Reg. 1919-20, *adopted* 33 Tex. Reg. 7154 (2008) (codified at 7 TEX. ADMIN. CODE §§ 117.1-9) (adopting new chapter without comment); 33 Tex. Reg. 1919, *adopted* 33 Tex. Reg. 7153 (repealing former chapter). The changes to the chapter also required changes to a form. 33 Tex. Reg. 1939, *adopted* 33 Tex. Reg. 7154 (2008) (codified at 7 TEX. ADMIN. CODE § 117.1-9 (adopting new form and repealing old form without comment)).

43. *See* NASSA.org, Statement of Policy Regarding Real Estate Programs, http://www.nassa.org/content/Files_Real_Estate_Programs.pdf (last visited Nov. 28, 2008) (“standards are primarily designed for public real estate syndications . . . which make or invest in [real estate] mortgage[s]”).

44. *See* 33 Tex. Reg. 8992, *adopted* 37 Tex. 1321 (2008) (codified at 7 TEX. ADMIN. CODE § 133.7) (adopting without comment); 32 Tex. Reg. 8992 (2007), *adopted* 33 Tex. Reg. 1321 (2008). The Texas legislature made the statutory change in 2001. Act of June 15, 2001, 77th Leg., R.S., ch. 1158, § 94, 2001 Tex. Gen. Laws 2570, 2615 (Vernon Supp. 2001) (repealing TEX. BUS. CORP. ACT ANN. art. 2.45, which prohibited obtaining a permit or license from any state action if the corporation was delinquent in its franchise tax payments). *See also* George Lee Flint, Jr., *Securities Regulation*, 56 SMU LAW REV. 1995, 2009-11 (2003) (discussing the statutory change and its impact on other Board rules).

45. *See In re D’Log Mining, Inc.*, No. ENF-08-CDO-1655, 2008 WL 2412066 (Tex. St. Sec. Bd. May 28, 2008) (agreed cease and desist order for selling gold certificates redeemable in the future for gold or the then price of gold and equity agreement contracts for 5% of the net income generated from mining an Alaskan lease); *In re BioDefense Corp.*, No. ENF-08-CDO-1651, 2008 WL 916881 (Tex. St. Sec. Bd. Mar. 28, 2008) (agreed cease and desist order for selling stock).

46. *See In re TierOne Converged Networks, Inc.*, No. ENF-08-CDO-1654, 2008 WL 2158815 (Tex. St. Sec. Bd. May 19, 2008) (emergency cease and desist order for the sale of

ues,⁴⁷ and omitting information on the promoter's prior investment programs.⁴⁸ Many involved the Board's identification of threats to inves-

convertible preferred stock omitting two arbitration awards for \$0.4 million, an order of the FIRA for payment of \$0.5 million in restitution to twenty-three individuals, and a bankruptcy filing to cancel \$0.9 million in potential arbitration awards, all for securities fraud committed by the issuer's principal); *In re* TPR-Tex. Petroleum Res., Inc., No. ENF-08-CDO-1648, 2008 WL 697627 (Tex. St. Sec. Bd. Mar. 5, 2008) (emergency cease and desist order for the sale of working interests in Texas oil and gas wells because of misrepresented validity of promoter modifications to subscription agreements contrary to statements made in the offering materials, ownership of a Railroad Commission operator number, several omitted Texas judgments against the issuer, and a Wisconsin order prohibiting the issuer and agent from selling the securities in Wisconsin); *In re* Provident Capital Indem., Ltd, No. ENF-08-CDO-1647, 2008 WL 283769, at *2-3 (Tex. St. Sec. Bd. Jan. 17, 2008) (emergency cease and desist order for the sale of bonded life contracts [line of credit promissory notes] with 15% per annum return because omitted a conviction to commit mail and wire fraud, a Florida receivership, a Texas Department of Insurance cease and desist order, and information on the promoters, issuer's operating history, and issuer's financials); *In re* Bramlett, No. ENF-07-CDO-1644, 2007 WL 4285304, at *1-2 (Tex. St. Sec. Bd. Dec. 3, 2007) (emergency cease and desist order against the sale of interests in a nightclub because omitted a conviction for mail fraud resulting in 121 months of incarceration and an order to pay restitution of \$8 million).

47. See *In re* Kensington Res., Inc., No. ENF-08-CDO-1662, 2008 WL 4686379, at *1-2 (Tex. St. Sec. Bd. Oct. 15, 2008) (emergency cease and desist order against sale of common stock of environmental company because represented orally a six-fold increase in value upon a financial audit and airing of television documentary).

48. See *In re* Crescent Dev., LLC, No. ENF-08-CDO-1646, 2008 WL 166481, at *2-3 (Tex. St. Sec. Bd. Jan. 15, 2008) (emergency cease and desist order for selling oil and gas interests because of omitted information on the promoter's background, operating history, an offer to transfer prior drilling program to another, failure to drill in another drilling program due to rig unavailability, failure to tender funds for a rescission on another drilling program, and operator charter forfeitures in prior drilling programs).

tors,⁴⁹ namely oil and gas scams,⁵⁰ ponzi schemes,⁵¹ internet fraud,⁵² and high-yield notes.⁵³

IV. REGISTRATION OF MARKET OPERATORS

One of the underpinnings of state regulation of securities is the requirement to register as a seller of securities before selling securities in the state, and as an investment advisor before rendering investment advice.⁵⁴ Registration infractions generally surface when applying or reapplying for registration.

For fraudulent selling schemes aimed at certain demographic groups, the Board adopted a new rule based on NASAA's model, pursuant to "a multi-state effort to focus national attention on unscrupulous practices

49. See, e.g., Press Release, Tex. State Sec. Bd., Securities Commissioner Identifies Top 10 Threats to Texas Investors Governor Perry Proclaims, "April Savings and Investing Month" (Apr. 6, 2005) (major threats are 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).

50. See *In re Rockwall Oil Co.*, ENF-08-CDO-1663, 2008 WL 4829382, at *1 (Tex. St. Sec. Bd. Oct. 15, 2008) (emergency cease and desist order for selling oil and gas interests because omitted promoter's use of investor funds from numerous previous drillings for personal expenses); *In re Whitt Oil & Gas, Inc.*, No. ENF-08-CDO/FIN-1659, 2008 WL 4118161, at *1-2 (Tex. St. Sec. Bd., Aug. 29, 2008) (agreed cease and desist order and order assessing administrative fine of \$3,000 for selling working interests in Louisiana oil and gas prospect); *In re Cottonwood Petroleum Co.*, No. ENF-08-CDO-1656, 2008 WL 2646582 (Tex. St. Sec. Bd., June 27, 2008) (agreed cease and desist order for selling working interests in Texas oil and gas prospect); *In re Exodus Exploration, LLC*, No. ENF-08-CDO-1652, 2008 WL 2102448 (Tex. St. Sec. Bd. May 8, 2008) (agreed cease and desist order for selling working interests in Louisiana oil and gas prospect); *In re GNG Operating Co.*, No. ENF-08-CDO-1653, 2008 WL 2102450 (Tex. St. Sec. Bd. May 8, 2008) (agreed cease and desist order for selling working interests in Texas oil and gas prospect through newspaper ads); *In re Sema Oil & Gas Inc.*, No. ENF-08-CDO-1645, 2008 WL 166480, at *1 (Tex. St. Sec. Bd. Jan. 3, 2008) (agreed cease and desist order for offering interests in oil and gas lease through newspaper ads).

51. See *In re Nat'l Funding Alliance, LLC*, No. ENF-08-CDO-1657, 2008 WL 2646585 (Tex. St. Sec. Bd. July 2, 2008) (emergency cease and desist order for selling interests in a program to leverage investment and trade with a return equal to the investment within one month for three months, and then a guaranteed monthly return of more than five times the investment amount, because omitted an indication of assets to satisfy guarantee, the identity of the trader, profitability of other investment opportunities sold, and any risks); *In re Painted Horse, LLC*, No. ENF-08-CDO-1650, 2008 WL 916880 (Tex. St. Sec. Bd. Mar. 28, 2008) (agreed cease and desist order for selling equity interests in a company seeking to develop North Dakota oil leases with annual return of 20% through newspaper ads).

52. See *In re Fabulair, LLC*, No. ENF-07-CDO-1643, 2007 WL 4219607, at *1 (Tex. St. Sec. Bd. Nov. 20, 2007) (agreed cease and desist order for internet offering of interests in limited liability company website).

53. See *In re Secure Growth LLC*, No. ENF-08-CDO-1661, 2008 WL 4295075, at *1 (Tex. St. Sec. Bd. Sept. 11, 2008) (agreed cease and desist order for sale of bonded life contracts [line of credit promissory notes] with 15% per annum return); *In re Rodney Int'l*, No. ENF-08-CDO-1649, 2008 WL 916879 (Tex. St. Sec. Bd. Mar. 28, 2008) (emergency cease and desist order for sale of debt product secured by real estate assets of the issuer returning 14.25% to 24% on annual basis because misrepresented a Canadian certificate to sell securities, omitted compliance with TSA for referral fees, and numerous Ontario court actions for attempting to sell watches with forged registered trademarks).

54. See TEX. REV. CIV. STAT. ANN. art. 581-13(A)(B) (Vernon Supp. 2008).

targeting senior [citizens].”⁵⁵ The rule prohibits the use of designations implying that the registered dealer or registered investment advisor had special training in providing brokerage services to senior citizens or retirees, provides a means for recognition of an accredited certifying organization, and places registered dealers and registered investment advisors on notice that use of misleading designations is administratively actionable.⁵⁶

The Board updated its definitional rule and its dealer and investment advisor rules to reflect the formation of the Financial Industry Regulatory Authority (FIRA) from “the merger of the [National Association of Securities Dealers (NASD)] and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange.”⁵⁷ The Board also repealed as outdated two dealer forms concerning minimum bookkeeping records for dealers and the memorandum to securities dealers.⁵⁸

A. DEALERS

The Board brought several enforcement actions against dealers and selling agents. Dealer infractions included expulsion from self-regulatory organizations,⁵⁹ failing to maintain adequate systems to prevent sales of unregistered securities,⁶⁰ failing to follow written supervisory procedures,⁶¹ and failing to provide the Board with requested

55. 33 Tex. Reg. 8761 (2008) (codified at 7 TEX. ADMIN. CODE § 115.16).

56. For dealers, 33 Tex. Reg. 6679, *adopted* 33 Tex. Reg. 8761 (2008) (codified at 7 TEX. ADMIN. CODE § 115.16) (adopting new rule without comment). For investment advisors, see 33 Tex. Reg. 6631, *adopted* 33 Tex. Reg. 8762 (2008) (codified at 7 TEX. ADMIN. CODE § 116.16) (adopting new rule without comment).

57. For the definitional rule, see 33 Tex. Reg. 7813, *adopted* 33 Tex. Reg. 1319 (2008) (codified at 7 TEX. ADMIN. CODE § 107.2 *adopted* 33 Tex. Reg. 7813, (adopting amendment to rules in that comment). For the update of dealer rules, see 33 Tex. Reg. 7814, *adopted* 33 Tex. Reg. 1310 (codified at 7 TEX. ADMIN. CODE §§ 115.1-115.5) (adopting amendment to rules without comment). For the update of investment advisor rules, see 33 Tex. Reg. 8815, *adopted* 33 Tex. Reg. 1319 (2008) (codified at 7 TEX. ADMIN. CODE §§ 116.2-116.3) (adopting amendment to rules without comment).

58. For the form concerning minimum bookkeeping records for dealers, see 33 Tex. Reg. 6682, *adopted* 33 Tex. Reg. 8762 (2008) (codified at 7 TEX. ADMIN. CODE § 133.21) (adopted without comment). For the form concerning the memorandum to securities dealers, see 33 Tex. Reg. 6682, *adopted* 33 Tex. Reg. 8762 (2008) (codified at 7 TEX. ADMIN. CODE § 133.22) (adopted without comment).

59. See *In re Dealer Registration of Costa Fin. Sec., Inc.*, No. IC08-REV-10, 2008 WL 3895879, at *1-2 (Tex. St. Sec. Bd. Aug. 14, 2008) (default order revoking registration of dealer expelled from a self-regulatory organization for violating NASD rules that required provision of information and documents related to an enforcement action with respect to private placement offerings).

60. See *In re Dealer Registration of Morgan Stanley & Co.*, No. IC08-CDO-15, 2008 WL 4544454, at *1-2 (Tex. St. Sec. Bd. Oct. 2, 2008) (consent order and administrative fine of \$448,055, Texas’s share of state settlement of \$8.5 million in NASAA investigation, for merger predecessor’s absence of a surveillance system to check for possible Blue Sky Law violations for most fixed income securities, and for failure to the correct system when automated and after merger for more than eight years).

61. See *In re Dealer Registration of SWS Fin. Servs., Inc.*, No. IC08-CAF-12, 2008 WL 4371758, at *1-3 (Tex. St. Sec. Bd. Sept. 22, 2008) (disciplinary order reprimanding and assessing administrative fine of \$35,000 for failure to submit branch office’s advertising, conducting investment seminars for seniors without approval as required by written supervisory procedures, and failure to have supervisory procedures requiring submission of business name changes of branch office); *In re Dealer Registration of Morgan Stanley & Co.*,

documents.⁶²

Selling agent violations involved selling unregistered securities while not registered as a dealer or agent,⁶³ failing to comply with a prior agreed undertaking with the Board,⁶⁴ violating the dealer's supervisory procedures,⁶⁵ using the name of an unaffiliated dealer in advertisements,⁶⁶ and

No. IC08-CAF-07, 2008 WL 2898321 (Tex. St. Sec. Bd. July 21, 2008) (disciplinary order reprimanding and assessing administrative fine of \$400,000 for branch manager's failure to follow supervisory procedures for agent's outside business information and to receive compliance department approval for agent's outside business, review of incoming letters requesting client money withdrawals, determination of purpose for large client withdrawals, and acceptance of three wire transfers).

62. See *In re Dealer Registration of Solomon Advisors, Inc.*, No. IC07-SUS-29, 2007 WL 4623026, at *1-2 (Tex. St. Sec. Bd. Dec. 20, 2007) (disciplinary order suspending dealer for two years for telling Board of document destruction for two client arbitrations but then later producing them to avoid violation of dealer's duties).

63. See *In re Perales*, No. ENF-08-CDO/FIN-1660, 2008 WL 4118162, at *1-2 (Tex. St. Sec. Bd. Aug. 29, 2008) (agreed cease and desist order and order assessing administrative fine of \$3,000 against the agent for selling working interests in Louisiana oil and gas prospect); *In re First Diversified Fin. Servs., Inc.*, No. ENF-08-CDO-1658, 2008 WL 4118158, at *1 (Tex. St. Sec. Bd., Aug. 27, 2008) (agreed cease and desist order for sale of Class A 8% Preferred Member Limited Liability Company Interests); *In re Agent Registration of John David Butler*, No. IC08-SUS-04, 2008 WL 2102451 (Tex. St. Sec. Bd. May 9, 2008) (disciplinary order granting registration, reprimanding and suspending agent for three days, and assessing administrative fine of \$10,000 for selling oil and gas interests while employed by oil companies).

64. See *In re Agent Registration of John Michael Curran*, No. IC08-SUS-11, 2008 WL 3997368, at *1-2 (Tex. St. Sec. Bd. Aug. 25, 2008) (disciplinary order reprimanding and suspending the agent for seven days, and assessing an administrative fine of \$17,500 for agent acting in a supervisory capacity contrary to the 2004 undertaking); *In re Agent Registration of John Edward Shryack*, No. IC08-SUS-06, 2008 WL 2898320 (Tex. St. Sec. Bd. July 17, 2008) (disciplinary order approving application and suspending the agent for five days for acting in a supervisory capacity contrary to the 1997 undertaking); *In re Applications for the Agent and Inv. Adviser Representative Registrations of Patricia Ann Shearer*, No. IC07-SUS-28, 2007 WL 4472937, at *1-3 (Tex. St. Sec. Bd. Dec. 10, 2007) (disciplinary order granting the applications, and reprimanding and suspending the agent for thirty days for failing to supervise as required in the 2004 undertaking).

65. See *In re Agent and Inv. Adviser Representative Registrations of Stanley Earnest Pyndus, Jr.*, No. IC08-SUS-09, 2008 WL 3827419, at *1-2 (Tex. St. Sec. Bd. Aug. 12, 2008) (disciplinary order suspending agent for six months for selling limited partnership interests in outside business activity when approved only for advisory position and barred from selling investment not approved by dealer's supervisory procedures); *In re Agent Registration of Philip Douglas Gundy*, No. IC08-CAF-05, 2008 WL 2789737 (Tex. St. Sec. Bd. July 14, 2008) (disciplinary order reprimanding and assessing administrative fine of \$5,000 for permitting client's spouse to withdraw \$30,000 without having an approved executed power of attorney or trading authorization documents on file as required by the dealer's written supervisory procedures).

66. See *In re Applications for the Inv. Adviser Registration of Select Asset Mgmt., LLC*, No. IC08-CAF-08, 2008 WL 2954055 (Tex. St. Sec. Bd. July 23, 2008) (disciplinary order granting the application, reprimanding, and assessing administrative fine of \$7,500 for rendering investment advice when not registered and using the name of an unaffiliated registered dealer in advertising materials); *In re Agent Registration of Martin Dean White, Sr.*, No. IC07-SUS-26, 2007 WL 4303792, at *1-2 (Tex. St. Sec. Bd. Dec. 5, 2007) (disciplinary order suspending agent for three years for mailings in connection with a private placement using the name of another dealer without authorization); *In re Agent Registration of Craig Alan Jansen*, No. IC07-SUS-25, 2007 WL 4219611, at *1-2 (Tex. St. Sec. Bd. Nov. 20, 2007) (same); *In re Dealer Registration of M & W Fin., Inc.*, No. IC07-CEN-24, 2007 WL 4219608, at *1-2 (Tex. St. Sec. Bd. Nov. 20, 2007) (disciplinary order reprimanding and assessing administrative fine of \$65,000 for failure to supervise agents who made misleading mailings and for failure to have supervisory procedures requiring approval of mailings).

failing to disclose to the Board a tax lien filed against an agent.⁶⁷

B. INVESTMENT ADVISERS

The Board's enforcement actions against investment advisers involved situations when advisers rendered compensated service without registration,⁶⁸ failed to comply with an agreed undertaking with the Board,⁶⁹ failed to establish a written supervisory policy to prevent advice from being given by unregistered investment advisor representatives,⁷⁰ failed to disclose to the Board outside businesses and used testimonials in advertising,⁷¹ failed to disclose to investors personal use of issuer funds and various misrepresentations made to the Securities and Exchange Commission (SEC),⁷² represented to the Board that corrective actions would be taken but failed to take them,⁷³ and failed to amend filings to reflect current business addresses.⁷⁴

67. See *In re* Application for Agent Registration of Sydney Barrett, No. IC08-DOR-02, 2008 WL 837053 (Tex. St. Sec. Bd. Mar. 21, 2008) (default order denying application for failure to disclose tax lien filed against agent and other business engaged in by agent, and for selling securities after revocation of registration).

68. See *In re* Inv. Adviser Registration of Alex Francis Weisberg, Jr., No. IC08-CEN-16, 2008 WL 4615719 (Tex. St. Sec. Bd. Oct. 14, 2008) (granting application while reprimanding for rendering service after registration expired in 2002).

69. See *In re* Inv. Adviser Registration of Gamboa Capital Mgmt. Inc., No. IC07-SUS-27, 2007 WL 4472938, at *2-3 (Tex. St. Sec. Bd. Dec. 10, 2007) (disciplinary order reprimanding and suspending adviser for ten days, and assessing administrative fines on adviser and advisor's representative of \$5,000 each for failing to have independent consultant review compliance as provided in 2005 undertaking).

70. See *In re* Mathew B. Burnham, No. IC08-CDO-13, 2008 WL 4452452 (Tex. St. Sec. Bd. Sept. 30, 2008) (disciplinary order reprimanding and assessing administrative fine of \$22,500 for lack of procedures for supervision of investment representatives, one of whom rendered services without registration, along with cease and desist order against representative and administrative fine of \$7,500).

71. See *In re* Inv. Adviser Registration of Int'l Wealth Mgmt., Inc., No. IC08-CAF-03, 2008 WL 2231792, at *2-3 (Tex. St. Sec. Bd. May 7, 2008) (disciplinary order reprimanding and assessing administrative fines of \$5,000 each on the investment adviser and the investment adviser's representative for using testimonials in advertising and for failure to disclose representative's ownership in real estate, trucking, and insurance businesses).

72. See *In re* Application for Inv. Adviser Registration of David Henry Disraeli, No. IC08-DOR-01, 2008 WL 484272, at *7-9 (Tex. St. Sec. Bd. Feb. 14, 2008) (application denied for failing to disclose to investors the promoter's tax lien, use of issuer funds for the promoter's personal expenses, and an issuer loan to promoter, and for misrepresenting to the SEC that the issuer was a newly formed adviser when he was not, that the promoter was required to register in thirty or more states when he was not, and that the promoter would be eligible for registration with the SEC when he had no reasonable belief of such occurring).

73. See *In re* Inv. Adviser Registration of Joseph Andrew Acciarito, No. IC08-SUS-14, 2008 WL 4452453, at *1-3 (Tex. St. Sec. Bd. Sept. 30, 2008) (disciplinary order reprimanding and suspending registration for forty-five days, and assessing an administrative fine of \$10,000 for failure to maintain a general ledger and income statement, erroneous claims of certified financial planner designation on Form ADV and letterhead, and for failure to correct such shortcomings after the first inspection as agreed).

74. See *In re* Inv. Adviser Registration of Mederick L. Shaw, No. IC07-SUS-23, 2007 WL 3514355, at *2 (Tex. St. Sec. Bd. Nov. 8, 2007) (disciplinary order reprimanding and suspending agent for fifteen days for failure to report change of business address).

V. SECURITIES FRAUD

One of the major reasons legislatures passed securities acts was to facilitate investors' actions to recover their moneys through a simplified fraud action that removed the most difficult elements to prove in common-law fraud, namely scienter and privity.⁷⁵

A. COURT DECISIONS UNDER THE TEXAS ACTS

Two Texas courts of appeal confirmed two unrelated matters that their sister courts had confronted in earlier years. To sustain a criminal conviction for securities fraud, one Texas court of appeals determined that a jury need not be unanimous in agreeing which of several misstatements and omissions constituted the fraudulent act.⁷⁶ With respect to civil liability for securities fraud, another Texas court of appeals concluded that, despite language in TSA voiding contracts in violation of the act, an issuer could not void a sales contract to sell unregistered securities since its own actions caused the lack of registration.⁷⁷

Federal courts, through their diversity and removal jurisdiction, also deal with securities fraud lawsuits brought under the Texas acts. Their opinions under TSA and TSFA have raised two issues of interest. First, the Fifth Circuit confirmed that federal courts apply the federal pleading rules to complaints under the Texas acts, requiring specific allegations on the misstatements, identification of the perpetrators, circumstances of the misstatements, and the motives for the misstatements.⁷⁸ Consequently, an investor pleading that lacked specific identification of material misrepresentations and/or omissions required repleading.⁷⁹ Second, although the Texas acts provide for aider and abetter liability, the Texas acts are difficult to apply to transactions in the secondary market. The investors need to replead under TSA to comply with the privity requirement with the primary perpetrator, which is unlikely in the secondary market, and under TSFA to reveal a duty to disclose something omitted by the aider and abetter, which is also unlikely in the secondary market.

1. *Criminal Jury Unanimity Not Required for Multiple Misstatements and Omissions*

Perpetrators of securities fraud generally make more than one misstatement or omission. The Texas constitution requires a unanimous jury verdict for a felony conviction.⁸⁰ The issue for a criminal conviction for securities fraud is whether each member of the jury must agree on the

75. See TEX. REV. CIV. STAT. ANN. ART. 581-4(f) (Vernon Supp. 2008).

76. See *Bridwell v. State*, Nos. 05-07-00258-CR, 05-07-00259-CR, 2008 WL 467271, at *4, *6 (Tex. App.—Dallas Feb. 23, 2008, no pet.) (not yet released for publication and so subject to revision or withdrawal).

77. *Anglo-Dutch Petroleum Int'l, Inc. v. Smith*, 243 S.W.3d 776, 779, 782 (Tex. App.—Houston [14th Dist.] 2007, pet. denied).

78. *Dorsey v. Portfolio Equities, Inc.*, 540 F.3d 333, 338-39 (5th Cir. 2008).

79. *Id.* at 341.

80. See TEX. CONST. art. V, § 13.

same misstatement or omission, or different jurors may base their guilty verdict on different misstatements or omissions made in the same transaction.⁸¹ In *Bridwell v. State*, the Dallas Court of Appeals determined that jury members need not agree on the same misstatement or omission.⁸² The perpetrator of the fraud had offered for sale working interests in oil and gas leases pursuant to a private placement memorandum that failed to disclose three material items, namely, his two separate convictions for securities fraud twenty years earlier, resulting in two prison terms,⁸³ and his settlement of a civil securities fraud action ten years earlier, resulting in an agreed judgment.⁸⁴ The jury instruction directed a fraud finding upon the occurrence of one of the three items, listed in the disjunctive, allowing conceivably, different jurors to find fraud based on different omissions.⁸⁵ Jury unanimity requires the jury to agree on the offense, but not necessarily on the same method of committing the offense, provided the legislature has proscribed an offense with multiple or alternate modes of commission, and provided that the legislative action is fair and rational.⁸⁶ With respect to the first proviso, the Texas Court of Criminal Appeals has determined that for transitive verbs describing the prohibited conduct, the jury must be unanimous,⁸⁷ but for adverbial phrases describing how the perpetrator committed the offense, the jury need not be unanimous.⁸⁸ For criminal securities fraud under TSA, the transitive verb is “engage,” while the adverbial phrase is “in fraud,” with “fraud” defined as any misstatement or omission.⁸⁹ Thus, TSA does not require that jury members unanimously agree on the same misstatement or omission. With respect to the second proviso, the due process requirement, the Texas Court of Criminal Appeals has deemed it satisfied if the various modes of commission all “involve the same injury, to the same complainant, during the same transaction, with a similar level of culpability.”⁹⁰ Therefore, misstatements or omissions, in the same private placement memorandum, presented to one investor for one sale of a security,

81. See *Bridwell*, 2008 WL 467271, at *4.

82. *Id.* at *4, 6.

83. These two convictions also were for failure to disclose prior fraudulent transactions with previous investors. See *Bridwell v. State*, 804 S.W.2d 900 (Tex. Crim. App. 1991), *affg* 761 S.W.2d 401 (Tex. App.—Dallas 1988).

84. *Bridwell*, 2008 WL 467271, at *6.

85. *Id.* at *6-7.

86. The Texas Court of Criminal Appeals has set out this principle for determining the necessity of jury unanimity for crimes committable by multiple modes. See *Jefferson v. State*, 189 S.W.3d 305, 309-12 (Tex. Crim. App. 2006), *cert. denied*, 549 U.S. 957 (2006) (upholding a conviction for injury to a child under a jury instruction permitting one of three acts in the disjunctive to cause the injury, without requiring unanimity on which of the three acts caused the injury).

87. *Pizzo v. State*, 235 S.W.3d 711, 721 (Tex. Crim. App. 2007).

88. *Id.* at 715 (citing *Jefferson*, 189 S.W.3d at 315 (Cochran, J., concurring)).

89. See TEX. REV. CIV. STAT. ANN. art. 581-29C(1) (Vernon Supp. 2008) (the penal offense: “[a]ny person who shall . . . engage in any fraud or fraudulent practice”); art. 581-4(F) (definitions: “[t]he terms ‘fraud’ or ‘fraudulent practice’ shall include any . . . intentional failure to disclose a material fact”).

90. *Jefferson*, 189 S.W.3d at 313.

satisfy the due process requirement.⁹¹ The Dallas Court of Appeals noted that the Houston Fourteenth District Court of Appeals has reached the same conclusion in a similar situation.⁹²

2. *Inability of Issuer to Void Sale for Lack of Registration*

TSA provides that any person performing a contract in violation of the TSA, or who has acquired any right under such a contract with knowledge of the facts making its performance in violation of TSA, may not base any lawsuit on that contract.⁹³ For example, in *Anglo-Dutch Petroleum International, Inc. v. Smith*, the issuer had sold litigation funding agreements to investors in order to fund its dispute with a major oil field operator concerning the development of a foreign oil field.⁹⁴ When recovery turned out to be less than expected, the issuer attempted to renegotiate the litigation funding agreements with the investors, seeking a reduced payment. One investor refused the lesser amount and sued for fraudulent inducement, conversion, breach of fiduciary duty, and breach of contract.⁹⁵ The trial court awarded the investor actual damages, exemplary damages, and attorney's fees. The Houston Fourteenth District Court of Appeals affirmed as modified by eliminating the exemplary damages.⁹⁶ The issuer contended that TSA voided the litigation funding agreements since they dealt with unregistered securities.⁹⁷ The appellate court noted that this same issuer had urged the same argument before the Houston First District Court of Appeals and lost.⁹⁸ The court held that the issuer of securities had no standing to bring a claim urging the unenforceableness of the securities based on those securities being unregistered.⁹⁹ The issuer itself caused the unregistered status by not registering them with the Board.¹⁰⁰ Although the sister court's opinion from that case did not bind the Houston Fourteenth District Court of Appeals, the court had previously elected to follow it.¹⁰¹

91. *Bridwell v. State*, Nos. 05-07-00258-CR, 05-07-00259-CR, 2008 WL 467271, at *6-8 (Tex. App.—Dallas Feb. 23, 2008, no pet.).

92. *Id.* at *7 (citing *Murchison v. State*, 93 S.W.3d 239, 257-59 (Tex. App.—Houston [14th Dist.] 2002, pet. ref'd) (criminal securities fraud conviction under disjunctive jury instructions for five omissions to disclose to investors)).

93. TEX. REV. CIV. STAT. ANN. art. 581-33(K) (Vernon Supp. 2008).

94. *Anglo-Dutch Petroleum Int'l, Inc. v. Smith*, 243 S.W.3d 776 (Tex. App.—Houston [14th Dist.] 2007, pet. denied).

95. *Id.* at 779-80.

96. *Id.* at 779.

97. *Id.* at 782.

98. *Id.* See *Anglo-Dutch Petroleum Int'l, Inc. v. Haskell*, 193 S.W.3d 87 (Tex. App.—Houston [1st Dist.] 2006, pet. denied). For a discussion of this case, see George Lee Flint, Jr., *Securities Regulation*, 60 SMU LAW REV. 1293, 1300-01 (2007) (under both TSA and federal securities laws, courts have determined that contracts to purchase securities “are not void but voidable only at the option of the purchaser”).

99. *Smith*, 243 S.W.3d at 782.

100. *Id.*

101. *Id.* See *Anglo-Dutch Petroleum Int'l, Inc. v. Littlemill Ltd.*, No. 14-06-00921-CV, 2007 WL 2826900, at *3 (Tex. App.—Houston [14th Dist.] Oct. 2, 2007, no pet.).

3. Federal Pleading Rules Apply to TSA and TSFA in Federal Court

Federal rules of pleading fraud require specific allegations of material misrepresentations and omissions, along with allegations of who made the statements, where the perpetrator made the statements, when the perpetrator made the statements, and why the perpetrator made the statements.¹⁰² For the latter scienter requirement, the Fifth Circuit requires that plaintiff must “set forth *specific facts* supporting an inference of fraud.”¹⁰³ The Fifth Circuit had previously stated in dicta that these pleading rules should apply to state actions brought in federal court.¹⁰⁴ In *Dorsey v. Portfolio Equities, Inc.*,¹⁰⁵ the Fifth Circuit made the matter clear. The investors had purchased promissory notes through both a private placement memorandum and subsequent solicitations from an issuer formed to finance another company’s purchases of single-family residences.¹⁰⁶ The private placement memorandum indicated that the issuer would receive mortgages in the acquired properties as security for the financing.¹⁰⁷ When the issuer failed to make payment when the notes became due and the investors discovered that the issuer lacked security for the financing, they brought suit under federal and state law.¹⁰⁸ The district court dismissed both the state and federal actions for failure to plead with the particularity required by the federal rules.¹⁰⁹ The Fifth Circuit affirmed in part and reversed in part.¹¹⁰ For the subsequent solicitations, the pleadings failed to allege purchases made pursuant to the solicitations and failed to identify those making the misrepresentations.¹¹¹ The TSFA claim failed since promissory notes are not “stock in

102. To successfully plead fraud under FED. R. CIV. P. 9(b), plaintiffs “must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person’s mind may be alleged generally.” FED. R. CIV. P. 9(b).

103. See, e.g., *Melder v. Morris*, 27 F.3d 1097, 1102 (5th Cir. 1994) (securities fraud under federal law). These pleading requirements are less stringent than the requirements for federal actions brought under the PSLRA. Under PSLRA plaintiff must “specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.” See 15 U.S.C. § 78u-4(b)(1) (2006). With respect to scienter, the PLSA stiffens the requirement to a strong inference. See 15 U.S.C. § 78u-4(b)(2) (2006) (“the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”).

104. See *Williams v. WMX Techs., Inc.*, 112 F.3d 175, 177 (5th Cir. 1997), *cert. denied*, 522 U.S. 966 (1997) for a case involving the same misrepresentations under federal securities law and the state common law fraud action, in which the investors made no distinction between the federal claims and state claims. In the case, the court stated, “[w]e see no principled reason why the state claims of fraud should escape the pleading requirements of the federal rules, and the parties have not urged a separate focus upon state law claims of negligent misrepresentation.”

105. 540 F.3d 333 (5th Cir. 2008).

106. *Id.* at 337.

107. *Id.*

108. *Id.* at 337-38.

109. *Id.* at 338-39.

110. *Id.* at 333.

111. *Id.* at 341 n.10.

a corporation,” as required for fraud in violation of the TSFA.¹¹² The aiding and abetting claim under the TSA failed since the investors had not pled scienter of the aider and abetter.¹¹³ But the other claim under the TSA, along with the common law securities fraud claim, survived.¹¹⁴ TSA has no scienter requirement for fraud by the seller.¹¹⁵ With respect to the common law claim, the Fifth Circuit found that the investor sufficiently pled scienter, although only alleging that the perpetrator was an officer of the company. Normally, such pleading does not give an inference of scienter, but the Fifth Circuit recognizes an exception for a one-product company with few employees.¹¹⁶ The issuer had only one product, its loans to one company, and had no employees.¹¹⁷

Federal district courts also applied the federal pleading rules to claims brought in federal court under Texas law. In *In re Enron Corp. Securities, Derivative & ERISA Litigation*,¹¹⁸ the district court found that the investors had not sufficiently pled the violation against the primary perpetrator under the TSA because the pleadings lacked specific identifications of material misrepresentations and omissions, as well as the where, when, who, and why under the federal rules.¹¹⁹

In another TSA case, a federal district court similarly applied the federal fraud pleading rules to the real estate portion of the TSFA. In *Bilouiris v. Sundance Resources, Inc.*,¹²⁰ the federal district court considered a motion to dismiss the complaints against a company that had set up “Rig Bank Funds” to fund the purchase of oil and gas drilling rigs.¹²¹ Investors purchased units in the “Rig Bank Funds” that, in turn, lent the money to the company to purchase rigs in return for interests in oil and gas leases.¹²² The company’s insiders “systematically” transferred the company’s assets to themselves, thereby shifting the funds acquired from the investors to the company’s insiders and driving the company into insolvency.¹²³ The investors asserted fraud in selling these real estate interests under the real estate portion of the TSFA.¹²⁴ The investors alleged

112. See TEX. BUS. & COM. CODE ANN. § 27.01 (Vernon 2008) (regarding “[f]raud in a transaction involving . . . stock in a corporation or joint stock company”).

113. See TEX. REV. CIV. STAT. ANN. art. 581-33F(2) (Vernon Supp. 2008) (requiring an “intent to deceive or defraud or with reckless disregard for the truth or the law”).

114. *Dorsey*, 540 F.3d at 344.

115. See *Wood v. Combustion Eng’g Inc.*, 643 F.2d 339, 345 (5th Cir. 1981) (using the Texas two-year statute of limitations for general fraud with scienter rather than the TSA statute of limitations to a federal rule 10b-5 claim since the rule 10b-5 claim requires scienter while TSA does not); see also *Herrmann Holdings Ltd. v. Lucent Techs. Inc.*, 302 F.3d 552, 563-64 (5th Cir. 2002) (finding an exception to the TSA’s no scienter requirement for an untrue promise of future performance).

116. See *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 424-25 (5th Cir. 2001) (finding one product with thirty-three employees).

117. *Dorsey*, 540 F.3d at 337.

118. 540 F. Supp. 2d 759 (S.D. Tex. 2007).

119. *Id.* at 797.

120. 559 F. Supp. 2d 733 (N.D. Tex. 2008).

121. *Id.* at 735.

122. *Id.*

123. *Id.*

124. *Id.*

fraud for inducing them to purchase the units,¹²⁵ as well as a violation of the TSA for the sale of unregistered securities.¹²⁶ With respect to the securities fraud under the statutory fraud act, the investors relied on group allegations of fraud but failed to denote which perpetrator made which representation.¹²⁷ The district court dismissed this count without prejudice to refile.¹²⁸ With respect to the sale of unregistered securities under the TSA, the company and its insiders urged dismissal since the “Rig Bank Funds” were exempt from registration because they were sold to less than thirty-five investors.¹²⁹ The district court overruled the motion to dismiss this count; since the company and its insiders neglected to plead the matter, it could not be considered on a motion to dismiss.¹³⁰ One can but wonder, at the ultimate success of the perpetrator’s argument for exemption in light of the Board’s cease and desist order for not registering these units or the agents selling them.¹³¹

4. Aider and Abetter Liability in the Secondary Market

When the perpetrator of fraud lacks funds to satisfy a judgment, injured investors seek lucrative sources of recovery from third parties who enabled the alleged perpetrator to sell the securities. For investors engaged in the secondary market, holding these aiders and abettors liable for their investment loss under both the TSA and TSFA involves some difficulties. The federal system generally has two securities statutes: one for the primary market—the Securities Act¹³²—and one for the secondary market—the Exchange Act.¹³³ In contrast, the Texas system basically has one statute, the TSA.¹³⁴ The liability provisions of the TSA, especially for sellers, are modeled on the federal Securities Act for the primary market.¹³⁵ The TSA generally treats transactions on the secondary market as exempt securities,¹³⁶ leaving regulation of the secondary

125. See *Bilouiris v. Sundance Res., Inc.*, No. 307CV01591, 2008 WL 4067653, at *29 (N.D. Tex. June 30, 2008) (trial Pleading; count 4).

126. One of the TSA violations involved violation of a cease and desist order of the Board. See *Bilouiris*, 2008 WL 4067653, at *31 (trial Pleading; count 11). The Board issued its order to stop the sale of working interests in oil and gas drilling projects without registering the securities and the selling agents. See *In re Sundance Res., Inc.*, No. ENG-06-CDO-1623, 2006 WL 3891516, at *1 (Tex. St. Sec. Bd. Dec. 22, 2006), mentioned in George Lee Flint, Jr., *Securities Regulation*, 61 SMU L. REV. 1107, 1114 n.37.

127. *Bilouiris*, 559 F. Supp. 2d at 736-37.

128. *Id.* at 737.

129. *Id.* at 740.

130. *Id.*

131. See *Sundance Res., Inc.*, No. ENG-06-CDO-1623, 2006 WL 3891516, at *1 (Tex. St. Sec. Bd. Dec. 22, 2006).

132. See 15 U.S.C. § 77 (2006).

133. See 15 U.S.C. § 78 (2006).

134. TEX. REV. CIV. STAT. ANN. art. 581-33 (Vernon Supp. 2008).

135. See TEX. REV. CIV. STAT. ANN. art. 581-33 cmt. to 1977 Amendment (for seller liability for registration violations, “§ 33A(1) . . . is similar to U.S. Securities Acts § 12(1)”; for seller liability for misstatements and omissions, “[c]hanges have been made . . . [to] § 33A(2) . . . [to] bring this provision closer to . . . U.S. Securities Acts § 12(2)”).

136. See TEX. REV. CIV. STAT. ANN. art. 581-6(F) (Vernon Supp. 2008) (exemption for securities traded on a recognized exchange).

market to the federal system. The result is to impose requirements on aiding and abetting liability more appropriate to the primary market than to the secondary market.

A federal district court in *In re Enron Corp. Securities, Derivative & ERISA Litigation*,¹³⁷ ruled on a motion to dismiss investor lawsuits brought under the TSA and the TSFA against an investment banker for aiding and abetting Enron in defrauding the investors by helping to devise and implement complex sham transactions that helped Enron hide debt and overstate income.¹³⁸ The investors, primarily insurance companies and investment companies, had purchased Enron common stock, bonds, and commercial paper from another investment banker in the secondary market, and retained these securities through Enron's collapse.¹³⁹

The elements for aider and abetter liability under the TSA are: (1) a violation by the primary perpetrator of one of the proscriptions against selling without registering, seller misrepresentations and omissions, buyer misrepresentations and omissions, or misrepresentations and omissions in a non-selling issuer prospectus for selling shareholders; (2) a "general awareness of the aider and abetter's" role in the violation;¹⁴⁰ (3) "substantial assistance" by the aider and abetter in the violation; and (4) the aider and abetter's intent to deceive the victim or reckless disregard of the truth.¹⁴¹ The investors alleged that the primary perpetrator had violated the seller misrepresentation provision and the non-selling issuer prospectus requirement.¹⁴² However, the seller misrepresentation provision requires privity between the perpetrator and the investors.¹⁴³ Since the investors had not purchased their Enron securities from Enron but instead from an investment banker on the secondary market, they lacked privity with Enron.¹⁴⁴ Therefore, to succeed the investors needed to plead that their immediate seller was an agent of Enron under the principles of Texas law.¹⁴⁵ With respect to the non-selling issuer provision, the district court concluded that a transaction exemption applied, foreclosing liability against the primary perpetrator under the provision since the in-

137. 540 F. Supp. 2d 759 (S.D. Tex. 2007).

138. *Id.* at 763-74.

139. *Id.* at 763.

140. See TEX. REV. CIV. STAT. ANN. art. 581-33(F)(2) (Vernon Supp. 2008); *Sterling Trust Co. v. Adderley*, 168 S.W.3d 835, 840-43 (Tex. 2005) (affirming the general awareness element derived from federal securities law); see also *Goldstein v. Mortenson*, 113 S.W.3d 769, 776 (Tex. App.—Austin 2003, no pet.).

141. *In re Enron Corp.*, 540 F. Supp. 2d at 769-70.

142. *Id.* at 767.

143. See TEX. REV. CIV. STAT. ANN. art. 581-33 cmt. to 1977 Amendment ("§ 33A(1) [like §§ 33A(2) and 33B] is a privity provision, allowing a buyer to recover from his offeror or seller [or a seller to recover from his offeror or buyer]. However, some nonprivity defendants may be reached under §§ 33C and 33F" for nonselling issuers registering for insiders selling and for aiding and abetting); *In re Enron Corp. Sec., Derivative & ERISA Litigation*, 258 F. Supp. 2d 576, 601-08 (S.D. Tex. 2003).

144. *In re Enron*, 540 F. Supp. 2d at 767.

145. *Id.*

vestors were all insurance companies and investment companies.¹⁴⁶ The TSA's fraud provisions do not apply to sales to insurance companies and investment companies, since, as sophisticated investors, they do not need the protection of TSA.¹⁴⁷ This transaction exemption, however, does not apply to the seller misrepresentation and omission proscription since that proscription specifically states that liability accrues regardless of any transaction exemption.¹⁴⁸ Consequently, the district court permitted the investors to replead to correct for these shortcomings.¹⁴⁹

The TSFA aider and abetter provision imposes liability on those who have awareness of the falsity made by the perpetrator, fail to disclose it to the victim, and benefit from the false representation.¹⁵⁰ In *In re Enron Corporation Securities, Derivative & ERISA Litigation*, the issue between the investors and the aider and abetter was whether the TSFA imposed a duty to disclose an omission on the aider and abetter when such language was absent from the aider and abetter provision. Based on cases dealing with the real estate element of statutory fraud, the district court determined that the TSFA does impose the affirmative duty to disclose an omission on the aider and abetter in certain situations.¹⁵¹ Consequently, the district court permitted the investors to replead to correct for this shortcoming.

B. COURT DECISIONS UNDER THE FEDERAL ACTS

Under the federal statutes, the Fifth Circuit considered a case of first impression and determined that an issuer could not recover damages for

146. *Id.* at 798; *see also id.* at 763, 786 (identifying the plaintiffs as insurance companies and investment companies).

147. *See* TEX. REV. CIV. STAT. ANN. art. 581-5H (Vernon Supp. 2008) (transaction exemption for, among others, insurance companies and investment companies).

148. *See* TEX. REV. CIV. STAT. ANN. art. 581-33A(2) (Vernon Supp. 2008) (“[u]ntruth or Omission. A person who offers or sells a security (whether or not the security or transaction is exempt under Section 5 or 6 of this Act)”).

149. *In re Enron*, 540 F. Supp. 2d at 696-97.

150. *See* TEX. BUS. & COM. CODE ANN. § 27.01(d) (Vernon 2008).

151. *In re Enron*, 540 F. Supp. 2d. at 793 n.42, 799. The statutory fraud cases for real estate held that the statutory fraud provision is the same as for common law fraud, except that the statute eases the scienter requirement from “knowingly or recklessly” to “inducing” the victim to enter the contract of sale. *See, e.g., Larsen v. Carlene Langford & Assoc., Inc.*, 41 S.W.3d 245, 249 (Tex. App.—Waco 2001, pet. denied); *Diversified, Inc. v. Walker*, 702 S.W.2d 717, 723 (Tex. App.—Houston [1st Dist.] 1985, writ ref’d n.r.e.). The common law imposes a duty to disclose an omission in four situations: (1) where there is a fiduciary relationship between the aider and abetter and the victim, (2) where the aider and abetter voluntarily discloses some information but not all, (3) when new information renders the aider’s and abetter’s prior representation misleading or untrue, and (4) where the aider and abetter partially discloses to convey a false impression. *See Hoggett v. Brown*, 971 S.W.2d 472 (Tex. App.—Houston [14th Dist.] 1997, pet. denied). Therefore, some Texas courts have imposed the same duty to disclose an omission under the TSFA and the real estate portion of the statutory fraud provision. *See* 1994 Land Fund II-Dallas 1, L.P. v. Ramur, Inc., No. 05-98-00074-CV, 2001 WL 92696, at *6 (Tex. App.—Dallas Feb. 5, 2001, no pet.) (for TSFA); *Swanson v. Schlumberger Tech. Corp.*, 895 S.W.2d 719, 732 (Tex. App.—Texarkana 1994), *rev’d on other grounds*, 959 S.W.2d 171 (Tex. 1997) (fraud by nondisclosure for offshore mineral interests).

violations of the Williams Act made by the acquirer.¹⁵² The Fifth Circuit also imposed a requirement of scienter before a Sarbanes-Oxley whistleblower could recover against the issuer for terminating the whistleblower's employment.¹⁵³ The Supreme Court, in order to determine the difference between a perpetrator and an aider and abetter, rejected the concept of scheme liability used by some federal courts but previously rejected by the Fifth Circuit.¹⁵⁴

1. *Damages Denied Issuer for Reporting Disclosure Violations Under Williams Act*

The Fifth Circuit had the opportunity to join its sister circuits and affirm a matter under the Williams Act¹⁵⁵ for tender offers. The Williams Act requires disclosure of the shareholder's intentions when the shareholder's ownership exceeds five percent of the issuer's outstanding shares.¹⁵⁶ Courts have fashioned an implied action under the Williams Act. The few circuit courts to have considered a case in which an issuer is seeking damages, rather than an injunction, in a private action against a shareholder for misrepresentation or omission under the Williams Act, have uniformly denied damages.¹⁵⁷ In *Motient Corp. v. Dondero*, a target issuer complained of statements made in the acquirer's Schedule 13D filings, disparaging the management of the target issuer.¹⁵⁸ The issuer claimed that the acquirer erroneously stated that the issuer's board had not met to discuss and evaluate an exchange offer the acquirer wanted derailed; failed to state the issuer's board had worked with independent financial advisors to structure a consolidation opposed by the acquirer; and accused the issuer's audit committee of failing to properly investigate allegations brought by the acquirer of self-dealing, conflicts of interest, fiduciary lapses, and excessive payments to the issuer's board.¹⁵⁹ The target issuer sought damages and an injunction to prevent the acquirer from purchasing or selling shares of the target issuer, or soliciting votes of

152. *Motient Corp. v. Dondero*, 529 F.3d 532, 536 (5th Cir. 2008).

153. *Allen v. Admin. Review Bd.*, 514 F.3d 468, 479-80 (5th Cir. 2008).

154. *Stonebridge Inv. Partners v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 764-65 (2008).

155. Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended in scattered sections of 15 U.S.C.).

156. See 15 U.S.C. § 78m(d) (2006).

157. In the Second Circuit, see *Hallwood Realty Partners, L.P. v. Gotham Partners, L.P.*, 286 F.3d 613, 620 (2d Cir. 2002). The Eleventh Circuit, in dicta, has determined that no private cause of action for damages exists for the issuer under Exchange Act § 13(d). Compare *Florida Commercial Banks v. Culverhouse*, 772 F.2d 1513, 1519 (11th Cir. 1985) (issuer does have private cause of action for injunctive relief for corrective disclosure) with *Liberty Nat. Ins. Holding Co. v. Charter*, 734 F.2d 545, 564-65 (11th Cir. 1984) (no private cause of action for issuer, but issuer sought only injunctive relief for divestiture, not damages). The Seventh Circuit upheld a district court's dismissal for an issuer that obtained injunctive relief but sought additional damages under state law where the district court regarded the state actions as an attempt to circumvent the Williams Act's restriction on issuer recovery of damages. *Champion Parts, Inc. v. Oppenheimer & Co.*, 878 F.2d 1003, 1005 (7th Cir. 1989).

158. 529 F.3d 532 (5th Cir. 2008).

159. *Id.* at 534.

other shareholders of the issuer.¹⁶⁰ The federal district court dismissed with prejudice for failure to state a claim.¹⁶¹ The Fifth Circuit affirmed the district court's decision on damages and remanded for dismissal without prejudice on the injunction.¹⁶² The Fifth Circuit noted the damage remedy was an issue of first impression in the circuit. Congress passed the Williams Act to protect investors in the target issuer from making decisions on a tender offer without adequate information about the acquirer's qualifications and intentions, and so that the investor will not favor the target issuer's management or the acquirer in their contest for control.¹⁶³ Sister circuits, in considering the matter, have also decided against allowing the damage remedy.¹⁶⁴ The Exchange Act itself provides a remedy for damages suffered due to misstatements in Exchange Act filings, subject to a defense that the perpetrator did not know the statement was false or misleading.¹⁶⁵ With respect to the request for an injunction, the Fifth Circuit noted that the acquirer's subsequent sale of its stock in the target issuer mooted the question.¹⁶⁶ The Fifth Circuit refused to issue an opinion on the validity of the injunctive relief other than to note that, as mooted, the irreparable harm required for injunctive relief was absent.¹⁶⁷

2. *Sarbanes-Oxley Whistleblower Suit Denied in Absence of Scienter*

The Sarbanes-Oxley Act of 2002 provides that public companies may not discharge or discriminate against employees reporting information the employee reasonably believes constitutes a violation of certain laws, including a criminal securities fraud statute and any rule or regulation of the SEC.¹⁶⁸ In *Allen v. Administrative Review Board*, the issuer, a funeral home and cemetery company, terminated, among others, three employees in an issuer-wide reduction-in-force.¹⁶⁹ The three employees challenged their termination under the Sarbanes-Oxley Act by filing with the

160. *Id.* at 532.

161. *Id.* at 535.

162. *Id.* at 536.

163. *See, e.g., id.*

164. *See* cases cited *supra* note 99.

165. *See* 15 U.S.C. § 78r(a) (2006).

166. *Motient*, 524 F.3d at 535-36.

167. *See Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 56 (1975) (equity's irreparable harm requirement also applies to injunctive relief under Exchange Act § 13(d)).

168. *See* Pub. L. No. 107-204 § 806, 116 Stat. 745 (codified in scattered sections of 18 U.S.C.); 18 U.S.C. § 1514A (2008) (“[N]o [publicly-traded company] . . . may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee (1) to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of . . . [18 U.S.C.] section 1348 [securities fraud], any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by . . . (C) a person with supervisory authority over the employee. . . .”); *see also* 18 U.S.C. § 1348 (2008) (criminal securities fraud).

169. 514 F.3d 468, 474 (5th Cir. 2008).

Department of Labor, contending the issuer terminated them because they had reported protected information.¹⁷⁰ They had reported to their superiors errors in refund interest calculations for customers that prepaid on their installment contracts, thereby overcharging those customers that did not complain; delays in payment of the refunds to customers that might lead to state law sanctions; and sending bills to customers showing zero balances when the insurance companies had yet to make payment, thereby hindering collections from customers shocked by subsequent bills if the insurance companies did not pay. One employee, a certified public accountant, had reported to a superior that internal accounting reports overstated income by not following a SEC staff accounting bulletin prohibiting public companies from recognizing sales revenues before delivering the merchandise, a past practice of the issuer. The administrative law judge dismissed the action, which was affirmed by the Administrative Review Board of the Department of Labor, because the employees had not engaged in protected activities.¹⁷¹ The Fifth Circuit affirmed.¹⁷² The Fifth Circuit used both a subjective and an objective standard to govern the employees' "reasonable belief" concerning the issuer's alleged violations.¹⁷³ With respect to the interest calculation, delayed refunds, and billing problems, the employees asserted protection based on violating federal law against fraud on the shareholders. Citing opinions relating to securities fraud under Rule 10b-5,¹⁷⁴ the Fifth Circuit imposed a scienter requirement on the issuer for violation of "federal law relating to fraud against shareholders."¹⁷⁵ The court then found substantial evidence supporting the administrative law judge's and Administrative Review Board's findings that the employees did not "reasonably believe" the issuer intended to defraud its shareholders.¹⁷⁶ For the interest calculation, the employees knew the issuer was working on a computer program to correct the problem, performed manual calculations for all accounts, included solving the matter as a goal, and sponsored a conference to address the problem with field personnel. For the delayed refunds, the employees knew the issuer had a significant backlog of refunds and was attempting to remedy the problem. For the billing problems, the employees knew the customers were contractually obligated and that the issuer used collection agencies to collect unpaid bills. With respect to the staff accounting bulletin, the employee asserted a violation of an SEC regulation. The Fifth Circuit found substantial evidence supporting the administrative law judge's and Administrative Review Board's findings that the employee did not "reasonably believe" the issuer violated an SEC rule.¹⁷⁷

170. *Id.* at 471.

171. *Id.*

172. *Id.*

173. *Id.* at 477.

174. *See* 17 C.F.R. § 240.10b-5 (2008).

175. *Allen*, 514 F.3d at 479-80.

176. *Id.*

177. *Id.* at 478-80.

The staff accounting bulletin did not have the force of law and did not apply to internal financial statements not reported to the SEC.¹⁷⁸ The Fifth Circuit noted that the staff accounting bulletin in question stated it was not a rule of the SEC but was merely an “interpretation[] and practice[] followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of the Federal securities laws.”¹⁷⁹ Consequently, the staff accounting bulletin only applied to financial statements filed with the SEC. Not only had the employee testified that she knew that the staff accounting bulletin did not apply to internal financial statements, but she had made no effort to examine the issuer’s SEC filings to determine whether those statements complied with the staff accounting bulletin.¹⁸⁰

3. *Scheme Liability Unavailable for Aider and Abettor Liability*

Under federal law, courts do not permit private actions for securities fraud under Rule 10b-5 against aiders and abettors.¹⁸¹ Consequently, many investors under federal law attempt to avoid the prescription by alleging a primary violation of the federal securities laws by the aiders and abettors. Since many aiders and abettors neither make public misstatements nor violate a duty to disclose,¹⁸² the problem becomes one of determining the difference between a primary perpetrator and an aider and abettor for employing an artifice to defraud or engaging in fraudulent conduct.¹⁸³ For this determination, the lower federal courts have taken two approaches. The first approach follows the past language of the Supreme Court¹⁸⁴ and divides the Exchange Act’s proscription against “manipulative or deceptive device[s] or contrivance[s]”¹⁸⁵ into two separate offenses. Manipulative devices are limited to those in the securities market that prevent the marketplace from accurately reflecting the securities’ value.¹⁸⁶ Deceptive devices or contrivances are those involving misstate-

178. *Id.* at 478.

179. *Id.* at 478 n.5; Staff Accounting Bulletin 101, 1999 WL 1100908, at *1 (Dec. 3, 1999).

180. *Id.* at 479.

181. *See Cent. Bank of Denver*, 511 U.S. at 179-80.

182. Aidere and abettors thereby do not violate the misstatement or omission portion of rule 10b-5(b) (“[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading”). 17 C.F.R. § 240.10b-5.

183. For the remaining portions of rule 10b-5, see 17 C.F.R. § 240.10b-5 (“[t]o employ any device, scheme, or artifice to defraud”) & 10b-5(c) (“[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person”).

184. *See Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 177 (1994) (stating “[a]s in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act.”); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473 (1977) (holding that the “language of [§] 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception.”).

185. *See* 15 U.S.C. § 10(b) (2006).

186. *See, e.g., Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1360 (N.D. Tex. 1974) (issuers filing false SEC reports or issuing misleading press releases or insiders trading on inside information alone is not manipulative); *see also Santa Fe*, 430 U.S. at 476

ments and omissions.¹⁸⁷ Consequently, one with a duty to disclose, who makes no misrepresentation or omission and who does not engage in manipulative securities price activities, cannot be liable under Rule 10b-5, and, at worst, can only be an aider and abetter.¹⁸⁸ The second approach follows the language of the SEC generally submitted in amicus briefs. The SEC's scheme liability provides primary liability for "[a]ny person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud."¹⁸⁹ Aiders and abettors are those that assist other participants in the scheme, but do not themselves participate in a deceptive or manipulative act.¹⁹⁰

The significance of this distinction for Texas lawyers is that the Fifth Circuit followed the first approach,¹⁹¹ while the Southern District of Texas followed the second approach.¹⁹² Moreover, Texas law allows private actions against aiders and abettors under both the TSA and the TSFA.¹⁹³ Since the fraud provisions of the TSA are modeled on the federal statutes,¹⁹⁴ Texas courts interpreting TSA frequently look to the federal decisions.¹⁹⁵

The Supreme Court recently decided to end the split among the various circuits over which approach to use for aiding and abetting under Rule 10b-5. In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta*,

(stating that "[t]he term [manipulation] refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.").

187. See, e.g., *Hundahl*, 465 F. Supp. at 1360 (1979) (issuers filing false SEC reports or issuing misleading press releases, or insiders trading on inside information alone is not manipulative); see also *Santa Fe*, 430 U.S. at 474-75 (must be manipulative or deceptive and situation without misrepresentation or omission is not deceptive).

188. See *In re Charter Commc'ns, Inc., Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006), *aff'd sub nom.*, *Stoneridge Inv. Partners v. Scientific-Atlanta*, 128 S. Ct. 761 (2008); accord *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) (auditor not liable under rule 10b-5 for privately approving press release that contained unaudited financials, and no mention of the audit firm, since it made no misrepresentation or omission [and act is not manipulation]), *cert. denied*, 525 U.S. 1104 (1999); see also *Fidel v. Farley*, 392 F.3d 220, 235 (6th Cir. 2004) (scienter case: stating in dicta that the auditors not liable under Rule 10b-5, for not insisting on revisions to unaudited financials since it made no misrepresentation or omission [and act is not manipulation]); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1225-27 (10th Cir. 1996) (reversed auditor's conviction on jury instruction that contained aiding and abetting liability; in dicta stating that for accountant liability under Rule 10b-5, "they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors").

189. See, e.g., *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 439 F. Supp. 2d 692, 715 n.27 (S.D. Tex. 2007).

190. See *id.* at 722-23.

191. See *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 386-87 (5th Cir. 2007), *cert. denied*, 128 S. Ct. 1120 (2008). For a discussion of the case, see George Lee Flint, Jr., *Securities Regulation*, 61 SMU LAW REV. 1107, 1126-28 (2008).

192. See *In re Enron*, 439 F. Supp. 2d at 715.

193. See TEX. REV. CIV. STAT. ANN. art. 581-33F(2) (Vernon Supp. 2008); TEX. BUS. & COM. CODE ANN. § 27.01(d) (Vernon 2008).

194. See TEX. REV. CIV. STAT. ANN. art. 581-33 cmt. to 1977 Amendment (Vernon Supp. 2008).

195. See, e.g., *Herman Holdings Ltd. v. Lucent Techs., Inc.*, 302 F.3d 552, 563-64 (5th Cir. 2002) (for TSA fraud provision, TEX. REV. CIV. STAT. ANN. art. 581-33).

Inc.,¹⁹⁶ investors brought suit under Rule 10b-5 against suppliers of the issuer for entering into contracts that allowed overcharging for the suppliers' equipment, plus the suppliers' equal overpayments for the purchase of advertising from the issuer.¹⁹⁷ These two transactions, treated as a wash as required by Generally Accepted Accounting Principles (GAAP), enabled the issuer to treat the advertising payment as income and capitalize the overpayment on the equipment purchase, contrary to GAAP. The federal district court dismissed the action.¹⁹⁸ The Eighth Circuit affirmed on the ground that the petition, alleging scheme liability, failed to allege a securities fraud claim against the suppliers as primary perpetrators since they made no misstatement to the public, had no duty to disclose omissions, and engaged in no manipulation.¹⁹⁹ The Supreme Court affirmed, but not on the distinction used in the circuit courts. Instead, the majority concluded that the deceptive acts committed by the suppliers, but not disclosed to the investing public, were "too remote to satisfy the requirement for reliance/[causation]" for a private action under Rule 10b-5.²⁰⁰ The majority then supplied a number of policy reasons to shield these aiding and abetting acts from liability.²⁰¹ Congress, reacting to the Supreme Court's action eliminating aiding and abetting from Rule 10b-5 actions, only reinstated it for the SEC.²⁰² The majority feared that expansion of Rule 10b-5 liability to this sort of aiding and abetting would increase the number of "weak claims to extort settlements from innocent [issuers]" and would deter overseas firms from doing business in the United States.²⁰³ Since the Rule 10b-5 action is a judicial construct, it is up to Congress to expand it beyond what the Supreme Court had previously announced as the limits of the Exchange Act.²⁰⁴ There are SEC actions and state actions against these acts of aiding and abetting.

These policy grounds did not convince the dissenters.²⁰⁵ The dissenting opinion would apply the foreseeability test of common law torts, imposing liability on a person making a misrepresentation to a third person if he has reason to expect the third person will communicate the misrepresentation to the victim.²⁰⁶ The investors had alleged the suppliers knew that the perpetrator would use the deceptive acts to influence the market

196. 128 S. Ct. 761 (2008) (J. Kennedy).

197. *Id.* at 766-67.

198. *Id.* at 767.

199. *Id.*

200. *Id.* at 770.

201. *Id.* at 770-74.

202. *Id.* at 771; see *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994); Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.; 15 U.S.C. § 78t(e) (2006).

203. *Stoneridge*, 128 S. Ct. at 772.

204. *Id.* at 772-73; see *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 474-76 (1977) (act must be manipulative or deceptive: affecting market activity, a misrepresentation, or an omission).

205. *Stoneridge*, 128 S. Ct. at 777 (Stevens, J., dissenting) (J. Breyer to no part in the decision of the case).

206. *Id.*; see RESTATEMENT (SECOND) OF TORTS § 533 (1977).

price of the issuer's stock. Herein lies the difference between the majority and the dissent. The majority saw that the suppliers accounted for the transactions correctly and thus, should be able to expect the perpetrators to do the same.²⁰⁷ The dissent saw all issuers as immoral, and so the suppliers should have known they would not account for the transaction correctly.²⁰⁸ Under the majority opinion, future market players need not worry about their inability to predict future acts of perpetrators of securities fraud.

VI. CONCLUSION

The Texas federal courts have continued to narrow the application of Texas securities laws. The Fifth Circuit applied the federal class action preemption test of SLUSA after consolidation in federal court, but permitted unconsolidated state actions to continue unpreempted. The Fifth Circuit also determined that the stringent federal pleading rules apply to state law actions in federal court. The Southern District of Texas narrowed aider and abetter liability in the secondary market by imposing a privity requirement for the primary perpetrator under the TSA and requiring a duty to disclose by the aider and abetter under the TSFA.

Texas courts expanded the number of appellate jurisdictions accepting the rule that jury members need not agree on the same misrepresentation or omission to impose criminal liability for securities fraud and that a defaulting issuer cannot void a contract in violation of the securities laws.

The Texas federal courts also narrowed the application of the federal securities laws in Texas. The Fifth Circuit rejected a private cause of action for issuer damages for reporting violations during a tender offer and imposed a scienter requirement for terminated employees seeking damages under Sarbanes-Oxley whistleblower lawsuits. The Supreme Court narrowed the ability to impose primary liability on aiders and abettors by rejecting scheme liability.

207. *Stoneridge*, 128 S. Ct. at 774.

208. *Id.* (Stevens, J., dissenting).