Volume 2

2016

Securities Regulation

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

Securities Regulation

*George Lee Flint, Jr.**

TABLE OF CONTENTS

Securities regulation deals primarily with the laws preventing and providing remedies for fraud in the sale of stocks and bonds. Texas has two major statutes to combat securities fraud: The Texas Securities Act (TSA) and the Texas Stock Fraud Act (TSFA).[1] Since the legislature modeled the fraud provisions of the TSA on the federal statutes,[2] Texas courts use federal decisions under the federal statutes to interpret the

* 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. *See* Tex. Rev. Civ. Stat. Ann. art. 581-1 to 581-600 (West 2010); Tex. Bus. & Com. Code Ann. § 27.01 (West 2015).

2. *See* Tex. Rev. Civ. Stat. Ann. art. 581-33 cmt. (Comment to 1977 Amendment); House Comm. of Financial Institutions, Tex. S.B. 469, 65th Leg., R.S. (1977).

TSA's similar language.[3] This Article, therefore, includes the U.S. Court of Appeals for the Fifth Circuit cases involving state law and securities fraud under federal law. The author does not intend for this Article to exhaust all aspects of securities regulation, but rather to update the Texas-based securities practitioner on new developments of interest during the period of November 1, 2013 to October 31, 2015.

I. COVERAGE OF THE TEXAS SECURITIES ACTS

The definitions, especially those relating to what constitutes a security or a stock and the persons liable, as well as federal preclusion of state securities fraud actions, determine the fraudulent transactions subject to the state's securities acts.[4] Texas courts, both state courts under the TSA and federal courts under a similar provision in the Securities Act (SA),[5] have determined that interests in life settlements constitute "investment contracts" and therefore are securities under both the TSA and the SA; consequently, the state and investors can sue for securities fraud against fraudsters peddling interests in life settlements.[6] A Texas court also determined that an employee's separation contract that provided for immediate vesting of all previously awarded restricted stock awards satisfied the TSFA requirement for a transaction involving stock in a corporation so that an employer could sue for statutory fraud against a defrauding employee.[7] Additionally, the U.S. Supreme Court determined that certificates of deposit backed by "covered securities" were not covered securities for purposes of excluding remedies under the TSA by the Securities Litigation Uniform Standards Act (SLUSA)[8] so that victims of a Ponzi scheme could sue the aiders and abettors of the fraud.[9]

3. *See, e.g.*, Highland Capital Mgmt., L.P. v. Ryder Scott Co., 402 S.W.3d 719, 741 (Tex. App.—Houston [1st Dist.] 2012, no pet.); Anglo-Dutch Petroleum Int'l, Inc. v. Haskell, 193 S.W.3d 87, 102 n.13 (Tex. App.—Houston [1st Dist.] 2006, pet. denied); *see also* George Lee Flint, Jr., *Securities Regulation*, 66 SMU L. Rev. 1129, 1129–30 n.3 (2013) [hereinafter Flint 66] (discussing *Highland Capital Management, L.P.*); George Lee Flint, Jr., *Securities Regulation*, 60 SMU L. Rev. 1293, 1293–1302 (2007) [hereinafter Flint 60] (discussing *Haskell*, 193 S.W.3d 87).

4. *See* 15 U.S.C. § 77b(a)(1)–(3) (2012); Tex. Civ. Stat Ann. art. 581-4(A)–(B).

5. *See* 15 U.S.C. § 77b(2)(a)(1)–(2).

6. *See* Life Partners, Inc. v. Arnold, 464 S.W.3d 660, 662 (Tex. 2015) [hereinafter *Arnold II*]; Arnold v. Life Partners, Inc., 416 S.W.3d 577, 592 (Tex. App.—Dallas 2013) [hereinafter *Arnold I*], *aff'd*, 464 S.W.3d 660 (Tex. 2015); State v. Life Partners Holdings, Inc., 459 S.W.3d 619, 621 (Tex. App.—Austin 2014) [hereinafter *Life Partners Holdings*], *aff'd sub nom.*, 464 S.W.3d 660 (Tex. 2015); S.E.C. v. Life Partners Holdings, Inc., 41 F. Supp. 3d 550, 556 (W.D. Tex. 2013) [hereinafter *Life Partners Holdins 2013*].

7. Ginn v. NCI Bldg. Sys., Inc., 472 S.W.3d 802, 824 (Tex. App.—Houston [1st Dist.] Aug. 13, 2015, no pet. h.).

8. 15 U.S.C. § 78bb(f)(1)(A).

9. Chadbourne & Park LLP v. Troice, 134 S. Ct. 1058, 1062 (2014).

A. Confirmation that Interests in Life Settlements are Securities

The Texas Supreme Court, consolidating two appeals from lower courts of appeals, one for investors from Dallas and one for the Texas State Securities Board (TSSB) from Austin, affirmed the courts of appeals' decisions holding that interests in life settlements constitute investment contracts and therefore are securities under the TSA.[10] Similarly, a federal district court in Texas made the same determination for the Securities and Exchange Commission (SEC) under the analogous provision of federal law.[11]

1. *State Law*

The key issue for the Texas Supreme Court in *Life Partners, Inc. v. Arnold* involved interests in life settlements.[12] A life settlement is a transaction under which an owner of a life insurance policy sells the policy at a discount (reflecting a future rate of return and premium costs over the owner's expected life) in order to obtain current moneys to spend.[13] Life Partners is a financial intermediary that locates the policy sellers, negotiates the discount, locates investors to provide the purchase price of fractional interests in the life insurance policies, takes title to the policies as agents of the investors, and maintains a trust fund to pay the premiums. If the insured outlives the life expectancy used to discount the sales price of the policy, Life Partners requires the investors to contribute additional amounts to pay premiums needed to continue the policies. Life Partners, led by the serial fraudster Brian D. Pardo,[14] is notorious for underestimating the life expectancies used in calculating the discounts.[15] Life Part-

10. *See Arnold II*, 464 S.W.3d at 662–63.

11. *See Life Partners Holdings 2013*, 41 F. Supp. 3d at 556.

12. *See Arnold II*, 464 S.W.3d at 662. The other issue in the case involved whether to give the decision only a prospective application, since a retroactive application would violate both the Texas Constitution and the federal Constitution prohibitions against retroactive laws. The supreme court declined to give the decision only a prospective application. *Id.* In *Chevron Oil Co. v. Huson*, the U.S. Supreme Court requires that the decision establish a new principle of law for non-retroactivity. Chevron Oil Co. v. Huson, 404 U.S. 97, 106–07 (1971). Federal courts had established this principle of law for life settlements at least ten years before in *SEC v. Mut. Benefits Corp.* SEC v. Mut. Benefits Corp. (Mut. Benefits), 408 F.3d 737, 743 (11th Cir. 2005).

13. Financial Industry Regulatory Authority, *Seniors Beware: What You Should Know About Life Settlements*, 2011, at 1, 1, http://www.finra.org/sites/default/files/InvestorDocument/p125848.pdf [https://perma.cc/7VMP-4ZBQ].

14. The principal behind Life Partners, Inc.—a subsidiary of Life Partners Holdings, Inc. and a public company located in Waco, Texas—was Brian D. Pardo. *See* George Lee Flint, Jr., *Securities Regulation*, 1 SMU Ann. Tex. Surv. 101, 102 n.10 (2014) [hereinafter Flint 1] (discussing some of Brian D. Pardo's other frauds, the author's former firm's representation of Brian D. Pardo's prior public corporation for securities matters, and the SEC's earlier attempts to stop his securities frauds).

15. *See, e.g.*, Mark Maremont & Leslie Scism, *Odds Skew Against Investors In Bets on Strangers' Lives*, Wall St. J. (Dec. 21, 2010), http://www.wsj.com/articles/SB10001424052748704694004576019344291967866 [https://perma.cc/PH5B-92QP] (for investments made in 2002 through 2005, 83% of the insureds lived past their life expectancies calculated by Life Partners).

ners concealed this information from the investors prior to their purchases.[16] These miscalculations reduced the expected rates of return and increased the premium costs, potentially leading to losses on the investment.[17] Life Partners concealed those errors by providing the investors with only the total acquisition cost and no breakdown of the amounts paid to the policy owners, the escrow amount, Life Partners' fees, or the expenses such as physician fees, escrow fees, consultant fees, and broker fees.[18]

Life Partners, Inc. v. Arnold involved two cases: one from the Dallas Court of Appeals and one from the Austin Court of Appeals, consolidated for purposes of oral argument.[19] In the Dallas Court of Appeals case,[20] the investors of interests in the life settlements sued in district court under the TSA for rescission or damages for failure to register the interests with the Texas State Securities Board (TSSB)[21] and for making an untrue statement of a material fact by claiming the life settlements were not securities.[22] Life Partners filed a counterclaim against the investors, asserting that the investors' claims were groundless and brought to harass. Life Partners then moved for summary judgment on the investors' claims and its counterclaim, contending that no violation of the TSA occurred because the interests in the life settlements were not securities as a matter of law, the TSA excludes contracts of insurance from the definition of security,[23] and the TSA's statute of limitations had run on most of the claims.[24] The district court granted the motion for summary judgment

16. *Id.*
17. *Id.*
18. *Arnold I*, 416 S.W.3d 577, 587 (Tex. App.—Dallas 2013), *aff'd*, 464 S.W.3d 660 (Tex. 2015).
19. *Arnold II*, 464 S.W.3d 660, 662–63 (Tex. 2015).
20. *See Arnold I*, 416 S.W 3d 577; *see also* Flint 1, *supra* note 14, at 102–09 (discussing *Arnold I*).
21. *See* Tex. Rev. Civ. Stat. Ann. art. 581-33(A)(2) (West 2010) ("A person who offers or sells a security in violation of Section 7 [requiring registration with the TSSB] . . . is liable to the person buying the security from him . . . for rescission or for damages if the buyer no longer owns the security"). The action was brought as a class action, but the trial court did not certify a class. Since the securities involved are not covered securities, the class action need not be brought in federal court. *See, e.g.*, 15 U.S.C. § 77p(b) & (c) (2012) (Securities Act: requiring class actions involving covered securities based on state law alleging an untrue statement or omission to be maintained in federal court); §§ 77p(f)(3), 77r(b) (Securities Act: defining covered securities as listed on a national exchange or sold only to accredited persons).
22. *See* Tex. Rev. Civ. Stat. Ann. art. 581-33(A)(2) ("A person who offers or sells a security . . . by means of an untrue statement of a material fact . . . is liable to the person buying the security from him . . . for rescission or for damages if the buyer no longer owns the security.").
23. *See id.* art. 581-4(A) ("Provided, however, that this definition [of "security"] shall not apply to any insurance policy, endowment policy, annuity contract, optional annuity contract, or any contract or agreement in relation to and in consequence of any such policy or contract, issued by an insurance company subject to the supervision or control of the Texas Department of Insurance when the form or such policy or contract has been duly filed with the Department . . . .").
24. For the failure to register claim, the statute of limitations is three years from the date of the sale. *See id.* art. 581-33(H)(1) ("(1) No person may sue under Section 33A(1) . . . more than three years after the sale"). For the untrue statements claim, the statute of

and found the investors' pleadings frivolous. The court of appeals found that the interests in the life settlements were indeed investment contracts, not insurance contracts, and were therefore securities, and affirmed in part (the claims on which the statute of limitations had run), reversed and rendered in part (the harassment claim), and reversed and remanded in part (the claims on which the statute of limitations had not run).[25]

In the Austin Court of Appeals case,[26] the TSSB, through the Attorney General, filed a lawsuit against Life Partners and its principals, Brian D. Pardo and R. Scott Peden, in district court in Travis County for violations of the TSA, seeking injunctive relief, the appointment of a receiver over both Life Partners, Inc. and Life Partners Holdings, Inc. (the parent corporation), restitution, disgorgement, a constructive trust, and civil penalties.[27] The district court, finding that the interests in life settlements were not securities, denied the relief sought by the TSSB. The court of appeals, rendering its decision in a memorandum opinion after the last survey, agreed with and adopted the analysis of the Dallas Court of Appeals.[28]

The Texas Supreme Court noted that the term "security" includes an "investment contract,"[29] that the term was modeled on the federal definition of a security,[30] that the TSA authorizes a broad construction to implement its remedial purposes,[31] and that the court had previously relied on the U.S. Supreme Court in determining whether a particular investment scheme constituted an investment contract for TSA purposes.[32] Consequently, the supreme court examined the U.S. Supreme Court's decisions[33] on investment contracts as securities and gleaned three interpretive principles applicable to determining whether any investment contract qualifies as a security: (1) construe investment contracts to maximize the protection to investors; (2) use economic realities to determine whether the requirements of an investment contract are met; and (3) disregard the

---

limitations is three years from the discovery of the untruth, but no more than five years from the sale. *See id.* art. 581-33(H)(2) ("(2) No person may sue under Section 33A(2) . . . more than three years after discovery of the untruth or omission, or after discovery should have been made by the exercise of reasonable diligence; or . . . more than five years after the sale . . . .").

25. *Arnold I*, 416 S.W.3d at 588, 592–93.

26. *See Life Partners Holdings*, 459 S.W.3d 619 (Tex. App.—Austin 2014), *aff'd*, 464 S.W.3d 660 (Tex. 2015).

27. *See* Brief of Appellant at viii, *Life Partners Holdings*, 459 S.W.3d 619 (Tex. App.—Austin 2014) (No. 03-13-00195-CV), 2013 WL 3973955.

28. *See Life Partners Holdings*, 459 S.W.3d at 620; *see generally Arnold I*, 416 S.W 3d 577.

29. *See* TEX. REV. CIV. STAT. ANN. art. 581-4(A) ("The term 'security' . . . shall include . . . investment contract . . . .").

30. *See* Searsy v. Commercial Trading Corp., 560 S.W.2d 637, 639 (Tex. 1977).

31. *See* TEX. REV. CIV. STAT. ANN. art. 581-4(A) ("The term 'security' . . . includes . . . any other instrument commonly known as a security, whether similar to those herein referred to or not").

32. *See Searsy*, 560 S.W.2d at 639–41.

33. *See* SEC v. Edwards, 540 U.S. 389 (2004); Reves v. Ernst & Young, 494 U.S. 56 (1990); United Hous. Found. Inc. v. Forman, 421 U.S. 837 (1975); SEC v. W.J. Howey Co., 328 U.S. 293 (1946); SEC v. C.M. Joiner Leasing, 320 U.S. 344 (1943).

terminology used by the parties to describe their investment contract.[34]

The supreme court had previously determined that a purported investment contract must satisfy four requirements to be a security: "(1) an investment of money; (2) a common enterprise; (3) an expectation of profit;" and (4) a profit predominantly from the entrepreneurial or managerial efforts of others.[35] This fourth requirement modified the Supreme Court's requirement of "solely from the efforts of others"[36] in two respects: "solely" had become expanded to "predominant," and "efforts of others" had become restricted to "entrepreneurial or managerial efforts of others."[37] Since the only real question for interests in life settlements was the last element,[38] the supreme court reexamined related federal court precedent, including Supreme Court opinions modifying this fourth requirement and concluded that the Texas version agreed with the current federal interpretation of the fourth requirement.[39] Life Partners

34. *See generally Searsy*, 560 S.W.2d 637.

35. *See id.* at 640–41.

36. *See W.J. Howey*, 328 U.S. at 301 (an investment contract "involves an investment of money in a common enterprise with profits to come solely from the efforts of others").

37. *Arnold II*, 464 S.W.3d 660, 681 (Tex. 2015).

38. *See* Mut. Benefits, 408 F.3d 737, 743 (11th Cir. 2005); SEC v. Life Partners, Inc., 87 F.3d 536, 549 (D.C. Cir. 1996) [hereinafter *Life Partners 1996*] (Wald, J., dissenting). For some federal circuits, the common enterprise element might not be satisfied by interests in life settlements. There are two types of common enterprise: (1) horizontal commonality (multiple investors under a promoter); and (2) vertical commonality (an investor and a promoter). The Fifth and Ninth Circuits recognize vertical commonality, while the Seventh Circuit does not. *See* Zang v. Alliance Fin. Serv. of Ill., Ltd., No. 08-C-3370, 2010 WL 3842366, at *5 (N.D. Ill. Sept. 27, 2010) (finding interests in life settlements not to be securities for failure to satisfy the common enterprise element).

39. *See* United Hous. Found. Inc. v. Forman, 421 U.S. 837, 852 (1975) ("This test, in shorthand form . . . is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others;" omitting "solely" and inserting "entrepreneurial or managerial"). For federal circuit court cases dealing with "solely," see McCown v. Heidler, 527 F.2d 204, 214 (10th Cir. 1975) (finding that total reliance on promoter is not required); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 475 (5th Cir. 1974) (demonstrating that efforts by others than the investors are the significant ones essential for success); SEC v. Glenn W. Turner Enters., Inc., 474 F.2d 476, 482 (9th Cir. 1973) (explaining that a security finding could be evaded by requiring a modicum of effort by the investor); *see also* SEC v. Int'l Loan Network Inc., 968 F.2d 1304, 1308 (D.C. Cir. 1992) (finding that the profits were expected to accrue "predominantly from the efforts of others"); Bailey v. J.W.K. Props., Inc., 904 F.2d 918, 920 (4th Cir. 1990) (concluding that "the most essential functions or duties must be performed by others and not the investors"); Williamson v. Tucker, 645 F.2d 404, 418 (5th Cir. 1981) (noting that in *Forman*, the Supreme Court omitted solely). For federal circuit court cases dealing with "entrepreneurial or management," see Fargo Partners v. Dain Corp., 540 F.2d 912, 914–15 (8th Cir. 1976) (finding that "[w]here investors' duties were nominal and insignificant, their roles were perfunctory or ministerial, or they lacked any real control over the enterprise, the contracts are securities as investment contracts," but where purchasers of an apartment building "retained ultimate control of the operation of the apartment complex by reserving the right to fire [the sellers] . . . on 30 days' notice," the transaction is not an investment contract); *see also* Long v. Shultz Cattle Co., 881 F.2d 129, 134 (5th Cir. 1989) (finding that cattle feeding consulting agreements were securities as investment contracts where investors had theoretical control since they were required to authorize every management decision, but it was undisputed that at each management decision the investors relied on the seller's advice); Siebel v. Scott, 725 F.2d 995, 998 (5th Cir. 1984) (characterizing limited partnership units as investment contracts, thus securities, where there was "no evidence that any of the limited partners planned or desired to par-

agreed.[40]

The supreme court then went on to address the issue of the timing of the entrepreneurial and managerial efforts.[41] One federal circuit court[42] had limited consideration of entrepreneurial and managerial efforts to after the sale of the investment, an opinion one court of appeals had followed.[43] Another federal circuit court[44] later rejected that approach and considered both pre- and post-sale efforts, a decision followed by the two courts of appeals whose opinions were before the supreme court.[45] The supreme court decided to follow the latter approach.[46] The TSA permits a construction to maximize investor protection and coordination with federal law[47] and protects investors from harmful acts of promoters before

---

ticipate in the operation" of the investment); Martin v. T.V. Tempo, Inc., 628 F.2d 887, 890 (5th Cir. 1980) (holding franchise agreements are not investment contracts where franchisees had exclusive right to sell advertisements for and arrange distribution of TV magazine in defined areas).

40. For the "predominant" modification, see Brief of Appellee at 9, *Arnold II*, 464 S.W.3d 660 (Tex. 2015) (No. 14-0226), 2014 WL 6453571 (contending "that the efforts of the investors were [not] sufficient to defeat the existence of an investment contract"); Brief of Appellant Life Partners, Inc. at 13–16, *Arnold II*, 464 S.W.3d 660 (Tex. 2015) (No. 14-0122), 2014 WL 4185527 (arguing that many courts have declined to interpret the "solely from the efforts of others" prong of the *Howey* test strictly). For the "entrepreneurial or managerial" modification, see Brief of Appellants at 21–22, *Arnold II*, 464 S.W.3d 660 (Tex. 2015) (No. 14-0226), 2014 WL 4185528 (contending that the efforts of Life Partners were not entrepreneurial or managerial); Brief of Appellant Life Partners, Inc. at 17, *Arnold II*, 464 S.W.3d 660 (No. 14-0122), 2014 WL 4185527 ("[F]or investment contract to arise, the promoter must commit to enhancing the value of the investment through its entrepreneurial or managerial efforts."). Life Partners contended their duties were not entrepreneurial or managerial but were to protect, preserve, and maintain property, which are ministerial functions. *See* Brief of Appellant Life Partners, Inc. at 19, *Arnold II*, 464 S.W.3d 660 (No. 14-0122), 2014 WL 4185527.

41. *Arnold II*, 464 S.W.3d at 676–80.

42. *See Life Partners 1996*, 87 F.3d at 545–46; *but see id.* at 552 (Wald, J., dissenting) (purporting that the focus should be on the investors' dependence on the promoter and lack of information, which makes the life settlement different from non-securities investments such as silver bars or paintings). The dissent noted that other federal circuit courts had used pre-sale efforts in the determination of the presence of an investment contract. *See id.* at 552–53; *see also* Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 756 F.2d 230, 240–41 (2d Cir. 1985) (involving a promoter who used market power to negotiate favorable CD rates with banks and agreed to maintain a secondary market for the CDs, a ministerial duty, afterwards); Gordon v. Terry, 684 F.2d 736, 740–43 (11th Cir. 1982) (involving a promoter's expertise in locating bargain-priced properties for the investor to purchase as well as post-purchase activities); Glenn-Arden Commodities, Inc. v. Constantino, 493 F.2d 1027, 1035 (2d Cir. 1974) (finding that investor profits depended on promoter's expertise in selecting whisky for purchase as well as promise to buy the whisky back in the future).

43. *See* Griffitts v. Life Partners, Inc., No. 10-01-00271-CV, 2004 WL 1178418, at *2 (Tex. App.—Waco May 26, 2004, no pet.) (succumbing to the erroneous post-sale/pre-sale distinction, only significant post-sale factor is death of insured, not efforts of others).

44. *See* Mut. Benefits, 408 F.3d 737, 743 (11th Cir. 2005) (violation of federal securities acts); *see also* Wulliger v. Eberle, 414 F. Supp. 2d 814, 824 (N.D. Ohio 2006) (same).

45. *Arnold II*, 464 S.W.3d at 662–63.

46. *Id.* at 676–80.

47. *See* TEX. REV. CIV. STAT. ANN. art. 581-10-1(A) (West 2010) ("This Act may be construed and implemented to effectuate its general purpose to maximize coordination with federal and other states' law and administration . . . ."); *id.* art. 581-10-1(B) ("This Act may be construed and implemented to effectuate its general purposes to protect investors . . . .").

the sale of the security in other situations.[48] Consequently, the supreme court also rejected as inconsistent with the TSA the idea that an investment contract could not exist without some post-sale efforts.[49]

Having determined the legal principles to apply, the supreme court proceeded to apply them to the facts of *Life Partners*. There was no doubt that the pre-sale activities (identifying the insured, negotiating the discount for the policy, evaluating the policy's terms and conditions, and evaluating the health of the insured) satisfied the entrepreneurial and management activities.[50] Even the federal circuit court, excluding consideration of pre-sale activities from the determination of an investment contract, had concluded that the pre-purchase activities were essential to the success of the investment.[51] But, the supreme court also found that the post-sale activities amounted to entrepreneurial and management efforts.[52] Life Partners exercised complete control over the investment post-sale: It had title to the policy; monitored the policy and its payment of premiums; notified purchasers if additional premiums were required when the insured lived beyond the Life Partners' predicted life expectancy; and in its discretion, made the additional premium payments, monitored the insureds, obtained death certificates of deceased insureds, prepared required insurance forms for collection, collected the insurance payouts, and managed the distributions of the necessary funds to the investors on a pro-rata basis.[53] The investors did not have the power or the information to complete these tasks. At the beginning of its opinion, the supreme court noted that Life Partners's advertising warned potential investors that they would become entirely dependent on Life Partners for "premium administration, tracking, and policy benefit collection services" and that if these tasks were not done properly, the investors could lose their interests in the policies.[54] Consequently, Life Partners's post-sale efforts were managerial, not ministerial.[55] As such, the life settlement in-

48. *See id.* art. 581-7(A) (requiring sellers to register and obtain a permit before selling a security); *id.* art. 581-7(B)(2)(a)(8)(c) (authorizing the Commissioner of the TSSB to act against misleading facts at any time before or after registration of the securities); *id.* art. 581-9 (providing investor protection against misleading offers to sell a security); *id.* art. 581-22 (regulating offers); *id.* art. 581-33 (imposing liability for misleading offers to sell a security).

49. The ridiculous idea that there should be some post-sale effort by the promoters comes from the State's brief in their appeal. *See* Brief of Appellee at 30–31, *Arnold II*, 464 S.W.3d 660 (Tex. 2015) (No. 14-0226), 2014 WL 6453571 (suggesting such a requirement is consistent with the dissenting opinion in *Life Partners 1996*. *Life Partners 1996*, 87 F.3d 536, 551–52 (D.C. 2008)); *but see id.* at 552–53 (Wald, J., dissenting) ("[T]he *Howey* test can be met by pre-purchase managerial activities of a promoter when it is the success of these activities, either entirely or predominantly, that determines whether profits are eventually realized. . . . I have found no case which holds, as the majority here does, that pre-purchase activities alone cannot satisfy *Howey*'s third prong.").

50. *Arnold II*, 464 S.W.3d at 681–82.

51. *See Life Partners 1996*, 87 F.3d at 547.

52. *Arnold II*, 464 S.W.3d at 681.

53. *Id.* at 682.

54. *Id.* at 665.

55. Life Partners viewed their post-sale efforts as ministerial, claiming Life Partners only held the property in anticipation of appreciation, or as caretaker to protect, preserve,

terests were investment contracts, and as such, were securities under the TSA.[56]

Life Partners, Inc. v. Arnold confirms that Texas securities law is now near the American mainstream jurisprudence with respect to interests in life settlements.[57] A finding that interests in life settlements are securities will end the fraud of Life Partners but will not stop legitimate sales of interests in life settlements. It would only require the appropriate registrations and disclosures required by the TSA, thus exposing the expense structures and the track record for underestimating life expectancies of the insureds engaged in by the disreputable Life Partners and, unfortunately for investors, other life settlement companies.[58]

2. *Federal Law*

Life Partners fared no better under the federal law that the Texas Su-

---

and maintain the property, or with no effort to enhance the property. *See* McConathy v. Dal Mac Commercial Real Estate, Inc., 545 S.W.2d 871, 874–76 (Tex. Civ. App.—Texarkana 1977, no writ) (finding that fractional interest in real estate joint venture is not an investment contract); Wilson v. Lee, 601 S.W.2d 483, 484 (Tex. Civ. App.—Dallas 1980, no writ) (finding that interest in real estate joint venture is not an investment contract). *Compare* Rodriguez v. Banco Cent. Corp., 990 F.2d 7, 11 (1st Cir. 1993) (finding that purchase of lots with no promise for development not an investment contract), *with* McCown v. Heidler, 527 F.2d 204, 208 (10th Cir. 1975) (finding that purchase of residential lots with promise of later improvements is an investment contract); *see also* Brief of Appellant at 20–24, Arnold II, 464 S.W.3d 660 (Tex. 2015) (No. 14-0122), 2014 WL 4185527 (citing *McConathy*, 545 S.W. 2d 841; *Wilson*, 601 S.W.2d 483; *Rodriguez*, 990 F.2d 7; and *McCown*, 527 F.2d 204); Brief of Appellants at 12–16, Arnold II, 464 S.W.3d 660 (Tex. 2015) (No.14-0226), 2014 WL 4185528 (same). The claim for the Texas court of appeals cases reveals a misunderstanding of joint venture law, because the joint venturers had control of the investment. *See McConathy*, 545 S.W.2d at 873–74 (involving an investor's lawyers who thoroughly investigated the transaction, where the manager could not sell, transfer, or encumber without 70% vote of joint venturers); *Wilson*, 601 S.W.2d at 484 (showing that 60% of joint venturers could fire manager and direct operations, but certain actions could occur only by a 100% vote). The claim for the *Rodriguez* case similarly distorts the law, because the investment contract element involved there was the common enterprise element, not the efforts of others element. *See Rodriguez*, 990 F.2d at 11.

56. *Arnold II*, 464 S.W.3d at 682.

57. *See generally* Life Settlements Task Force, Staff Report to the U.S. SEC (July 22, 2010), www.sec.gov/news/studies/2010/lifesettlements-report.pdf [https://perma.cc/K5FP-3FC5]. The report indicated that by 2010, thirty-five states had amended their securities statutes to include interests in life settlements in the definition of security (although Ky., Iowa, Me., Neb., N.J., N.C., N.D., Ohio, and Wis. exempt the sale between the policy owner to the promoter), that nine additional states (Del., La., Md., Mass., N.H., N.Y., Ore., Va., and Wash.) had found life settlements securities under an investment contract analysis, and that securities regulators in three additional states (Ala., Pa, and R.I.) had issued policy statements concluding life settlements as securities under an investment contract analysis. *Id.* at 36. Only Connecticut and Wyoming had made no determinations. *Id.* Texas was listed as divided, with the Waco Court of Appeals determining that life settlements were not securities and the TSSB issuing cease and desist orders finding life settlements securities. *Id.* n.175 (citing Griffitts v. Life Partners, Inc., No. 10-01-00271-CV, 2004 WL 1178418, at *2 (Tex. App.—Waco May 26, 2004, no pet.); *In re* Ret. Value, LLC, Bruce Collins & Richard "Dick" Gray, No. ENF-10-CDO-1686, 2010 WL 1267213, *9 (Tex. St. Sec. Bd. Mar. 29, 2010)). The staff report recommended an amendment to the federal securities laws to include interest in life settlements in the definition of securities under the federal securities laws. *Id.* at 39.

58. *See infra* notes 189–203 and accompanying text for a TSSB enforcement action against another defrauding life settlement company.

preme Court followed. In *SEC v. Life Partners Holdings, Inc.*,[59] the U.S. Securities and Exchange Commission (SEC) instituted a securities fraud action[60] against Life Partners Holdings, Inc., a public company and parent of Life Partners, as well as Pardo and Peden, its principal officers, for disclosure and accounting fraud on the sustainability of Life Partners's revenues and profit margin. Life Partners concealed from its shareholders that it systematically used life expectancies known to be materially short, using a doctor for over ten years to calculate those life expectancies even though the doctor had no experience in rendering life expectancies or actuarial training and had never researched the methodology used by life settlement underwriters. Life Partners failed to disclose to shareholders, as a contingent risk, the underestimation of life expectancies in the period from 2006 to 2011. During this period the Colorado Securities Commissioner sued and obtained a $12.8 million settlement with Life Partners[61] for selling securities (the life settlement interests) and omitting disclosure of the high frequency rate at which insureds outlived their predicted life expectancies.[62] Pardo and Peden concealed this information by (1) continuing to tout high returns during quarterly calls with investors[63]; (2) stating that the doctor's life expectancy calculations and methodology were consistent with industry practices; (3) giving auditors spread sheets of the maturities that excluded 1,230 policies where the insureds outlived their life expectancies; (4) misstating income by prematurely recognizing revenue[64] from life settlement transactions not yet completed; (5) backdating for the auditors; and (6) failing to properly reduce the value of the settlement policies owned by Life Partners.[65] These officers had also sold $11.5 million and $300,000 worth of Life Partner stock on material, non-public information.[66] The SEC sought a permanent injunction

59. 41 F. Supp. 3d 550 (W.D. Tex. 2013).

60. For the allegations subsequently described, see Complaint, *Life Partners Holdings 2013*, 41 F. Supp. 3d 550 (W.D. Tex. 2013) (No. 12CV00033), 2012 WL 95257 (involving causes of action for violations of the antifraud provisions of both the Securities Act and Exchange Act, violations of the reporting provisions and books and records provisions of the Exchange Act, failure to implement internal control and misconduct in preparing required reports).

61. *See* Joseph v. Life Partners, Inc., No. 07CV5218, 2007 WL 1725432, at *4 (Colo. Div. Sec. May 29, 2007) (listing as one of the material omissions the high frequency rate that insureds outlive their predicted life expectancies).

62. *Life Partners Holdings 2013*, 41 F. Supp. 3d at 560.

63. *See Joseph*, 2007 WL 1725432, at *3 (claiming a 14-year average annual return of over 16%).

64. Unfortunately, this was not the first instance of Brian D. Pardo's misstating revenues by accelerating revenue recognition. *See* SEC, SEC News Dig. 89-137-05, Complaint Names Ask Corporation and Brian D. Pardo (1989) (involving fraud for overstatement of Ask Corporation's revenues and profits for the first three quarters in each of its 1983 and 1984 fiscal years, and the first two quarters in fiscal 1985 in filings with the SEC); *see also* Fine v. Am. Solar King Corp., 919 F.2d 290, 293–95 (5th Cir. 1990) (explaining the method of overstatement for the fiscal 1982: recognizing income before completing an installment sale).

65. *See* Complaint ¶ 11–18, *Life Partners Holdings 2013*, 41 F. Supp. 3d 550 (W.D. Tex. 2013) (No. 12CV00033), 2012 WL 95257.

66. *Id.* ¶ 11.

prohibiting these officers from committing or aiding and abetting further violations of the security laws; barring them from serving as officers or directors of a public company; and requiring them to disgorge their ill-gotten gains, to pay civil monetary penalties, and to repay Life Partners for bonuses and profits paid during the time when Life Partners reported materially misstated financial results.[67]

With respect to the SEC's claim for violation of the antifraud rules for making misstatements in selling the interests in life settlements, Life Partners and Peden moved for partial summary judgment on the omissions (the impact of the Colorado actions) and misstatements (about the doctor's qualifications and rates of return) made to investors in the life settlements[68] since they claimed the misstatements did not relate to securities,[69] citing their lone favorable federal circuit court opinion.[70] Despite the absence of an SEC response, the federal district court was not bamboozled;[71] it found the Eleventh Circuit case suggesting that the court should consider pre-sale and post-sale efforts[72] and seized upon the dissent in the cited case that suggested that pre-sale efforts alone were enough.[73] Consequently, the district court also found that the sale of the interests in life settlements constituted investment contracts and therefore were securities and accordingly denied the motion for partial summary judgment.[74]

After a jury verdict in the SEC's favor, the district court permanently enjoined Life Partners and its principal officers from committing, or aiding and abetting future violations of the Exchange Act (EA)'s[75] reporting requirements, primarily due to serial fraudster Pardo's numerous securities law violations dating back to 1991, showing he had yet to learn his lesson on the correct behavior under the securities laws and underscoring

---

67. *Id.* ¶ 18.

68. *See* Defendant's Motion for Partial Summary Judgment and Brief in Support, *Life Partners Holdings 2013*, 41 F. Supp. 3d 550 (W.D. Tex. 2013) (No. 1-12-CV-00033), 2013 WL 8373307 (asking dismissal of the claims made to investors in the life settlements based on the Colorado action, statements that the doctor's methodology met industry standards, and the rate of returns).

69. Rule 10b-5 requires the misstatement to be in connection with a purchase or sale of a security. *See* 17 C.F.R. § 240.10b-5 (2011) ("It shall be unlawful . . . (b) [t]o make any untrue statement of a material fact . . . in connection with the purchase or sale of any security.").

70. *See* Defendant's Motion for Partial Summary Judgment and Brief in Support, *Life Partners Holdings 2013*, 41 F. Supp. 3d 550 (W.D. Tex. 2013) (No. 1-12-CV-00033), 2013 WL 8373307 (citing only the D.C. Circuit Court opinion, *Life Partners 1996*, 87 F.3d 536, 545–46 (D.C. Cir. 1996)).

71. The district judge used the term cozen. *See Life Partners Holdings 2013*, 41 F. Supp. 3d 550, 555 (W.D. Tex. 2013).

72. Mut. Benefits, 408 F.3d 737, 743–44 (11th Cir. 2005) ("[B]oth pre- and post-purchase managerial activities, . . . should be taken into consideration in determining whether *Howey*'s test is satisfied.").

73. *See Life Partners 1996*, 87 F.3d at 551–52 (Wald, J., dissenting) ("[T]he *Howey* test can be met by pre-purchase managerial activities of a promoter when it is the success of these activities, either entirely or predominantly, that determines whether profits are eventually realized.").

74. *See Life Partners Holdings 2013*, 41 F. Supp. 3d 550, 554–56 (W.D. Tex. 2013).

75. *See* 15 U.S.C. § 78a (2012).

the lack of oversight by the current board of directors.[76] The district court ordered Life Partners to disgorge $15 million to the SEC for the shareholders[77] and to pay civil penalties[78] to the SEC in the amount of $27.7 million for Life Partners's sixty-eight securities violations, $6.2 million for Pardo, and $2 million for Peden.[79]

The travails of these serial fraudsters continue. Life Partners Holdings, Inc. declared bankruptcy on January 20, 2015, and Life Partners, Inc. did so on May 19, 2015.[80] The purpose of the bankruptcy filing was to substitute a self-selected examiner, favorable to Pardo and Peden, for a district court-appointed receiver over Life Partners that would investigate any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of Life Partners.[81] Peden, a licensed attorney, had his privilege to practice before the SEC revoked it.[82]

---

76. One can but wonder about the efficacy of these permanent injunctions, since Pardo was already subject to one prohibiting the same reporting violations under the EA for his securities law violations with a prior public company. *See* SEC v. Life Partners Holdings, Inc., 71 F. Supp. 3d 615, 618 (W.D. Tex. 2014) [hereinafter *Life Partners Holdings 2014*] (mentioning the prior injunction), 625 (enjoining Pardo from aiding and abetting any violation of § 13(a) of the EA and Rules 12b-20, 13a-1, and 13a-13, the same as the prior injunction); *see also* SEC, SEC NEWS DIG. 91-14, FINAL JUDGMENT OF PERMANENT INJUNCTION AGAINST ASK CORPORATION AND BRIAN PARDO (1991) (enjoining Pardo from future violations of EA Section 10(b) and Rule 10b-5 and from future aiding and abetting of violations of EA 13(a) and Rules 12b-20, 13a-1 and 13a-13).

77. The SEC's request was for $500 million. *See Life Partners Holdings 2014*, 71 F. Supp. 3d at 621. But, there are two sets of victims to Pardo's fraud: Life Partners's other shareholders and those that bought interests in Life Partners's life settlements. *See, e.g.*, Stone v. Life Partners Holdings, Inc., 26 F. Supp. 3d 575, 585 (W.D. Tex. 2014) (deciding a shareholder class action against Life Partners, Pardo, and Peden for securities fraud for misrepresenting the financial condition of the company to shareholders in public statements made in filings with the SEC, press releases, and during public conference calls); Tim Grant, *Life Settlements Present a Murky Alternative to Stocks, Bonds*, PITTS. POST-GAZETTE (Sept. 20, 2015), http://www.post-gazette.com/business/money/2015/09/20/Life-settlements-a-murky-alternative-to-stocks-bonds/stories/201509060011 [https://perma.cc/4MLL-999Z] (focusing on a retiree that had purchased interests in three life settlements, receiving a smaller return on one due to the insured living longer than expected and uncertain about the other two due to the bankruptcy filing of Life Partners).

78. The SEC's request was for $1.5 billion. *See Life Partners Holdings 2014*, 71 F. Supp. 3d at 624.

79. *See id.*; *see also* SEC v. Life Partners Holdings, Inc., No. A-12-CV-00033 JRN, 2015 WL 433094, at *2 (W.D. Tex. Feb. 2, 2015) (denying stay of execution during appeal for Pardo and Peden, claiming, on the basis of unverified financial statements [possibly fraudulent since they failed to appear at the hearing on their motion], that they lack sufficient funds to post the required bonds). Pardo and Peden's appeal is based on the insufficiency of evidence for the fraud claim and the absence of jury findings to support civil penalties, not that interests in life settlements are not securities. *See* Brief of Appellants Brian D. Pardo and R. Scott Peden at 2, SEC v. Life Partners Holdings, Inc., No. 14-51353 (5th Cir. June 30, 2015), 2015 WL 4055445.

80. *See In re* Life Partners Holdings, Inc., Docket No. 4:15-BK-40289 (Bankr. N.D. Tex. Jan. 20, 2015).

81. *See* Objection of the SEC to Debtor's Motion for Entry of an Order Appointing Tracy A. Bolt as Examiner with Expanded Powers at 1, *In re* Life Partners Holdings, Inc., No. 15-40289-rfn-11 (Bankr. N.D. Tex.), 2015 WL 513550.

82. *See In re* R. Scott Peden, Esq., No. 34-75135, 2015 WL 3562620, at *1 (June 9, 2015).

B. Separation Agreement Vesting Stock Awards is a Transaction Involving Stock Under the TSFA

Litigation under the TSFA dealt with defining its scope. In *Ginn v. NCI Building Systems, Inc.*,[83] the First Houston Court of Appeals considered whether a separation agreement that immediately vested previous stock awards constituted a transaction involving the purchase or sale of stock under the TSFA and whether the Covenants Not to Compete Act[84] preempted the TSFA provision for legal fees.[85] A public company had terminated a founder's son by eliminating his position as executive vice-president. The separation agreement referred to the vice-president's resignation and also contained a non-compete provision, a non-solicitation of company employees provision, and a confidentiality provision. The vice-president allowed the company to cleanse company data off of his office computer (retained by him) and his home computer. But, regarding his resignation as a termination without cause, the vice-president retained an undisclosed back-up hard-drive containing confidential and proprietary company information, including sales information, pricing data, financial records, and customer lists. The separation agreement provided for subsequent one-year consulting services at the vice-president's normal salary and for immediate vesting of his previously granted stock awards. Some stock awards had a four-year vesting schedule of twenty-five percent per year, while others had a requirement of no vesting until age sixty-five. Failure to remain in service during these vesting periods would result in the forfeiture of the stock award.[86] After separation, the ex-vice-president developed several competing entities, solicited company employees, and used and disclosed the company's confidential information. The company brought suit for statutory fraud and legal fees under the TSFA among other claims.[87] The jury found liability for statutory fraud, along with several other claims,[88] and found damages of $360,000, which was the consulting salary.[89] The trial court disregarded the statutory fraud claim, concluding that the separation agreement was not a transaction involving stock in a corporation, raised the damages to $1.9 million to include the value of the stock that vested that the jury claimed had no

83. Ginn v. NCI Bldg. Sys., Inc., 472 S.W.3d 802, 810 (Tex. App.—Houston [1st Dist.] 2015, no pet.).

84. *See* Tex. Bus. & Com. Code Ann. § 15.50 (West 2011).

85. *Ginn*, 472 S.W.3d at 824–25. The other issues dealt with the sufficiency of evidence for the common law fraud action, whether the court could rescind the agreement, and whether damages were calculated properly. *Id.* at 827, 836–37, 842–45.

86. *See* Appellee's Response Brief & Cross-Appellant's Brief at 5, Ginn v. NCI Bldg. Sys., Inc., 472 S.W.3d 802 (Tex. App.—Houston [1st Dist.] 2015) (No. 01-12-00502-CV), 2013 WL 4052416.

87. Other claims included breach of contract, common law fraud, breach of fiduciary duty, and unjust enrichment. *See Ginn*, 472 S.W.3d at 811.

88. Specifically, the jury found the ex-vice-president liable for common law fraud, breach of fiduciary duty, and unjust enrichment, while the trial court granted the ex-vice-president a partial summary judgment on the breach of contract claims. *Id.* at 810.

89. *Id.* at 820–21.

value, and denied legal fees.[90]

The court of appeals noted that the elements of the TSFA claim listed in the statute are: (1) a transaction involving stock; (2) a false representation of fact or a false promise made during the transaction; (3) the making of the falsity to induce a party into the contract; (4) that party's reliance on the falsity; and (5) the reliance lead to the injury.[91] The real estate cases decided under the same TSFA provision[92] required an actual conveyance as a key element of a transaction involving stock.[93] Although most statutory fraud transactions cases involve fraud by the seller, there have been cases involving fraud by buyers to induce the sale of stock.[94] For stock transactions, courts found statutory fraud for transactions transferring stock options provided that they are vested.[95] Because the involved transaction provided for immediate vesting of forfeitable past

---

90. *Id.* at 820–22.

91. *Id.* at 823.

92. The statutory fraud provision also applies to transactions in real estate. *See* Tex. Bus. & Com. Code Ann. § 27.01 (West 2015) ("Fraud in a transaction involving real estate or stock in a corporation or joint stock company consists of . . . .").

93. *See* Stanfield v. O'Boyle, 462 S.W.2d 270, 272 (Tex. 1971) (finding that an agreement to substitute security for a real estate loan under the predecessor to the TSFA is not a conveyance but merely a contract to convey in the future); BLM of Brownwood, Inc. v. Mid-Tex Cellular, Ltd., No. 11-11-00311-CV, 2014 WL 1285765, at *6 (Tex. App.—Eastland Mar. 31, 2014, no pet.) (mem. op.) (finding oral contract invalid because conveyance does not satisfy the Statute of Frauds); Tukua Inv., LLC v. Spenst, 413 S.W.3d 786, 796–97 (Tex. App.—El Paso 2013, pet. denied) (holding real estate sales contract is a conveyance); Evans v. Wilkins, No. 14-00-00831-CV, 2001 WL 1340356, at *3 (Tex. App.—Houston [14th Dist.] Aug. 14, 2013, no pet.) (finding real estate joint venture agreements not mentioning any specific properties are not conveyances); Tex. Commerce Bank Reagan v. Lebco Constructors, Inc., 865 S.W.2d 68, 82 (Tex. App.—Corpus Christi 1993, writ denied) (finding loan agreement for real estate is not a conveyance); *see also* Life Ins. Co. of Va. v. Murray Inv. Co., 646 F.2d 224, 227 (5th Cir. 1981) (finding statutory fraud provision inapplicable to purchase of notes secured by real estate); Burleson State Bank v. Plunkett, 27 S.W.3d 605, 611 (Tex. App.—Waco 2000, pet. denied) (finding statutory fraud provision inapplicable to construction loan); Nolan v. Bettis, 577 S.W.2d 551, 556 (Tex. Civ. App.—Austin 1979, writ ref'd n.r.e.) (finding statutory fraud provision inapplicable to purchase of lien note to foreclose).

94. *See* Fisher v. Yates, 953 S.W.2d 370, 381 (Tex. App.—Texarkana 1997, no writ) (finding statutory fraud for purchase of minority shareholders stock prior to sale of company); *see also* Read v. Cary, 615 S.W.2d 296, 298 (Tex. Civ. App.—Dallas 1981, writ ref'd n.r.e.) (inducing shareholders to sell stock violated statutory fraud provision providing court jurisdiction).

95. *Cf.* Wright v. Modern Grp., Ltd., No. 13-12-00293-CV, 2013 W.L. 4714930, at *9–10 (Tex. App.—Corpus Christi Aug. 30, 2013, pet. denied) (mem. op.) (finding statutory fraud inapplicable to phantom equity agreement granting an option for 5% of the company since condition precedent of 5 years of service was unsatisfied); Beebe v. Compaq Comput. Corp., 940 S.W.2d 304, 307 (Tex. App.—Houston [14th Dist.] 1997, no pet.) (finding statutory fraud inapplicable to stock option plan that suspended vesting of options during leave of absence when employee never returned from leave of absence); Stephanz v. Laird, 846 S.W.2d 895, 905 (Tex. App.—Houston [1st Dist.] 1993, writ denied) (finding statutory fraud inapplicable to granted stock options since precondition precedent for vesting of 18-months service was unsatisfied).

stock awards,[96] this requirement for statutory fraud was satisfied.[97]

But using a separation agreement to vest the stock with a non-compete provision added an additional issue concerning the successful employer's right to legal fees. The TSFA provides for legal fees,[98] but the Covenants Not to Compete Act only allows legal fees for successful employees and not successful employers.[99] The Covenants Not to Compete Act provides remedies for enforcement of non-compete agreements, but it also preempts other remedies.[100] The employer's efforts to enforce the non-compete provisions of the separation agreement with a temporary injunction and breach of contract lawsuit triggered the Covenants Not to Compete Act and its preemption of legal fees under TSFA.[101]

C. Confirmation that the TSA is not Precluded for Fraud in Connection with Uncovered Securities

The SLUSA preclusion narrows the scope of the TSA and TSFA by prohibiting state law class actions with over fifty investors for misrepresentation or omission of a material fact in connection with a sale or purchase of "covered securities."[102] Covered securities are those traded on a national exchange or sold, under the Jumpstart Our Business Startups Act (JOBS) amendment, only to accredited persons.[103] SLUSA does not apply to actions by the state, class actions in the state of incorporation, and state securities commissioners' enforcement actions.[104] The key significance of SLUSA preclusion involves the inability of victims of securities fraud to recover from aiders and abettors under federal securities

96. The employee's lawyers had difficulty understanding vesting schedules. They saw the separation agreement as not involving the sale of stock, claiming the stock awards had already conveyed the stock. *See* Appellants' Reply Brief & Cross-Appellees' Response Brief at 16, Brief at 5, Ginn v. NCI Bldg. Sys., Inc., 472 S.W.3d 802 (Tex. App.—Houston [1st Dist.] 2015) (No. 01-12-00502-CV), 2013 WL 4052417. Without the immediate vesting, though, their client would have received far less stock when he his employment terminated, forfeiting the unvested stock.

97. *Ginn*, 472 S.W.3d at 824.

98. *See* Tex. Bus. & Com. Code Ann. § 27.01(e) (West 2015) ("Any person who violates the provisions of this section shall be liable to the person defrauded for reasonable and necessary attorney's fees . . . .").

99. *See id.* § 15.51(a) (enforcement remedies: promisee [employer] may get damages and injunctive relief); *id.* § 15.51(c) (defense remedies: promisor [employee] may get costs and reasonable attorney's fees).

100. *See id.* § 15.52 (preemption provision: remedies provided under the act are exclusive).

101. *See id.*

102. *See* 15 U.S.C. § 78bb(f)(1)(A) (2012) ("No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging (A) a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security . . . .").

103. *See* § 77r(6)(1) (defining of covered security as one traded on a national exchange or one determined by SEC rule and registered mutual funds); § 78bb(f)(5)(E) (referring to the SA definition of covered security); *see also* § 77r(b)(4)(C) (making sales to only accredited persons covered securities), *as amended by* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 305(a), 126 Stat. 306, 322 (2012).

104. *See* § 78bb(f)(3)(A)(i) (where incorporated); § 78bb(f)(3)(B)(i) (by state); § 78bb(f)(4) (state securities commissioner).

law,[105] while they can under some states' blue sky laws, including the TSA.[106]

In *Chadbourne & Parke LLP v. Troice*, the victims of Allen Stanford's multi-million dollar Ponzi scheme sued the aiders and abettors of the fraud, some under Louisiana law and some under the TSA.[107] They had purchased certificates of deposit (CDs) of an offshore bank with assets supposedly invested in a diversified portfolio of marketable securities. The invested assets were to provide funds for redeeming the CDs whenever needed. The Texas victims filed a federal class action against the bank's insurance brokers who misrepresented material facts and the bank's lawyers who prevented the SEC from uncovering the Ponzi scheme for aiding and abetting securities fraud under the TSA.[108] The district court noted that the CDs were not covered securities because they were not registered or traded on a national exchange.[109] In the absence of any Fifth Circuit precedence, the district court adopted the Eleventh Circuit's induced and depended upon principle, and determined that the "in connection with the purchase or sale of covered securities"[110] element was satisfied and dismissed the victims' TSA lawsuits.[111] The U.S. Court of Appeals for the Fifth Circuit reversed and remanded.[112] The Fifth Circuit adopted the Ninth Circuit's test that the fraud and sale of covered securities be more than tangentially related.[113] The U.S. Supreme Court affirmed under its own test.[114]

Fearing a narrow interpretation of "in connection with," the SEC, as amicus curiae, first opposed the granting of certiorari[115] and later sup-

105. *See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 152, 155 (2008); Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 180 (1994).

106. *See* TEX. REV. CIV. STAT. ANN. art. 581-33(F)(2) (West 2010) (TSA liability for one who intentionally materially aids a fraudster).

107. Chadbourne & Parke LLP v. Troice, 134 S. Ct. 1058, 1059 (2014). The victims also brought a claim for civil conspiracy. The federal courts consolidated the TSA cases with others brought under the Louisiana securities act. *See id.* at 1065.

108. *Id.* at 1065.

109. *See* 15 U.S.C. § 77r(b)(1).

110. § 78bb(f)(1).

111. *See* Roland v. Green, 675 F.3d 503, 510 (5th Cir. 2012), *aff'd sub nom.*, Chadbourne & Parke LLP v. Troice, 134 S. Ct. 1058 (2014); *see also* Flint 66, *supra* note 3, at 1139–41 (discussing *Roland*, 675 F.3d 503). The CDs backed by covered securities induced the victims to purchase and the victims sold covered securities to raise money for the purchase of CDs. *See Roland*, 675 F.3d at 510.

112. *See Roland*, 675 F.3d at 524.

113. *See* Madden v. Cowen & Co., 576 F.3d 957, 966 (9th Cir. 2009); *see also Roland*, 675 F.3d at 519–20 (adopting the *Madden* test). Applying this test to the sale of the nonregistered CDs by the insurance brokers, the Fifth Circuit found that the misrepresentation of a backing by covered securities was only one of eight misrepresentations and therefore could not be more than tangentially related. *Roland*, 675 F.3d at 522–23. Similarly, sale by some investors of marketable securities to buy the CDs from the insurance brokers was only tangentially related since they could have raised money by other means. *Id.* at 521–22. With respect to the aiding and abetting law firm, its obstruction fraud also was not more than tangentially related. *See id.* at 511–24.

114. *Troice*, 134 S. Ct. at 1066.

115. *See* Brief for the United States as Amicus Curiae at 2, 7, 22, Chadbourne & Parke LLP v. Troice, 134 S. Ct. 1058 (2014) (Nos. 12-79, 12-86, 12-88), 2012 WL 6591478. The

ported the fraudsters and aiders and abettors in their appeal.[116] To the SEC, the Fifth Circuit had misapplied the tangential test because the crux of the fraud was to convince the investors that the CDs were safe and backed by a diversified portfolio including marketable securities of stable national governments, international banks, and multinational companies, some of which securities were covered securities.[117] The SEC desired a broad interpretation of the "in connection with" requirement, rather than the tangential test, which would encourage victims to allege numerous non-securities related fraud allegations to avoid preclusion of their suits by SLUSA and create a loophole for fraudsters seeking to hamper the SEC efforts to protect the securities markets from the variety of different forms of fraud.[118]

Armed with this concern, the Supreme Court laid out the framework to determine the reach of SLUSA. The correct test would not limit the SEC's ability to prosecute nor preclude the current victims' state actions.[119] The Supreme Court explained that "[a] fraudulent misrepresentation or omission is not made 'in connection with' such a 'purchase or sale of a covered security' unless it is material to a decision by one or more individuals (other than the fraudster) to buy or to sell a 'covered security.'"[120] The Supreme Court also noted that the key to this test is not the absence of the fraudster's purchase or sale,[121] but the presence of

---

SEC claimed there was no conflict in the circuits concerning the application of SLUSA. *See id.* at 8. The Fifth Circuit found differently when it selected which Circuit's rule to follow. The Eleventh and Second Circuits use an "induced" test, which the Fifth Circuit rejected as too narrow by adding a causation requirement. *See Roland*, 675 F.3d at 519; *see also* Instituto De Prevision Militar v. Merrill Lynch, 546 F.3d 1340, 1349 (11th Cir. 2008) (using an "induced" test and also adding a "depend" test); Romano v. Kazacos, 609 F.3d 512, 522 (2d Cir. 2010) (using an "induced" test). The Sixth Circuit uses a "depend on" test, which the Fifth Circuit rejected as too narrow. *See Roland*, 675 F.3d at 513; *see also* Segal v. Fifth Third Bank, N.A., 581 F.3d 305, 310 (6th Cir. 2009) (using a "depend on" test). The Eighth and Seventh Circuits use the Supreme Court's "coincide" test with no useful explanations, which the Fifth Circuit rejected as too narrow. *See Roland*, 675 F.3d at 513–14; *see also* Siepel v. Bank of Am., N.A., 526 F.3d 1122, 1127 (8th Cir. 2008) (using a "coincide" test); Gavin v. AT & T Corp., 464 F.3d 634, 639 (7th Cir. 2006) (using a "coincide" test, but more than "but for").

116. *See* Brief for the United States as Amicus Curiae Supporting Petitioners at 11, Chadbourne & Parke LLP v. Troice, 134 S. Ct. 1058 (2014) (Nos. 12-79, 12-86, 12-88), 2013 WL 1947418.

117. *See* Brief for the United States as Amicus Curiae at 12, Chadbourne & Parke LLP v. Troice, 134 S. Ct. 1058 (2014) (Nos. 12-79, 12-86, 12-88), 2012 WL 6591478.

118. *See* Brief for the United States as Amicus Curiae Supporting Petitioners at 11–12, Chadbourne & Parke LLP v. Troice, 134 S. Ct. 1058 (2014) (Nos. 12-79, 12-86, 12-88), 2013 WL 1947418.

119. *See Troice*, 134 S. Ct. at 1062.

120. *See id.* at 1066.

121. The Supreme Court had previously held SLUSA precludes a state action by those who retained their shares due to the fraud since the fraudster was trading with others in the market. *See* Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 85 (2006). Similarly, under 17 C.F.R. § 240.10b-5 (2011), the Supreme Court had allowed a criminal action against a fraudster for trading on inside information stolen from an issuer since the fraudster was trading with others in the market. *See* United States v. O'Hagan, 521 U.S. 642, 651–53 (1997).

fraud about a covered security.[122] The Supreme Court supported this test with several reasons besides the plain meaning of the statute's language. SLUSA's purpose was to shield issuers of covered securities, not uncovered securities, from state class actions.[123] Every Supreme Court case that had found fraud in connection with a security involved a victim who had bought, sold, or maintained ownership of that security.[124] Similarly, the underlying regulatory statutes, the SA and the EA, also deal with fraud in the buying and selling of securities.[125] And to interpret "in connection with" more broadly would interfere with state regulation of ordinary frauds where the fraudster intends later to invest in exchange-traded securities or to pool mortgages into covered securities.[126]

The *Chadbourne & Parke* case did produce a dissent that the majority regarded as an error.[127] The dissent would effectively abolish the distinction between covered and uncovered securities. Focusing more on maintaining the integrity of the marketplace[128] than on antifraud, the dissent would more severely limit class actions to federal law, not state law.[129] The reason: to eliminate "complex and costly state-law litigation based on allegations of aiding or participating in transactions that are in fact regulated by the federal securities laws."[130] The dissent viewed the failure to understand the Congressional purpose was to protect shareholders of the

122. *See Troice*, 134 S. Ct. at 1066–68.

123. Victims' lawyers were circumventing the Private Securities Litigation Reform Act of 1995 (PLSRA) by providing heightened pleading standards enforced by automatic stays against discovery through state class actions. *See* H.R. Rep. No. 105-803, 10th Cong., 2d Sess. 1, 13 (1998); 144 Cong. Rec. S4799 (daily ed. May 13, 1998) (statement of Sen. Lieberman), https://www.congress.gov/crec/1998/05/13/CREC-1998-05-13-pt1-PgS4778-3.pdf [https://perma.cc/X8QP-ENWT]; 144 Cong. Rec. H10780 (Oct. 13, 1998) (statement of Rep. Eshoo), https://www.congress.gov/crec/1998/10/13/CREC-1998-10-13-pt1-PgH10771-2.pdf [https://perma.cc/9CBT-KPZH]; *see also* 15 U.S.C. § 77z-1 (2012) (providing private securities litigation for the Securities Act); § 78u-4 (providing the same for the Exchange Act). Congress also wanted to preserve state regulation for non-covered securities. *See* S. Rep. No. 105-182, 105th Cong., 2d Sess. 1, 8 (1998).

124. *See Dabit*, 547 U.S. at 77 (involving holders of overvalued stock from the fraudsters actions); SEC v. Zandford, 535 U.S. 813, 822 (2002) (involving a client's securities sold by broker with discretion for broker's personal use); Wharf Holdings Ltd. v. United Int'l Holdings Inc., 532 U.S. 588, 592 (2001) (involving a company purchased oral option to purchase 10% of stock by company with no intent to honor the option); *O'Hagan*, 521 U.S. at 655–56 (involving a lawyer's use of inside information to purchase options on target company that harmed the investing public); Superintendent of Ins. of N.Y.C. v. Bankers Life & Casualty Co., 404 U.S. 6, 10 (1971) (involving an insurance company damaged when outside collaborators, corporate officer, and controlling shareholder stripped company of its treasury bonds).

125. *See* 15 U.S.C. §§ 77q (SA's antifraud provision § 17), 78j(b) (EA's antifraud provision §10(b)).

126. *See Troice*, 134 S. Ct. at 1068.

127. *Id.* at 1072 (Kennedy, J., dissenting).

128. *See id.* at 1074 ("SLUSA seeks to preclude a broad range of state law securities claims in order to protect those who advise, counsel, and otherwise assist investors from abusive and multiplicitous class actions designed to extract settlements from defendants vulnerable to litigation costs. This, in turn, protects the integrity of the markets.").

129. *See id.* at 1075 ("Congress intended to make, 'federal law, not state law, . . . the principal vehicle for asserting class-action securities fraud claims.'").

130. *Id.* at 1074 ("[The majority opinion] will subject many persons and entities whose profession it is to give advice, counsel, and assistance in investing in the securities markets

extorted issuers, not those feeding off the fraudsters.[131] The dissent would use a rule that finds "in connection with" when the misrepresentation coincides with the purchase or sale of a covered security.[132] Because the promise to buy covered securities was so essential to the fraud of selling the CDs, the dissent would find the coincide test satisfied and reverse the Fifth Circuit, thereby denying the victims of a remedy under both federal law and state law.[133]

Chadbourne & Parke is not likely to have a great impact on securities law. Few class actions are for uncovered securities that are in some way related to covered securities. The major uncovered securities are U.S. securities not traded on a national exchange (such as private placements other than those made only to accredited persons)[134] and foreign stocks and bonds traded outside the United States. Following *Chadbourne & Parke*, the other major Ponzi scheme, Bernard Madoff's sale of British Virgin Islands mutual funds that were invested in covered securities, has produced two cases against aiders and abettors.[135] Those cases, however, did not survive SLUSA preclusion because the investors intended to indirectly invest in covered securities.[136] Still, lawyers, accountants, and financial advisers may want to improve their internal controls to avoid potential problems when representing fraudsters if they are dealing with non-covered securities.

Meanwhile, the *Chadbourne & Parke* saga continues with the district court dismissing some TSA actions as beyond the three-year statute of limitations and dismissing the negligent supervision claim over the errant lawyer who hindered the SEC investigation because Texas does not recognize a duty of care to third parties.[137]

II. REGISTRATION AND ENFORCEMENT

The TSA created the TSSB to handle the registrations required by the TSA and to serve as an enforcement agency.[138] The basic rule of most securities laws is that securities must be registered with their corresponding regulatory agency unless they fall within an exemption.[139] Similarly,

---

to complex and costly state-law litigation based on allegations of aiding or participating in transactions that are in fact regulated by the federal securities laws.").

131. *Id.* at 1079; *see infra* note 245 and accompanying text for the purpose behind the Private Securities Litigation Reform Act of 1995 whose evasion required SLUSA.

132. *See Troice*, 134 S. Ct. at 1078; *see also* Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 85 (2006) (enunciating the coincide rule).

133. *See Troice*, 134 S. Ct. at 1078.

134. *See* 15 U.S.C. § 77r(b)(4)(C) (2012) (finding that sales to only accredited persons are covered securities), *as amended by* Jumpstart Our Business Startups Act (JOBS), Pub. L. No. 112-106, § 305(a), 126 Stat. 306, 322 (2012).

135. *See In re* Kingate Mgmt. Ltd. Litig., 784 F.3d 128, 142 (2d Cir. 2015); *In re* Herald, 753 F.3d 110, 113 (2d Cir. 2014), *cert. denied*, Davis v. Kohn, 135 S. Ct. 1701 (2015).

136. *See In re Kingate Mgmt. Ltd. Litig.*, 784 F.3d at 142; *In re Herald*, 753 F.3d at 113.

137. *See* Troice v. Proskauer Rose LLP, No. 3:09-CV-1600-N, 2015 WL 1219522, at *6–7, *12–13 (N.D. Tex. Mar. 4, 2015), *rev'd*, 816 F.3d 341 (5th Cir. 2015).

138. *See* Tex. Rev. Civ. Stat. Ann. art. 581-1 (West 2010).

139. *See id.* art. 581-7(A).

unless they fit an exemption from registration, sellers of securities must register before selling securities in the state, and investment advisers must register before rendering investment advice in the state.[140] Enforcement actions generally focus on issuers failing to register their securities and simultaneously on their selling agents making misleading statements to aid their sales.

A. ISSUER SECURITIES

The recent financial crisis spawned an interest in a possible new method of offering securities: crowdfunding. The issue for the TSSB is to establish the conditions that allow exemption from registration for the securities offered through crowdfunding. New business ventures use crowdfunding to raise money from a large number of investors through an online portal, frequently using social media to direct people to the portal.[141] Early efforts provided a product or service in exchange for the money (such as Kickstarter founded in 2009);[142] later efforts provided securities to accredited investors (such as AngelList founded in 2010).[143] Accredited persons, among other entities, are those humans with net assets over $1 million or an income for two years, plus an expected third year, over $200,000 (with spouse over $300,000).[144] Crowdfunding proponents hope to democratize these efforts by permitting unaccredited investors to participate in funding startup companies and hopefully reap a reward if the startup succeeds.[145]

To encourage new small business ventures and to take advantage of the populace's penchant for gambling, Congress passed the JOBS Act in 2012 to facilitate the raising of money through crowdfunding by requiring the SEC to take certain actions timely.[146] Seeing its mission as protecting investors, the SEC took a slow approach.[147] Title II of the JOBS Act required the SEC to amend Rule 506 to permit accredited persons to invest through crowdfunding within ninety days of the act; the SEC acted a year later.[148] Title IV of the JOBS Act required the SEC to provide a new

---

140. *See id.* art. 581-13(A).

141. Adam Heitzman, *How Crowdfunding is Changing The Way Startups Raise Money*, INC. (Jan. 20, 2015), http://www.inc.com/adam-heitzman/how-crowdfunding-is-changing-the-way-startups-raise-money.html [https://perma.cc/C2DW-9GM4].

142. KICKSTARTER, https://www.kickstarter.com/about?ref=nav [https://perma.cc/4EZ7-BFM4] (last visited Sept 3, 2016).

143. *Syndicates/For Founders*, ANGELLIST, https://angel.co/syndicates/founders [https://perma.cc/Z2TZ-QB68] (last visited Sept. 3, 2016).

144. *See* 17 C.F.R. § 230.501(a) (2011); *see also* 15 U.S.C. § 77b(15) (2012).

145. Chance Barnett, *SEC Approves Title III of JOBS Act, Equity Crowdfunding with Non-Accrediteds*, FORBES (Oct. 30, 2015), http://www.forbes.com/sites/chancebarnett/2015/10/30/sec-approves-title-iii-of-jobs-act-equity-crowdfunding-with-non-accredited/#3fcd7d966535 [https://perma.cc/6H28-4WLZ].

146. *See* JOBS, Pub. L. No. 112-106, 126 Stat. 306 (2012).

147. SEC, THE INVESTOR'S ADVOCATE: HOW THE SEC PROTECTS INVESTORS, MAINTAINS MARKET INTEGRITY, AND FACILITATES CAPITAL FORMATION, https://www.sec.gov/about/whatwedo.shtml [https://perma.cc/ZHK2-WL8L] (last visited Sept. 3, 2016).

148. *See* JOBS, Pub. L. No. 112-106, § 201, 126 Stat. 306, 313; *see also* 17 C.F.R. § 230.506(c) (the amended rule removing the prohibition against general advertising for

exemption for small issues, for which the SEC revised Regulation A allowing investment by accredited and unaccredited persons.[149] This is not overly helpful. Regulation A is so onerous that Regulation A filings dropped from 116 in 1997 to 19 in 2011, and the number of Regulation A filings becoming qualified dropped from 57 in 1998 to 1 in 2011, principally because of the costs in preparing the disclosure documents for the SEC and various state regulatory bodies, including Texas,[150] and the requirement for audited financials.[151] Title III of the JOBS Act required the SEC to issue rules providing an exemption from registration for crowdfunding within 270 days of the act; the SEC acted after several years at the end of the current review period.[152]

In this absence of SEC action, the TSSB[153] decided to create its own

sales to accredited investors, thereby permitting crowdfunding); 78 Fed. Reg. 44771-01 (July 24, 2013) (adopting the amendment July 24, 2013, effective Sept. 23, 2013).

149. *See* JOBS, Pub. L. No. 112-106, § 401, 126 Stat. 306, 323; *see generally* 17 C.F.R. §§ 230.251–.263 (Regulation A as amended for the new exemption). The amendment provides for a Tier I offering under $20 million and a Tier II offering under $50 million, both in a twelve month period to both accredited and unaccredited investors with affiliate sales limited to 30%. Affiliates are those in control of the issuer. *See* 17 C.F.R. § 230.405. The issuers must be organized in the United States or Canada, not be public companies, not be no purpose shell companies, not be selling asset-backed securities or mineral interests, not be subject to a SEC order within the last five years, have filed all required reports in the last two years, and do not have a Regulation A bad actor. *See generally* 17 C.F.R. §§ 230.251–230.263. Tier II offerings, but not Tier I offerings, are exempt from state law, must provide audited financials, and file periodic reports with the SEC. 17 C.F.R. § 230.251.

150. *See* 7 Tex. Admin. Code § 113.1 (2016) (requiring a regular registration for Regulation A offerings since there are a federal exemption and cannot be done by coordination).

151. *See* U.S. Gov't Accountability Office, GAO-08-751, Securities Regulation: Factors That May Affect Trends in Regulation A Offerings (2012), http://www.gao.gov/products/GAO-12-839 [https://perma.cc/6M2Q-W869]. The author did a Regulation A offering for American Solar King Corporation in 1980 and found it just as burdensome as a registration and only used it since at that time it required one year of audited financials, not three as with a registration, and the issuer only had one year of audited financials, the prior year's financials being qualified. An offering statement replaces the registration statement. *See* 17 C.F.R. § 230.252. An offering circular replaces the prospectus. *See* 17 C.F.R. § 230.253. But note that the amended Regulation A has removed the requirement of audited financials for Tier I offerings and preempted state law for Tier II offerings. *See* 17 C.F.R. § 239.90, Form 1-A, Part II-Information Required in Offering Circular, Part F/S (b) (no audited financial statements for Tier I offerings required) & (c) (audited financial statement for Tier II offerings required) (2011), https://www.sec.gov/about/forms/form1-a.pdf [https://perma.cc/6GN8-DNMU]; 17 C.F.R. § 230.257 (only Tier II offerings are subject to audited financials in periodic reports).

152. *See* JOBS, Pub. L. No. 112-106, § 302(c), 126 Stat. 306, 318; SEC, No. 15-249, SEC Adopts Rules to Permit Crowdfunding (Oct. 30, 2015); *see also* Crowdfunding, Securities Act Release No. 9470, Exchange Act Release No. 70741, 2013 WL 5770346 (Oct. 23, 2013) (proposed rules on the crowdfunding exemption); 15 U.S.C. § 77d(a)(6) (2012) (providing a crowdfunding exemption for registered issuers through registered portals of not more than $1 million in a twelve month period, unaccredited investors invest no more than $2000 or 5% of their annual income or net worth, whichever is larger, if under $100,000 and 10% if over $100,000); § 77d-1 (laying out the requirements for registered portals and issuers).

153. Texas is not the only state to take this approach. *See* North American Securities Administrators Association (NASAA), *State Crowdfunding Update: National Conference of State Legislatures 2015 Legislative Summit* (2015), at 1, 6, http://www.ncsl.org/documents/summit/summit2015/onlineresources/crowdfund-

exemption for crowdfunding,[154] along with registration of the trading portals[155] and a permission for small business issuers (if their previous securities sales do not exceed $1 million and the registration is for less than $5 million) to use financials reviewed by a certified public accountant rather than audited ones.[156] The exemption from registration will facilitate the capital raising efforts of Texas small businesses by diverting through crowdfunding some gambling monies from the Texas Lottery (itself a diversion of gambling monies to support public schools),[157] the Kickapoo Lucky Eagle Casino, pari-mutuel wagering, fantasy football, and out of state casinos. The TSSB based its crowdfunding exemption, effective November 17, 2014,[158] on the intrastate exemption from federal registration.[159] Consequently, the gambler/investor must be a Texas resident (evidenced by a driver's license, voter registration, or property tax record); the issuer must be organized in Texas; 80% of the issuer's gross revenue, assets, and net proceeds must be in Texas; and resale of the securities is restricted to Texas residents for nine months.[160] The exemption provides a funds raised limit of $1 million in a twelve-month period,[161] a bad actor disqualification,[162] sales through a registered dealer or portal,[163] a $5000 investment limit for an unaccredited investor,[164] an escrow

---

ing_101_update_coverman.pdf [https://perma.cc/AG56-G5YJ] (listing states with intrastate crowdfunding exemptions as of Aug. 1, 2015: Ala., Ariz., Ga., Id., Ind., Kans., Ken., Me., Md., Mass., Mich., Miss., Mont., Ore., S.C., Tenn., Tex., Vt., Va., Wash., and Wis.).

154. *See* 7 Tex. Admin. Code §§ 133.15–133.17 (West 2016) (Forms for the exemption); *id.* § 139.25 (intrastate crowdfunding exemption)). In 2010, the Texas legislature entered the crowdfunding arena by mandating that the TSSB provide an exemption from registration for crowdfunding by certain public and nonprofit entities. *See* Tex. Rev. Civ. Stat. Ann. art. 581-44 (West 2010), *see also* Act of June 17, 2015, 84th Leg., R.S., ch. 652, § 1, 2015 Tex. Sess. Law Serv. 652 (West) (making the amendment). The public entities are municipal corporations, those created by municipalities under the government code, the Texas Veterans' Commission, a nonprofit community development financial institution, and a nonprofit organization authorized by the federal government to distribute housing and community development block grants. The Texas legislature also exempted ABLE accounts, a savings vehicle for disabled children under the Internal Revenue Code, by defining them not to be securities. *See* Tex. Educ. Code ANN. § 54.907 (West 2012), *see also* Act of June 19, 2015, 84th Leg., R.S., ch. 1213, § 2, 2015 Tex. Sess. Law Serv. 1213 (West) (making the amendment).

155. *See* 7 Tex. Admin. Code §§ 115.1 (definition of crowdfunding portal), 115.3 (examination waiver for portal), 115.19 (crowdfunding financial portal registration)).

156. *See id.* § 113.5 (without comment).

157. *See* Texas Lottery, http://www.txlottery.org/export/sites/lottery/About_Us/index.html [https://perma.cc/3LDP-QKTL] (last visited Sept. 3, 2016).

158. 7 Tex. Admin. Code § 139.25.

159. *See* 17 C.F.R. § 230.147.

160. *Compare* 7 Tex. Admin. Code § 139.25(a) (Texas purchasers), (b) (issuer organization in Texas and 80% requirements in Texas), & (k) (nine month resale restriction to Texans), *with* 17 C.F.R. § 230.147(c) (issuer's organization state and 80% requirements), (d) (purchasers of that state), & (e) (nine month resale restriction to that state). The resale restriction is virtually meaningless since generally there is no secondary market for startup issuers.

161. 7 Tex Admin. Code § 139.25(d).

162. *Id.* § 139.25(m).

163. *Id.* § 139.25(a).

164. *Id.* § 139.25(e).

requirement for funds raised until the minimum amount is raised,[165] information (e.g. risk factors, description of business, operations, and management, financials certified by the chief executive officer) disclosed on the portal for twenty-one days before the sale, and communications with investors only through the portal.[166]

By June 2015, the TSSB had approved eight crowdfunding portals.[167] The portals specialize in specific types of industry such as small business loans, restaurants, and energy companies, and connect the issuers, who set a campaign target and funding deadline, with local investors.[168] To raise revenue, these portals charge fees to both the issuers and investors.[169] During the waiting period, the issuer's executives answer questions from investors through the online website.[170] The trend is to follow the crowdfunding that has attracted accredited and institutional investors. Some portals attract investors through creative deals. For example, one Houston portal's first deal involved a loan to a hair salon, with the issuer sweetening the security with gift certificates for their services to increase business, the amount dependent on the amount loaned.[171] According to one San Antonio registered portal, real estate deals presently predominate.[172] Despite the increased accessibility, a Fort Worth financial planner thought an average person examining the disclosure documents would be lost.[173]

The TSSB cautions the newly permitted unaccredited gambler/investors that only one-third to one-half of startup businesses survive their first year and that the venture capital companies only make money by investing in numerous startups so that the ones that succeed produce lucrative enough returns to outweigh the failures.[174] Consequently, these newly permitted unaccredited gambler/investors could seriously dent their bank

---

165. *Id.* § 139.25(f).

166. *Id.* § 139.25(i).

167. R. Jason Pierce, *Texas Crowdfunding Portals Provide Texas Businesses New Access to Investment Dollars*, SUMMER NEWSLETTER 2015 (Bus. Law Section of the State Bar of Tex.), July 2015, at 7, 7, http://web1.amchouston.com/flexshare/003/BusinessLaw/2015/BusinessLawSection_Summer2015_Newsletter.pdf [https://perma.cc/AFV9-24XD].

168. *Id.* at 7–9.

169. *Id.*

170. C. Todd Gibson et al., *Joining the Crowd: SEC Adopts Final Crowdfunding Regulation – Part II – Issuers* (Nov. 19, 2015), http://www.klgates.com/joining-the-crowd-sec-adopts-final-crowdfunding-regulations—part-ii—issuers-11-19-2015/ [https://perma.cc/HKG2-7KT5].

171. *See* Andrea Rumbaugh, *Crowdfunding by Texans for Texans Takes Hold*, HOUS. CHRONICLE (June 18, 2015), www.houstonchronicle.com/business/article/Crowdfunding-by-Texans-for-Texans-takes-hold-6336673.php/ [https://perma.cc/P5GM-9H9U].

172. *See* Teresa Mcusic, *Texas Investors Can Now Turn to Offers On Crowdfunding Portals*, FORT WORTH STAR TELEGRAM (May 8, 2015), http://www.star-telegram.com/news/business/biz-columns-blogs/teresa-mcusic/article20543823.html [https://perma.cc/X2AE-G74J].

173. *Id.*

174. TEX. STATE SEC. BD., INFORMATION FOR INVESTORS: CROWD WISDOM OR THE 'MADNESS OF CROWDS'? (Nov. 7, 2014), https://www.ssb.texas.gov/texas-securities-act-board-rules/texas-intrastate-crowdfunding/information-investors [https://perma.cc/3VFN-PDZF].

accounts by putting $5000 into several offerings, all of which could fail.[175]

B. Market Operators

One common feature of state regulation of securities is the usual requirement to register as a seller of securities before selling securities in the state, and to register as an investment adviser before rendering investment advice.[176] Registration infractions generally surface when applying or reapplying for registration. The TSSB created two exemptions from registration by market operators: one for mergers and acquisition dealers[177] and one for investment advisors to private funds.[178] Both exemptions were created to conform with actions by the SEC.

The SEC issued a no-action letter in 2014 for mergers and acquisition brokers who only purchase, sell, exchange, issue, repurchase, or redeem securities or assets of a privately-held company (not required to register under the EA) to a buyer that would actively operate the former privately-held company or its business with its assets, provided that the broker had no power to bind the parties, would not provide financing, would not have any custody of any assets, would not engage in any public offering, would provide written disclosure of who he represents, would not participate in a group of buyers, and had not been barred by the SEC or any state agency or suspended from associating with a broker-dealer.[179] Intending to follow the federal guidance, the Texas exemption from registration for merger and acquisition dealers for privately-held companies includes a more comprehensive bad person disqualification and also requires the dealer to maintain records (failure results in loss of the exemption) and furnish them to the TSSB upon request.[180]

The Dodd-Frank Wall Street Reform and Consumer Protection Act mandated registration with the SEC of investment advisors to private funds with assets under management of over $150 million and gave the SEC discretion for registration of mid-sized private fund advisors.[181] Because the federal Investment Advisor Act preempts state law for those

175. *See id.*
176. *See* Tex. Rev. Civ. Stat. Ann. art. 581-13(A) (West 2010).
177. 7 Tex. Admin. Code § 139.27 (West 2016).
178. *Id.* § 139.23.
179. *See* SEC, M & A Brokers, SEC No-Action Letter (Jan. 31, 2014). No-action letters do not bar any private right of action. The problem was created by the Supreme Court when it ruled that the sale of an entire business was a securities transaction. *See* Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985).
180. *See* 7 Tex. Admin. Code § 139.27 (adding bad person disqualifications for felony conviction for securities fraud, injunction for securities fraud, postal fraud, and administrative orders for securities fraud, all within the last five years)).
181. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 403, 125 Stat. 1376, 1571 (eliminating the prior exemption for private fund advisors with less than 15 clients), § 408, 125 Stat. 1376, 1575 (2010) (adding an exemption for private fund advisors with less than $150 million in assets under management and authorizing the SEC to also register mid-sized private fund advisors); *see also* 15 U.S.C. § 80b-3(m) (under $150 exemption), (n) (mid-size registration), (b) (2012) (the prior law's under 15 client exemption).

registered under the Investment Advisor Act,[182] the TSSB amended its exemption for investment advisors to private funds to coordinate with the SEC's new rules permitting registration of those investment advisors to private funds with over $100 million in assets under management:[183] an exemption for investment advisors not registered with the SEC and notice filings for those so registered.[184]

Under the Texas legislature's mandate, the TSSB also amended its rules to permit expedited registration as dealers and investment advisors for military spouses if already licensed in another jurisdiction and for military service members and veterans by providing them with credit for comparable service in the military.[185] Additionally, the Texas legislature repealed the additional fees for dealer and investment advisor registration, a portion of which went to the school fund.[186]

C. Enforcement

The TSSB generally enforces its requirements for registration through emergency orders.[187] Because con artists exploit current news and technology to confound unwary investors, the TSSB enumerates among the top ten threats to investors: Unregistered dealers, because investors do not know about the information available from the registration requirement; life settlements, because there is no way to reliably predict an individual's life expectancy; digital currency and private placements because both are not regulated; use of social media on which it is easier to lie than in print; high yield notes because investors cannot evaluate credit worthiness; and oil and gas deals since investors can't investigate the claim.[188] The TSSB's actions focus on these threats.

182. *See* 15 U.S.C. § 80b-3a(b)(1) (2012).

183. *See* 17 C.F.R. §§ 275.203(m)-1 (the over $150 million exemption) & 275.203A-1 (2011) (mid-size permission to register if between $100 million and $110 million).

184. *See* 7 Tex. Admin. Code §§ 109.6, 139.23.

185. *See id.* §§ 115.18 (dealers), 116.18 (investment advisors), & 133.4 (filing form) (West 2016); *see also* Act of May 18, 2013, 83rd Leg., R.S., S.B. No. 162 (the Chris Kyle Bill: mandating the expedited registration). The TSSB also modernized its procedures. The TSSB eliminated its requirement to send its delinquency and comment letters by U.S. mail and recognized email as an alternative method of communication with applicants. *See* 7 Tex. Admin. Code §§ 104.4 (securities), 104.5 (West 2016) (dealers and investment advisors)). The TSSB authorized electronic filings of Form D for filings in coordination with federal Rule 506. *See id.* § 107.2; *see also* 17 C.F.R. § 230.506 (2011). The TSSB authorized open records requests without a form and provided for a response in electronic form. *See* 7 Tex. Admin. Code §§ 101.4, 133.1. It authorized the use of email in notice and compliance for rule making. *Id.* § 103.2 (notice). The TSSB also created a form to assist financial officers in dealer registrations and investment advisor registrations, and in certifying financial statements. *See id.* §§ 115.2 (dealer registrations), 133.18 (investment advisor registrations), 116.2 (certifying financial statements).

186. *See* Act of June 15, 2015, 84th Leg., R.S., ch. 448, § 31, 2015 Tex. Seess. Law Serv. 448 (West) (repealing Tex. Rev. Civ. Stat. Ann. art. 581-41 (West 2010)).

187. *See* Tex. Rev. Civ. Stat. Ann. art. 581-23.

188. *See* Tex. St. Sec. Bd., Texas Securities Regulator Identifies Top 10 Investor Threats (Nov. 17, 2014), https://www.ssb.texas.gov/news-publications/investor-alert-texas-securities-regulator-identifies-top-10-investor-threats [https://perma.cc/ZR28-FESP] (also listing real estate deals).

1. Review of TSSB Orders

One TSSB enforcement action, dealing with another of the fraudsters' favorite fraud, life settlements, reached the court of appeals.[189] In *AGAP Life Offerings LLC v. Texas State Securities Board*,[190] the TSSB issued a temporary cease and desist order against a seller of life settlements for selling the unregistered securities through unregistered dealers as well as omitting material facts and making misleading statements.[191] This fraudster coupled the interest in the life settlement with a maturity bond to offer some protection against a longer than expected lifetime. AGAP challenged the order and requested a hearing.[192] After the hearing, the TSSB issued a modified cease and desist order retaining the prohibitions against selling unregistered securities through unregistered dealers. Two weeks later AGAP filed a motion for rehearing, waited forty-five days, and when the TSSB did not act on the rehearing, filed in district court. The TSSB filed a plea to the jurisdiction because the suit was not timely filed.[193] The district court granted the plea.[194]

The Austin Court of Appeals noted that the Administrative Procedure Act (APA) provides for petition filing within thirty days after the order becomes final[195] and that the order becomes final when the agency overrules the motion for rehearing or after forty-five days.[196] Under these rules, AGAP's petition was timely filed. Unfortunately for AGAP, the TSA has a different procedure: Emergency TSSB cease and desist orders become final and non-appealable within thirty days unless the subject of the order requests a hearing,[197] in which event the TSSB must have a hearing and the subsequent order is immediately final for purposes of enforcement and appeal.[198] Thus, the APA requires the petition against the TSSB order to be filed within thirty days of the issuance of that subsequent order.[199]

AGAP's arguments to escape this result fared no better than its fraud. First, AGAP contended that the APA's rehearing requirement applies

189. *See generally* AGAP Life Offerings LLC v. Tex. State Sec. Bd., No. 03-11-00535-CV, 2013 WL 6464537 (Tex. App.—Austin Nov. 26, 2013, no pet.) (mem. op.).

190. *Id.*

191. *See In re* AGAP Life Offerings, LLC, Charles D. Madden and Matthew Searle, No. ENF-11-CDO-1697, 2011 WL 280998, at *5 (Tex. St. Sec. Bd. Jan. 20, 2011) (Order Modifying Emergency Cease and Desist Order: not to sell until the securities are registered and the sellers are registered); *see also In re* AGAP Life Offerings, LLC, Charles D. Madden and Mathew Searle, No. ENF-10-CDO-1687, 2010 WL 1420226, at *3 (Tex. St. Sec. Bd. Apr. 5, 2010) (Emergency Cease and Desist Order: omissions including the principal's prior bankruptcy leading to the total loss of investors' funds, the amount of premium payments if the insured lived beyond his calculated life expectancy, the risk if the co-investors did not contribute their pro-rata portion of additional premiums).

192. *AGAP Life Offerings LLC*, 2013 WL 6464537, at *2.

193. *Id.* at *1.

194. *Id.*

195. *See* Tex. Gov't Code Ann. § 2001.176(a) (West 2008).

196. *See id.* §§ 2001.144(a)(2), 146(c).

197. *See* Tex. Rev. Civ. Stat. Ann. art. 581-23-2(C) (West 2010).

198. *See id.* art. 581-23-2(D), (E).

199. *AGAP Life Offerings LLC*, 2013 WL 6464537, at *1.

unless the agency's governing statutes provide otherwise. The TSA, however, clearly provides otherwise.[200] Next, AGAP contended that if there was a conflict between the APA and the TSA, the APA governed. The law, however, is the exact opposite.[201] The court of appeals also noted that the APA provided that if there is a conflict between a general provision and a more specific provision (such as the one in the TSA), the more specific governs.[202] Further, the court of appeals noted that the TSA provision was passed after the APA provision, reflecting the legislative intent.[203] The moral of the AGAP story: Oppose a TSSB order, and hire a lawyer that knows the TSSB procedures.

2. *Unregistered Securities*

The TSSB also took several enforcement actions against issuers for failure to register their non-exempt securities and selling agents.[204] Because sales to only accredited persons are covered securities and not subject to state registration due to preemption,[205] all these actions also involved failures to verify the accreditation of the investors. These serial fraudsters generally advertised on the Internet and failed to disclose the risks of their investment schemes, the details of their investments, and their prior securities law disciplinary histories.

Several unregistered schemes involved oil and gas interests in Texas, Kansas, and Louisiana sold by convicted felons with prior securities law violations wrongly claiming years of oilfield experience.[206] Others in-

200. *Id.* at *3–4.

201. The APA provides that its appeal rule applies unless otherwise provided by statute. *See* TEX. GOV'T CODE ANN. § 2001.176(b) (West 2008); *see also* Tex. Nat. Res. Conservation Comm'n v. Sierra Club, 70 S.W.3d 809, 812 (Tex. 2002).

202. *See* TEX. GOV'T CODE ANN. § 311.026.

203. *AGAP Life Offerings LLC*, 2013 WL 6464537, at *5.

204. *See generally In re* Petro-San Res., LLC, No. ENF-15-CDO-1739, 2015 WL 3939933 (Tex. St. Sec. Bd. June 22, 2015); *In re* Lonestar Mineral Assets, LLC, No. ENF-15-CDO-1738, 2015 WL 1412408 (Tex. St. Sec. Bd. Mar. 25, 2015); *In re* Quixote Xploration, LLC, No. ENF-14-CDO-1736, 2014 WL 5426357 (Tex. St. Sec. Bd. Oct. 20, 2014); *In re* James Dean French & Morning Tower, Ltd., No. ENF-14-CDO-1732, 2014 WL 1758086 (Tex. St. Sec. Bd. Apr. 28, 2014).

205. 17 U.S.C. § 77r(b)(4)(C) (2012) (the JOBS Act provision including sales to only accredited persons in definition of "covered securities" for which state law is preempted).

206. *See generally In re Petro-San Res., LLC*, 2015 WL 3939933 (involving a fraudster's nondisclosure of a 2005 felony conviction for promotion of a pyramid scheme in Texas, a pending misdemeanor driving while intoxicated charge, a pending misdemeanor assault with bodily injury charge, and cease and desist orders in Pennsylvania and Georgia, both for violating securities laws; ordered to stop selling unregistered securities and committing fraud); *In re Lonestar Mineral Assets, LLC*, 2015 WL 1412408 (involving no disclosure of an absence of registration to do business in Texas, a 1997 SEC disgorgement judgment of $1.2 million along with an injunction against securities fraud, and a restitution judgment of $7.6 million, along with a jail term for securities fraud; ordered to stop selling unregistered securities and committing fraud); *In re Quixote Xploration, LLC*, 2014 WL 5426357 (involving no disclosure of convictions in Florida for grand theft in 2000 with 33 months in jail, dealing in stolen property, and securities fraud sentenced to 98 months in jail and restitution of $620,000); *In re James Dean French & Morning Tower, Ltd.*, 2014 WL 1758086 (involving no disclosure of two theft convictions, a tax lien, and civil securities fraud lawsuit against the principal and Railroad Commission actions for failure to plug a well and meet inactive well requirements, and two civil securities fraud lawsuits).

volved high interest rate promissory notes sold by serial fraudsters with prior securities law violations or business judgments wrongly claiming the notes were risk free.[207]

Joint Venture Group sold a binary options program over the Internet advertised on Craigslist.[208] Binary options, a pure gambling play, offer a payout of a specified amount or nothing if the underlying security closes at a specified expiration time above or below a specified price.[209] The SEC believes binary options provide opportunities for fraud.[210] The investors would have their moneys invested by professional traders receiving a 25% commission and were required to sign "a contract . . . waiv[ing] [all] causes of action based on any inaccurate representations, breach of warranty or loss of property."[211] The serial fraudsters guaranteed to double the investor's account (guaranteed up to $250,000) in ninety days (and if not, to refund up to 200% of the investment) and to increase the account ten-fold in one year allowing retirement in two years.[212] The serial fraudsters failed to disclose the identity or qualifications of the traders, the entity insuring the accounts, the source of funds for the refunds, the true name of the principal (a convicted felon), the voidness of the contract waiving liability,[213] and the securities law disciplinary proceedings starting in 2006.[214]

EcoEnergy Group operated a Ponzi scheme by offering investments in intermodal shipping containers and leasing them to third parties, guaranteeing the investors 13% annualized returns, payable monthly or quarterly.[215] These fraudsters failed to disclose the risks associated with

---

207. *See generally In re* Woodbridge Mortg. Inv. Fund 3, LLC, No. ENF-15-DCO-1740, 2015 WL 4515161 (Tex. St. Sec. Bd. July 17, 2015) (involving no disclosure of no doing business in Texas registration and an order by securities commissioner of Massachusetts, a 2001 lawsuit by the SEC in Oregon, and an investor lawsuit in Georgia, all for securities fraud; ordered to stop selling unregistered securities through unregistered dealers and committing fraud); *In re* FlippingYourMoney.com, No. ENF-14-CDO-1734, 2014 WL 2709467 (Tex. St. Sec. Bd. June 10, 2014) (involving no disclosure of a 2012 Texas judgment for failure to repay a $500,000 loan, and a $90,000 Louisiana judgment for failure to pay on a lease; ordered to stop selling unregistered securities and committing fraud).

208. *See In re* Clifton Curtis Sneed, Jr., No. ENF-14-CDO-1737, 2014 WL 7284373, at *1–5 (Tex. St. Sec. Bd. Dec. 11, 2014) (involving no disclosure of a 2006 order by the securities commissioner of Utah, a criminal conviction in Utah with a five year probated sentence and restitution of $92,000, and a SEC action with disgorgement of $1.2 million, all for securities fraud, and a federal tax lien for $530,000; ordered to stop selling unregistered securities through unregistered dealers and committing fraud).

209. *See* Office of Investor Education and Advocacy, SEC, Investor Alert: Binary Options and Fraud, www.sec.gov/investor/alerts/ia_binary.pdf [https://perma.cc/75RN-Z73C] (last visited Sept. 25, 2016).

210. *See id.*

211. *See In re Clifton Curtis Sneed, Jr.*, 2014 WL 7284373, at *4.

212. *See id.* at *2.

213. *See* Tex. Rev. Civ. Stat. Ann. art. 581-33(L) (West 2010).

214. *In re Clifton Curtis Sneed, Jr.*, 2014 WL 7284373, at *2–3.

215. *See generally In re* EcoEnergy Grp., Inc., No. ENF-13-CDO-1730, 2013 WL 6840199 (Tex. St. Sec. Bd. Dec. 19, 2013) (involving no disclosure of principal's 2005 bankruptcy, four tax liens, a judgment of $3.8 million for trademark infringement, and a $1 million judgment for bankruptcy infractions, and the felony conviction for transporting stolen automobiles and two bankruptcies of the other principal; ordered to stop selling unregistered securities through unregistered dealers and committing fraud); Indictment,

intermodal shipping containers, any financials to support the guarantee, and the correct name of one principal and his felony convictions for criminal securities fraud in 1990 and 1996.

Several actions did not involve serial fraudsters with a track record of violations. One dealt with digital currency, which the TSSB believes poses serious risks to investors with minimal protection.[216] Balanced Energy sold working interests in Texas oil and gas prospects advertised at the Texas Bitcoin Conference and social media, claiming first year returns up to 117% by taking payment through Bitcoin.[217] The issuer would convert the Bitcoin to traditional currency to pay for operations without disclosing the risks inherent in oil and gas investments and the risks in using Bitcoin including the impact on operations caused by price fluctuations of the digital currency.[218]

Another scheme dealt with an options trading program with two versions promising astronomical returns.[219] One version, touted as a rescue plan for retirement accounts, would authorize the fraudster to trade options in the investor's online account following a proprietary strategy that would yield 1% to 3% weekly and rarely lost money.[220] The other version was to lend the fraudster money to trade options with 24% simple interest.[221] The fraudster failed to disclose his track record in trading options and the risks in trading options.[222]

United States v. Jones, No. 4:14-cr-00020 (S.D. Tex. Jan. 15, 2014), https://www.ssb.texas.gov/sites/default/files/files/news/Intermodal_indict_unsealed022714.pdf [https://perma.cc/947C-BV4K] (¶ 1 defendant successor to EcoEnergy Group; ¶ 7 third party leases shams to create appearance of being leased; counts 2-6 made payments to investors [establishing the Ponzi scheme]); *see also* Original Petition, Lin v. Jones, No. 201464889 (Dist. Ct., Harris County, Tex. Nov. 4, 2014), 2014 WL 6386472 (involving an investor suing for securities fraud under TEX. REV. CIV. STAT. ANN. art. 581-33).

216. *See* TEX. ST. SEC. BD., TEXAS SECURITIES COMMISSIONER WARNS ABOUT RISKS ASSOCIATED WITH INVESTMENTS TIED TO DIGITAL CURRENCIES (Feb. 25, 2014), https://www.ssb.texas.gov/news-publications/texas-securities-commissioner-warns-about-risks-associated-investments-tied [https://perma.cc/ZXE2-EB8F] (describing digital currencies as not subject to regulation, is extremely volatile in price, has questionable security, is subject to hackers, provides promoters anonymity, and is dependent on future acceptance in the commercial marketplaces).

217. *See In re* Balanced Energy, LLC, No. ENF-14-CDO-1731, 2014 WL 986102, at *3 (Tex. St. Sec. Bd. Mar. 10, 2014) (ordered to stop selling unregistered securities and committing fraud); *see also In re* Balanced Energy, LLC, No. 312-14-3801, 2014 WL 2441657, at *1 (Tex. St. Sec. Bd. May 28, 2014) (administrative hearing).

218. *See In re Balanced Energy, LLC*, 2014 WL 986102, at *3 (ordered to stop selling unregistered securities and committing fraud); *see also In re Balanced Energy, LLC*, 2014 WL 2441657, at *1 (administrative hearing).

219. *See generally In re* Ross Edmond Taylor, No. ENF-14-CDO-1733, 2014 WL 2441655 (Tex. St. Sec. Bd. May 27, 2014) (involving no disclosure of a lien filed against him for a judgment for failing to pay on a credit agreement; fraudster ordered to stop selling unregistered securities and committing fraud).

220. *Id.* at *1.

221. *Id.* at *2.

222. *Id.*

3. *Errant Market Operators*

Besides dealers involved with unregistered securities, the TSSB prosecuted several enforcement actions against other dealers and selling agents. These dealers failed to supervise their agents by enforcing their policies and incurred administrative fines.[223] In separate multi-state actions, both Citigroup Global Markets Inc. and J.P. Morgan Securities, LLC used unregistered sales assistants when their policies required registration of the sales assistants in the same states as the registered agent they served.[224] These sales assistants were missed by the computer programs used to check registrations.[225] TD Ameritrade, Inc. failed to enforce its policy when TD Ameritrade, Inc., using a manual process, missed dealers who failed to send written disbursement notices related to third-party wire transfers.[226] WFG Investments, Inc. (WFG) failed to enforce its policy that required its duly registered agents to limit individual investments in private placements and to review financials before making over-the-counter recommendations.[227] The failure arose because WFG regarded the sales of alternative investments as activities of the other registrant, even though WFG shared the commissions.[228] The TSSB also revoked the registration of a selling agent and investment adviser representative who impersonated as ex-clients before a former employer to gain account information from a mutual fund.[229]

The TSSB had several enforcement actions against investment advisers and investment-adviser representatives. These involved providing investment advice for a fee without registering,[230] failing to appear at a revocation hearing concerning unsuitable recommendations,[231] failing to comply

---

223. *See* TEX. REV. CIV. STAT. ANN. art. 581-23-1(A)(3) (West 2010) (authorizing fines for violations of the act or a TSSB rule); *see also* 7 TEX. ADMIN. CODE § 115.10(b)(1) (West 2016) (must reasonably enforce policies).

224. *See generally In re* Dealer Registration of Citigroup Global Mkt. Inc., No. IC15-CAF-02, 2015 WL 5000404 (Tex. St. Sec. Bd. Aug. 18, 2015) (reprimanded with Texas fine of $35,000); *In re* Dealer Registration of J.P. Morgan Sec., LLC, No. IC14-CAF-04, 2014 WL 1996994 (Tex. St. Sec. Bd. May 12, 2014) (reprimanded with Texas fine of $74,000).

225. *See generally In re Dealer Registration of Citigroup Global Mkt. Inc*., 2015 WL 5000404 (reprimanded with Texas fine of $35,000); *In re Dealer Registration of J.P. Morgan Sec., LLC*, 2014 WL 1996994 (reprimanded with Texas fine of $74,000).

226. *See In re* Dealer Registration of TD Ameritrade, Inc., No. IC15-CAF-01, 2015 WL 4607664, at *1–2 (Tex. St. Sec. Bd. July 27, 2015) (reprimanded with fine of $300,000 and $100,000 contribution to Investor Education Fund of the Investor Protection Trust).

227. *See In re* Dealer Registration of WFG Inv., Inc., No. IC15-CAF-03, 2015 WL 5316799, at *1–2 (Tex. St. Sec. Bd. Sept. 3, 2015) (reprimanded with fine of $175,000).

228. *See id.*

229. *See In re* Agent and Inv. Adviser Representative Registrations of Lloyd James Chappell, No. IC14-REV-01, 2013 WL 7022571, at *2 (Tex. St. Sec. Bd. Nov. 19, 2013) (default order).

230. *See generally In re* Lance A. Bell, No. ENF-14-CDO-1735, 2014 WL 3954092 (Tex. St. Sec. Bd. Aug. 1, 2014).

231. *See generally In re* Inv. Adviser Registration of Warren Fin. Serv., LLC, No. IC14-REV-05, 2014 WL 3022275 (Tex. St. Sec. Bd. June 27, 2014) (default order of revocation and stop fraudulent conduct); *see also In re* Inv. Adviser Registration of Warren Fin. Serv., LLC, No. IC14-03, 2014 WL 2154270 (Tex. St. Sec. Bd. May 19, 2014) (involving a fraudster who sold investment paying 2.5–5% of the gross income for 3–7 years of Warren Financial

with a prior undertaking,[232] failing to report a felony charge to the TSSB and the firm as required by the firm's policy,[233] and failing to disclose to clients the firm's receipt of fees from the brokerage used to execute the trades.[234]

III. SECURITIES FRAUD DECISIONS UNDER THE FEDERAL ACTS

The fraud provisions of the TSA are modeled on the federal statutes. Therefore, Texas courts look to federal decisions under the federal statutes to interpret TSA provisions with similar language.[235] As a result, there is an interest in Fifth Circuit securities law fraud opinions. Fraud actions under the federal statutes generally possess six elements: (1) a material misrepresentation or omission; (2) scienter; (3) a connection with a purchase or sale of a security; (4) reliance; (5) economic loss; and (6) "loss causation," that is, a causal connection between the material misrepresentation and the loss.[236] The last element comes from the Private Securities Litigation Reform Act (PSLRA).[237] The U.S. Supreme Court, considering a Fifth Circuit case for the second time, dealt with the reliance requirement.[238] The burning issue for the Supreme Court, in a never ending saga filed in 2002 to politically embarrass a sitting Vice

---

Services, failed to pay, unsuitably recommended the investment, and withdrew funds from third-party client custodial accounts without authorization).

232. *See generally In re* Inv. Adviser Registration of Wealth Solutions, Inc., No. IC14-CAF-02, 2014 WL 656867 (Tex. St. Sec. Bd. Feb. 19, 2014) (involving failure to timely make restitution payments; reprimanded and ordered to comply with the undertaking); *In re* Application for Inv. Adviser Representative Registration of Bruce William Schoendorf, No. REG 15-SUS-01 (Tex. St. Sec. Bd. Apr. 8, 2015), https://www.ssb.texas.gov/sites/default/files/files/news/REG15SUS-01.pdf [https://perma.cc/3ZYA-A2ME] (deciding not to exercise discretion over an account, granting the registration, reprimanding, and suspending for ten days).

233. *See generally In re* Application for Inv. Adviser Representative Registration of Jetmir Ahemeti, No. REG 15-SUS-02 (Tex. St. Sec. Bd. Oct. 21, 2015), https://www.ssb.texas.gov/sites/default/files/files/news/REG15SUS02.pdf [https://perma.cc/YYH8-APYR] (an assault, granting the registration, reprimanding, and suspending for thirty days); *see also* 7 TEX. ADMIN. CODE §116.9(a)(2) (West 2016) (registered investment adviser report a felony action to TSSB within thirty days).

234. *See generally In re* Inv. Adviser Registration of Mowery Capital Mgmt., LLC, No. 312-15-1299, 2015 WL 4868701 (Tex. St. Off. Admin. Hgs. July 31, 2015) (involving nondisclosure of a 2005 bankruptcy filing; principal altered documents concerning an unregistered investment representative used for referrals; proposed order to revise brochure, firm and its principal to pay administrative fine of $20,000 each); *see also In re* Inv. Adviser Registration of Mowery Capital Mgmt., LLC, No. IC 15-01, 2014 WL 6656703 (Tex. St. Sec. Bd. Nov. 17, 2014) (notice for administrative hearing: with additional charges that the firm's clients paying higher fees than the brokerage's other clients and the principal's plagiarism of a research report posted on the firm's website). The unregistered investment adviser representative was Kenneth Warren Paxton, the current Texas Attorney General. *See generally In re* Inv. Adviser Representative Registration of Kenneth Warren Paxton, Jr., No. IC14-CAF-03, 2014 WL 1875790 (Tex. St. Sec. Bd. May 2, 2014) (reprimand and administrative fine of $1000).

235. *See supra* note 3 and accompanying text.

236. *See* Dura Pharm, Inc. v. Broudo, 544 U.S. 336, 341 (2005) (discussing commission Rule 10b-5 and 17 C.F.R. § 240.10b-5 (2011)).

237. *See* 15 U.S.C. § 78u-4(b)(4) (2012).

238. *See generally* Erica P. John Fund, Inc., v. Halliburton Co., 131 S. Ct. 2179 (2011).

President of the United States,[239] concerned whether an issuer can use price impact to rebut the fraud-on-the-market theory's rebuttable presumption of reliance at the class certification stage.[240] In other cases, the U.S. Court of Appeals for the Fifth Circuit discussed the scienter requirement, considering whether following agency ratings that later proved incorrect[241] and whether boasting about an oil concession's prospects hoping for ultimate vindication, establish a strong inference of scienter.[242]

A. Price Impact Admissible at Class Certification to Rebut the Reliance Presumption

Congress passed the PSLRA[243] to discourage extortive securities litigation.[244] This included filing class action lawsuits for securities fraud whenever a significant change in the issuer's price occurred and following after class certification with an abuse of the discovery process to impose such burdensome costs on the issuer to make it more economical for the victimized issuer to settle, thereby harming its current shareholders.[245] To discourage this sort of abusive class action, the U.S. Court of Appeals for the Fifth Circuit had imposed a requirement for class certification that requires the investors to prove "loss causation" before allowing substitution of fraud-on-the-market theory's rebuttable presumption for the reli-

---

239. *See* Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., No. 3:02-CV-1152-M, 2008 WL 4791492 (N.D. Tex. Nov. 4, 2008) (mem. op.), *aff'd*, Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., 597 F.3d 330 (5th Cir. 2010), *rev'd*, Erica P. John Fund, Inc., v. Halliburton Co., 131 S. Ct. 2179 (2011), *on remand*, Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., 647 F.3d 533 (5th Cir. 2011), *on remand*, Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., No. 3:02-CV-1152-M, 2012 W.L. 565997, at *1 (N.D. Tex. Jan. 27, 2012), *aff'd*, Erica P. John Fund, Inc., v. Halliburton Co., 718 F.3d 423 (5th Cir. 2013), *rev'd*, Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398 (2014), *on remand*, Erica P. John Fund, Inc., v. Halliburton Co., 765 F.3d 550 (5th Cir. 2014), *on remand*, Erica P. John Fund, Inc., v. Halliburton Co., No. 3:02-CV-1152-M, 2015 WL 4522863 (N.D. Tex. July 25, 2015); *see also* George Lee Flint, Jr., *Securities Regulation*, 64 SMU Law Rev. 535, 550 (2011) (discussing Fifth Circuit's 2010 opinion); Flint 66, *supra* note 3, at 1151 (discussing Supreme Court's 2011 opinion); Flint 1, *supra* note 14, at 113 (discussing the Fifth Circuit's 2013 opinion).

The securities fraud class action was filed June 3, 2002. *See* Memorandum of Law in Support of Motion for Consolidation and Transfer of Related Cases, for Appointment of the Archdiocese of Milwaukee Supporting Fund, Inc. and John Miletello as Lead Plaintiffs and for Approval of Lead Plaintiffs' Selection of Counsel at 6, Moore v. Halliburton Co., No. 3:02-CV-1152-M (N.D. Tex. Aug. 2, 2002), 2002 WL 34235272. The alleged fraud involved false statements about the issuer's potential liability from asbestos litigation, accounting of revenue in the issuer's engineering and construction business, and benefits to the issuer of a merger, some made by Richard Cheny, the issuer's chief executive officer. *See Halliburton*, 134 S. Ct. at 2405. At the time of filing, Richard Cheny was Vice President of the United States.

240. *Halliburton*, 131 S. Ct. at 2184–86.

241. *See* Owens v. Jastrow, 789 F.3d 529, 541 (5th Cir. 2015).

242. *See* Spitzberg v. Hous. Am. Energy Corp., 758 F.3d 676 (5th Cir. 2014), *rev'g*, *In re* Hous. Am. Energy Corp., 970 F. Supp. 2d 613 (S.D. Tex. 2013).

243. *See* 15 U.S.C. § 78u-4 (2012).

244. *See* H.R. Rep. No. 104-369, 104th Cong., 1st Sess. 1, 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730.

245. *See id.*

ance element in a cause of action.[246] To invoke the U.S. Supreme Court's rebuttable presumption, the investors need to establish (1) the perpetrator made public misrepresentations; (2) the misrepresentations were material; (3) the securities traded in an efficient market; and (4) the investors traded between the misstatement and the revealing of the truth.[247] Although the Supreme Court generally requires proof at the certification stage of the elements necessary to establish the class,[248] the Supreme Court reversed the Fifth Circuit; the Supreme Court concluded that proof of loss causation is not required to obtain benefit of the presumption of reliance.[249] But the Supreme Court left open the issue of whether the issuer could use "price impact" to rebut an element of the presumption at the class certification stage.[250] After the district court's certification of the class,[251] the Fifth Circuit determined, under the Supreme Court's newly enunciated test,[252] that price impact could not be used to rebut the presumption at class certification.[253] The Supreme Court, in *Halliburton Co. v. Erica P. John Fund, Inc.* (*Erica P. John Fund II*), finally decided to add its contribution to stopping extortive securities fraud class actions and reversed and remanded.[254]

The Supreme Court accepted the appeal to consider whether to overrule the established reliance presumption,[255] as well as to resolve a conflict in the circuits.[256] Several amici curiae sought to abolish the

246. *See* Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 264–65 (5th Cir. 2007), *confirmed by* Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., 597 F.3d 330, 335 (5th Cir. 2010); *see also* George Lee Flint, Jr., *Securities Regulation*, 61 SMU L. Rev. 1107, 1128–29 (2008) [hereinafter Flint 61] (discussing *Oscar*, 487 F.3d 261).

247. *See* Basic Inc. v. Levinson, 485 U.S. 224, 248 n.27 (1988); *see also* Amgen Inc. v. Conn. Ret. Plans & Tr. Funds, 133 S. Ct. 1184, 1192–93 (2013).

248. *See* Comcast Corp. v. Behrend, 133 S. Ct. 1426, 1432 (2013) (involving an anti-trust class action, holding that enough evidentiary proof that damages are capable of measurement on a class-wide basis); Wal-Mart Stores Inc. v. Dukes, 131 S. Ct. 2541, 2551–52 (2011) (deciding a Title VII class action; class action certification rule is not a pleading standard, but party must affirmatively demonstrate compliance with the rule).

249. *See* Erica P. John Fund, Inc., v. Halliburton Co., 131 S. Ct. 2179, 2186 (2011) (error to require proof of loss causation to obtain class certification).

250. *See id.* at 2187 (to the extent the issuer preserved any further arguments against class certification).

251. *See* Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., No. 3:02-CV-1152-M, 2012 WL 565997, at *1 (N.D. Tex. Jan. 27, 2012) (also denying the issuer any ability to supplement the record as untimely, despite using an incorrect principle when making that record).

252. *See Amgen Inc.*, 133 S. Ct. at 1194–99.

253. *See* Erica P. John Fund, Inc., v. Halliburton Co., 718 F.3d 423, 434 (5th Cir. 2013) [hereinafter *Erica P. John Fund I*].

254. *See generally* Halliburton Co. v. Erica P. John Fund, Inc. , 134 S. Ct. 2398 (2014) [hereinafter *Erica P. John Fund II*].

255. Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 636 (2013) (granting certiorari); *see* Petition for Writ of Certiorari at i, *Erica P. John Fund II*, 134 S. Ct. 2398 (2014) (No. 13-317). Several amici curiae had advocated for the abolition. *See infra* note 257 and accompanying text.

256. *Compare In re* Salomon Analyst Metromedia Litig., 544 F.3d 474, 484 (2d Cir. 2008) ("[D]efendants are allowed to rebut the presumption prior to class certification, by showing, for example, the absence of a price impact . . . ."), *and In re* DVI, Inc. Sec. Litig., 639 F.3d 623, 638 (3d Cir. 2011) ("[W]e believe rebuttal of the presumption of reliance falls

rebuttable reliance presumption that had become no longer rebuttable and to replace it with a remedy resembling the only other aftermarket securities law remedy for fraud: fraud in documents filed with the SEC, which statutorily requires individual reliance, thereby foreclosing securities fraud class actions.[257] Justice Thomas, concurring in the judgment, called for the same.[258] The majority,[259] however, refused to go so far as to abolish the reliance presumption.[260] With respect to overturning any presumption, the Supreme Court requires special justification, not just that the prior opinion was decided wrongly.[261] Halliburton failed to make that justification. Halliburton had two arguments for overturning the presumption. First, the presumption is inconsistent with the Exchange Act (EA) in that it relieves the investors from proving reliance, which the most analogous EA action for misrepresentations in regulatory filings requires.[262] Unfortunately, the Supreme Court considered this matter when it adopted the presumption.[263] Consequently, it does not rise to the level of special justification.[264] Second, empirical economic studies indicated

---

within the ambit of issues that, if relevant, should be addressed by district courts at the class certification stage"), *with Erica P. John Fund I*, 718 F.3d at 435 ("[P]rice impact fraud-on-the-market rebuttal evidence should not be considered at class certification."), *and* Schleicher v. Wendt, 618 F.3d 679, 685 (7th Cir. 2010) ("Defendants say that, before certifying a class, a court must determine whether false statements materially affected the price. But whether statements were false, or whether the effects were large enough to be called material, are questions on the merits.").

These are basically the same conflicting opinions for granting review for *Amgen Inc. Amgen Inc.*, 133 S. Ct. at 1194; *see* Petition for Writ of Certiorari at 8-13, Amgen Inc. v. Conn. Ret. Plans & Tr. Funds, 133 S. Ct. 1189 (2013) (No. 11-1085). Clearly, the Supreme Court is not adept at resolving conflict. But *In re Salomon* and *In re DVI* involved using price impact to negate materiality. *See In re Salomon Analyst Metromedia Litig.*, 544 F.3d at 484; *In re DVI, Inc. Sec. Litig.*, 639 F.3d at 635–36.

257. *See* Brief for Former SEC Comm'rs & Officials & Law Professors as Amici Curiae in Support of Petitioners at 9–19, *Erica P. John Fund II*, 134 S. Ct. 2398 (2014) (No. 13-317) (arguing that investors should have to prove actual reliance as in section 18(a) of the Securities Exchange Act of 1934, where "in reliance upon" the falsity must be shown); *id.* at 19–22 (suggesting the court should overrule the presumption since it is effectively irrebuttable); *see also* Brief for Chamber of Commerce & Nat'l. Ass'n of Mfr. as Amici Curiae in Support of Petitioners at 6–13, 17–18, *Erica P. John Fund II*, 134 S. Ct. 2398 (2014) (No. 13-317) (contending that the court should overrule or modify the presumption of reliance due to excessive costs to businesses and due to modern studies calling into question the presumptions approach to market efficiency); *see also* Brief for DRI-The Voice of the Def. Bar as Amicus Curiae in Support of Petitioners at 3–9, *Erica P. John Fund II*, 134 S. Ct. 2398 (2014) (No. 13-317) (suggesting that issuer can rebut the presumption of reliance at the class certification stage with evidence of price impact).

In contrast, the SEC supported the investors. *See* Brief for the United States as Amicus Curiae Supporting Respondent at 6–7, *Erica P. John Fund II*, 134 S. Ct. 2398 (2014) (No. 13-317) (advocating affirmance).

258. *See Erica P. John Fund II*, 134 S. Ct. at 2417–18 (Thomas, J., concurring) (arguing that the presumption should be overruled).

259. The Supreme Court had another concurring opinion by Justice Ginsburg, in which Justices Breyer and Sotomayor joined. *See id.* at 2417 (Ginsburg, J., concurring).

260. *Id.* at 2414 (majority opinion).

261. *Id.* at 2407.

262. *See* 15 U.S.C. § 78r(a) (2012).

263. *See* Basic Inc. v. Levinson, 485 U.S. 224, 257–58 (1988) (White, J., concurring in part and dissenting in part).

264. *Erica P. John Fund II*, 134 S. Ct. at 2407–13.

that markets were not efficient.[265] Again, the Supreme Court had considered this matter when it adopted the presumption.[266] Moreover, Congress can overturn the presumption at any time. Congress did not do so when adopting the PSLRA to curtail class actions after the Supreme Court created the presumption.[267]

With respect to the conflict in the circuits, Halliburton again asserted the point it had lost when the case was previously before the Supreme Court—that the investors should have to prove price impact.[268] Despite rejecting that approach again, the Supreme Court did agree with Halliburton's second alternative to overturning the presumption: that the issuer should at least have a chance to use price impact to rebut the efficient market element of the presumption at the class certification stage.[269] Both parties agreed they could introduce some price impact information to prove or counter the market efficiency element. To disallow price impact to rebut the presumption in its entirety would make no sense (as judicially inefficient) and could lead to bizarre results, such as when a court finds market efficiency (thereby certifying the class), but there is no price impact from the alleged misrepresentation (defeating the entire lawsuit).[270] The remaining concern dealt with the Supreme Court's prior pronouncement that the materiality requirement of the presumption could not be rebutted at the class certification stage.[271] Materiality was objective and common to all members of the class.[272] It did not require proof at the certification stage because it did not relate to common issues predominating over issues impacting only individual members that the

---

265. *Id.* at 2409–11.

266. *See Basic Inc.*, 485 U.S. at 246–47 n.24 (majority opinion) ("We need not determine by adjudication what economists have debated . . . ."). Justice Thomas's concurring opinion in *Erica P. John Fund II* pointed out that those empirical studies are grossly outdated. *See Erica P. John Fund II*, 134 S. Ct. at 2420–21 (Thomas, J., concurring). The assumption that public statements are reflected in the market price depends on where the statement occurs: if "easily digestible (merger announcements or stock splits) or especially prominent (Wall Street Journal articles)," dissemination is fast; if filed with the SEC, dissemination is slow. *Id.* at 2421. The assumption that investors rely on the integrity of price ignores the belief that traders believing a stock is over- or under-valued; the fact that trades occur because the parties disagree about price reflecting value; and the use of trades to raise funds for liquidity, or taxes, or to rebalance portfolios. *See id.* at 2421–22.

267. Justice Thomas's concurring opinion pointed out this stare decisis argument is specious. *See id.* at 2425. It does not apply outside of statutory interpretation, is speculative, and the Supreme Court has violated it when decisions are unworkable, called into serious question, or detrimental to consistency in the law. *Id.* Moreover, Congress, in passing the PSLRA, provided that it did not ratify any private right of action. *Id.* at 2426–27; Private Securities Litigation Reform Act of 1995, Pub. L. 104-67, § 203, 109 Stat. 737, 762 (1995) ("Nothing in this Act or the amendments made by this Act shall be deemed to create or ratify any implied private right of action . . . .").

268. *See* Petition for Writ of Certiorari at 24, *Erica P. John Fund II*, 134 S. Ct. 2398 (2014) (No. 13-1317) (arguing that that court should modify the presumption to require plaintiffs to prove price impact).

269. *Erica P. John Fund II*, 134 S. Ct. at 2414; *see* Petition for Writ of Certiorari at 26–32, *Erica P. John Fund II*, 134 S. Ct. 2398 (2014) (No. 13-1317).

270. *Erica P. John Fund II*, 134 S. Ct. at 2415.

271. *See* FED. R. CIV. P. 23(b)(3) (2016); Amgen Inc. v. Conn. Ret. Plans & Tr. Funds, 133 S. Ct. 1184, 1198, 1203–04 (2013).

272. *Erica P. John Fund II*, 134 S. Ct. at 2416.

class certification rule requires. Clearly, price impact would fall within this pronouncement.[273] But the Supreme Court indicated that price impact differs from materiality in that indirect evidence of price impact already comes into the certification determination when trying to prove or disprove market efficiency.[274] There is no reason to limit the amount of price impact evidence to indirect evidence.[275] Hence, the issuer may introduce price impact evidence to rebut the presumption at the class certification stage.[276]

The decision reflects the Supreme Court's efforts to reign in abusive class action lawsuits by requiring proof of the prerequisites for class certification.[277] This trend has the effect of making the class certification process a mini-trial. This mini-trial aspect means both parties will need to invest time and money in the pre-certification discovery process, hiring experts to draft reports and conduct event studies on price impact.[278] Because the investors' attorney typically works on a contingency fee, being paid only upon recovery or settlement, and given the fact that cases without a price impact will not advance far enough to permit recovery of pre-certification discovery costs, the mini-trial aspect should reduce the number of securities fraud class actions by eliminating those the investors' lawyer believes lack merit and declines to pursue. For issuers, the mini-trial aspect advancing proof of price impact to the class certification stage provides a weapon to defeat non-meritorious securities fraud class actions before they reach the *in terrorem* class certified stage.

B. Establishing a Strong Inference of Scienter

The PSLRA also requires that the investors petition to recite facts giving a strong inference of scienter.[279] In the Fifth Circuit, scienter requires intent to defraud, severe recklessness with knowledge of the danger to investors, or action despite danger so obvious the officer must have been aware of the danger.[280] Moreover, the Fifth Circuit has rejected the group pleading doctrine, so the scienter must be of a specific issuer officer—scienter may not be implied from prospectuses, registration statements,

---

273. Justice Thomas's concurring opinion expressed the concern that the reliance presumption was becoming irrebuttable with the removal of evidentiary proof for its predicates. *See id.* at 2424–25 (Thomas, J., concurring). Although the presumption is rebuttable at the merit stage, the presumption essentially removes reliance from the case due to the *in terrorem* pressure for settlement. *Id.* at 2424 n.7.

274. *Id.* at 2416 (majority opinion).

275. *Id.* at 2417.

276. *Id.* at 2414–15.

277. *See supra* note 248 and accompanying text.

278. *See Erica P. John Fund II*, 134 S. Ct. at 2417 (Ginsburg, J., concurring) (expressing the belief that the added costs of discovery will not impose a heavy toll on investors with meritorious claims).

279. *See* 15 U.S.C. § 78u-4(b)(2) (2012) ("[T]he complaint shall . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.").

280. *See* Southland Secs. Corp. v. INSpire Ins. Sols., Inc., 365 F.3d 353, 366 (5th Cir. 2004); *see also* George Lee Flint, Jr., *Securities Regulation*, 58 SMU L. Rev. 1135, 1155–56 (2005) (discussing *Southland*, 365 F.3d 353).

and press releases.[281] The Fifth Circuit dealt with two cases involving the scienter issue. One reveals the difficulty of relying on circumstantial allegations for executives following the industry norm; the other reveals that allegations of the failure to follow industry norms might constitute recklessness.[282]

Owens v. Jastrow[283] involved the collapse of Guaranty Bank of Austin, Texas, in 2009,[284] in the wake of the last financial and housing crisis. A few days later, the bank's holding company filed for bankruptcy.[285] Two years later, the holding company's bankruptcy trustee filed an action against the holding company's prior parent and several executive officers, including those of the holding company, for looting the holding company and bank prior to spinning off the holding company to avoid making capital infusions into the holding company and bank.[286] The action resulted in an $80 million settlement.[287] Armed with this assertion, former shareholders of the holding company filed a securities fraud action against four executives, the chairman of the board, the chief executive officer, the chief financial officer, and the controller. The district court dismissed the action for failure to allege facts providing a strong inference of scienter.[288] The U.S. Court of Appeals for the Fifth Circuit affirmed.[289]

The shareholders alleged four circumstantial factual matters for scienter. First, these executives, except for the controller, knew the bank was undercapitalized through attendance at meetings to raise more capital.[290] This alone is insufficient because all corporate executives possess the desire to raise more capital.[291] The Fifth Circuit has held multiple times that a desire to raise capital, receive incentive compensation, and sell stock at inflated prices, is insufficient to show a strong inference of scienter.[292] Second, these executive officers knew the bank's portfolio of non-agency

---

281. *See Southland*, 365 F.3d at 366.

282. *See* Owens v. Jastrow, 789 F.3d 529, 541 (5th Cir. 2015); Spitzberg v. Hous. Am. Energy Corp., 758 F.3d 676 (5th Cir. 2014), *rev'g In re* Hous. Am. Energy Corp., 970 F. Supp. 2d 613 (S.D. Tex. 2013).

283. Because the Fifth Circuit affirmed the dismissal for failure to plead a strong inference of scienter, it did not reach the loss causation issue or whether an outside director was a maker of the misrepresentations. *See Owens*, 789 F.3d at 546–47.

284. *See* Press Release, Federal Deposit Insurance Corporation, BBVA Compass, Birmingham, Alabama, Assumes All of the Deposits of Guaranty Bank, Austin, Texas (Aug. 21, 2009), https://www.fdic.gov/news/news/press/2009/pr09150.html [https://perma.cc/QXP2-4WZG] (closing Guaranty Bank cost the agency's insurance fund $3 billion).

285. *See* Mark G. Douglas, *The Year in Bankruptcy 2009: Part I*, PRATT's J. BANKR. L. 2010.03-9.

286. *Owens*, 789 F.3d at 534.

287. *Id.*; *see* Plaintiff's Original Complaint ¶ 5, Tepper v. Temple-Inland, Inc., No. 11CV02088 (N.D. Tex. Aug. 22, 2011), 2011 WL 3665678 (explaining that cross-covenants provided that if bank became insolvent, Temple-Inland's debt defaulted); *id.* ¶¶ 227–431 (claiming sixteen counts of fraudulent transfers and breaches of fiduciary duty).

288. *Owens*, 789 F.3d at 534.

289. *Id.* at 547.

290. *Id.* at 538.

291. *Id.* at 539.

292. *See* Goldstein v. MCI WorldCom, 340 F.3d 238, 246 (5th Cir. 2003); Abrams v. Baker Hughes Inc., 292 F.3d 424, 434 (5th Cir. 2002).

mortgage backed securities, amounting to 22% of the bank's assets, was performing poorly with a 250% increase in delinquency rate, a drop in value to 60% of cost, and a downgrading of ten of its securities.[293] These "red flags" did not provide a strong inference of scienter because they were promptly disclosed to the marketplace.[294] Third, these officers knew their reported valuations of the non-agency mortgage-backed securities violated generally accepted accounting principles (GAAP) by not recognizing losses as "other than temporary."[295] These reported valuations, however, were accompanied by explanatory and cautionary information, such as disclosing that the valuations were difficult, involved a high degree of uncertainty, and might prove to be materially wrong.[296] Further, the chief executive officer and chief financial officer had received emails from other officers identifying valuation deficiencies without mentioning GAAP.[297] But the mortgage-backed securities were rated AAA by the rating agencies, and the bank's regulator (the Office of Thrift Supervision) regarded these ratings as crucial in valuing the securities.[298] Fourth, the magnitude of the valuation errors was large.[299] But the entire industry relied on the AAA ratings in the face of uncertainty and disagreement about the valuation of mortgage-backed securities.[300]

The shareholders' main ground for reversal was that the district court's two-step process of examining each allegation, weighing each allegation separately first before weighing them collectively, conflicted with the U.S. Supreme Court's requirement that courts weigh all allegations holistically.[301] But the Fifth Circuit, even after the Supreme Court's pronouncement, has approved the two-step process as being more efficient.[302] If one of the allegations is sufficient, the court need not examine the other allegations. The executives' main ground for affirmance was that the shareholders' allegations contained impermissible group pleading. The Fifth Circuit agreed that the shareholders mixed individually specific allegations with group allegations, but felt confident that it could separate out which group allegations applied to which executive.[303] When the Fifth Circuit examined all the allegations holistically, it determined that the executives merely exhibited poor business judgment, similar to thousands

293. *See* Appellant's Opening Brief at 47, Owens v. Jastrow, 789 F.3d 529 (5th Cir. 2015) (No. 13-10928), 2014 WL 796024. Non-agency mortgage backed securities are issued by private institutions and do not conform to the requirements of those guaranteed by agencies such as Ginnie Mae, Fannie Mae, or Freddie Mac. *See id.* at 9–10.

294. *Owens*, 789 F.3d at 540.

295. *Id.*

296. *Id.* at 541.

297. *Id.* at 544.

298. *Id.*

299. *Id.* at 541.

300. *Id.* at 544.

301. *See* Tellabs, Inc. v. Makor Issues & Rights Ltd., 551 U.S. 308, 326 (2007); *Owens*, 789 F.3d at 536.

302. *Owens*, 789 F.3d at 537; *see* Cent. Laborers' Pension Fund v. Integrated Elec. Servs. Inc., 497 F.3d 546, 552–55 (5th Cir. 2007); *see also* Flint 61, *supra* note 246, at 1123–25 (discussing *Central Laborers*, 497 F.3d 546).

303. *Owens*, 789 F.3d at 538.

of other financial institutions relying on AAA ratings during the crises that were unable to fully appreciate the severity of the crises and recognize that their securities had become riskier than originally believed.[304]

In *Spitzberg v. Houston American Energy Corp.*, the U.S. Court of Appeals for the Fifth Circuit dealt with a company developing an oil and gas concession in Colombia.[305] Within days of a 35% plunge in the value of the stock, shareholders brought a Rule 10b-5 action for securities fraud against the company, two of its officers, and several of its directors. The shareholders alleged two misrepresentations. First, in a slide presentation to investors in 2009, the company claimed its concession had recoverable reserves of four billion barrels.[306] The term "reserves" means estimated amounts based on actual production or formation tests.[307] The company had not conducted any formation tests, much less achieved actual production. Second, regulatory filings in 2011 claimed a well on the concession "produced 'strong inflow[s]' and 'significant shows' of both 'gas and oil'" at a time when the well produced no inflows or shows.[308] The district court dismissed the action for failure to plead a sufficiently strong inference of both scienter and loss causation. The Fifth Circuit reversed and remanded.[309]

The Fifth Circuit found that allegations surrounding both of these misrepresentations represented recklessness and hence satisfied the heightened scienter requirement of the PSLRA.[310] For the slide show misrepresentations, the investors also alleged a news website decrying the company's claim for reserves as the most audacious claim by any company operating in Colombia.[311] Using the term "reserves" to mean something other than what the industry understands it to mean constituted recklessness because the allegations showed it had seriously misled inves-

---

304. *Id.* at 545.

305. *See* Spitzberg v. Hous. Am. Energy Corp., 758 F.3d 676, 680 (5th Cir. 2014).

306. *See* Brief for Plaintiffs-Appellants at 6, *Spitzberg*, 758 F.3d 676 (5th Cir. 2014) (No. 13-20519) (stating that the Form 8-K filing included slides prepared for an investor presentation).

307. *See* Soc'y of Petroleum Eng'rs, *Petroleum Resources Management System*, 2008, at 1, 3, 24, http://www.spe.org/industry/docs/Petroleum_Resources_Management_System_2007.pdf [https://perma.cc/2LXU-6CN6] ("To be included in the Reserves class, there must be a high confidence in the commercial producibility of the reservoir as supported by actual production or formation tests."); *compare id.* at 44 ("Reserves are those quantities of petroleum anticipated to be commercially recoverable by application of development projects to known accumulations from a given date . . . ."), *with* 17 C.F.R. § 210.4-10(a)(26) (2011) ("Reserves are estimated remaining quantities of oil and gas and related substances anticipated to be economically producible, as of a given date, by application of development projects to known accumulations."), *and* Modernization of Oil and Gas Reporting, 74 Fed. Reg. 2158, 2160 (Jan. 14, 2009) ("The revisions and additions to the definition section . . . update our reserves definitions to reflect changes in the oil and gas industry . . . designed to be consistent with the Petroleum Resource Management System (PRMS)").

308. *Spitzberg*, 758 F.3d at 681.

309. *Id.* at 676.

310. *Id.* at 684.

311. *See* Consolidated Class Action Complaint ¶ 79, *In re* Hous. Am. Energy Corp. Sec. Litig., 970 F. Supp. 2d. 613 (S.D. Tex. 2013) (No. 4:12-cv-01332) (referring to allegations about the Shareshleuth.com article).

tors.[312] For the misrepresentations in the regulatory filings, the investors also alleged that a confidential witness, an employee of the company's partner who did the drilling, reported that there were no inflows or shows from the well on the concession and as a result his company refused to drill an additional test well.[313] Consequently, a falsity that related to essentially the entire business of the operation constituted recklessness since it could seriously mislead investors.[314] The Fifth Circuit found this conclusion supported by another allegation: the allegation that the SEC had issued subpoenas for the testimony of the chief executive officer and chief financial officers and for certain documents to determine whether the company had violated the securities laws.[315] Pressure from the news website and the SEC could have mandated the company's additional well test to prove them wrong.[316]

Scienter was not the only securities issue confronted by the Fifth Circuit in *Spitzberg*. The second ground for dismissal by the district court was failure to allege a heightened loss causation, negating other possible explanations such as changed economic circumstances or investor expectations or industry specific facts.[317] The Fifth Circuit recognizes no such requirement; notice pleading is sufficient.[318] Instead, a stock drop after a

---

312. The fraudsters claimed that investors would not be misled since they had only referred to future drillings. *Spitzberg*, 758 F.3d at 689–90. Had there been any past drillings, they would have named them. Moreover, they had disclaimers in the slide show that they were using terms that the SEC prohibits in its filings. Unfortunately, such a disclaimer did not identify "reserves" as one of those definitions. *Id.* at 690–91. The prohibited terms in a previous era were "probable reserves" and "possible reserves." As of the beginning of the year in which the slide show occurred, the SEC allowed in probable reserves and possible reserves. *See* Modernization of Oil and Gas Reporting, 74 Fed. Reg. 2158, 2167 (Jan. 14, 2009).

313. *See* Consolidated Class Action Complaint ¶¶ 63, 95, *In re* Hous. Am. Energy Corp. Sec. Litig., 970 F. Supp. 2d. 613 (S.D. Tex. 2013) (No. 4:12-cv-01332) (describing allegations by confidential witnesses and SK Innovation Co's refusal to drill a second test well).

314. *Spitzberg*, 758 F.3d at 684.

315. *See id.* at 686; Consolidated Class Action Complaint ¶¶ 106, 110, *In re* Hous. Am. Energy Corp. Sec. Litig., 970 F. Supp. 2d. 613 (S.D. Tex. 2013) (No. 4:12-cv-01332).

316. *See Spitzberg*, 758 F.3d at 684. The trial court could not imagine any company wasting a huge amount of money on a test well unless it believed there was oil present, negating scienter. *See In re* Hous. Am. Energy Corp. Sec. Litig., 970 F. Supp. 2d 613, 654 (S.D. Tex. 2013), *rev'd*, *Spitzberg*, 758 F.3d 676 ("[T]o spend another $5 million for more testing . . . was a desperate 'Hail Mary' decision [that] does not make sense for a small company . . . .").

317. *Spitzberg*, 758 F.3d at 686–87. The district court claimed not to use a heightened test, then did. *See In re Hous. Am. Energy Corp.*, 970 F. Supp. 2d at 620 (stating that notice pleading, not heightened pleading, is sufficient); *but cf. id.* at 654 ("Plaintiffs fail to address whether the alleged misstatements or omissions were the actual cause of their economic loss as opposed to other explanations . . . ."). The district court's error was to incorrectly cite a portion of a Supreme Court decision relating to what needs to be proved and to disregard the Supreme Court's avoidance as to whether the securities laws require more than notice pleading. *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 342–44 (2005).

318. *See* Lormand v. US Unwired, Inc., 565 F.3d 228, 267 (5th Cir. 2009) ("[W]e are not authorized or required to determine whether the plaintiff's plausible inference of loss causation is equally or more plausible than other competing inferences . . . ."); *see also* George Lee Flint, Jr., *Securities Regulation*, 63 SMU L. Rev. 795, 809–11 (2010) [hereinafter Flint 63] (discussing *Lormand*, 565 F.3d 228).

corrective disclosure is enough for loss causation allegations; the corrective disclosure does not have to be complete or mirror the misstatement either.[319] Consequently, an allegation that the stock plunged 35% when the issuer announced the abandonment of well drilling on the concession was sufficient to allege loss causation.[320]

The Fifth Circuit also addressed two other issues with respect to the slide presentation. First, the fraudsters asserted that their slide presentation was protected by the PSLRA safe harbor for forward-looking statements.[321] The Fifth Circuit noted that the slide presentation was a mixed statement.[322] Estimated recoverable reserves could be a forward-looking statement, but the shareholders saw the reserves as meaning that there had been past drilling on which to base the amount of reserves. Because the misrepresentations concerned the non-forward-looking statements, the Fifth Circuit decided to join the First, Third, and Seventh Circuits in denying the safe harbor to mixed statements.[323] Second, the fraudsters asserted that the two-year statute of limitations began when they filed a Form 10-K with the SEC that there were only 1.2 million barrels of proved reserves, thus negating the claim of 4 billion reserves.[324] the fraudsters argued that the two years had elapsed before the shareholders filed.[325] The Fifth Circuit found this unpersuasive because "proved reserves" is a subcategory of reserves and so does not negate the misrepresentation.[326]

IV. CONCLUSION

Several courts addressed the scope issues of the TSA and the TSFA. In an action by investors against a serial fraudster, the Texas Supreme Court determined that the interests in life settlements sold by the fraudster constituted investment contracts under the TSA and therefore constituted securities. The year before, a federal district court in Texas had determined the same and enabled the SEC to levy serious civil fines against a serial fraudster, resulting in the issuer seeking bankruptcy protection. The First Houston Court of Appeals found that an agreement, among other things, also transferred ownership of previously awarded stock subject to forfeiture by eliminating the forfeiture provision that dealt with a transaction involving stock in a corporation under the TSFA. Thereby an em-

319. *See* Alaska Elec. Pension Fund v. Flowserve Corp., 572 F.3d 221, 230–32 (5th Cir. 2009); Flint 63, *supra* note 318, at 812 (discussing *Alaska Electrical*, 572 F.3d 221).

320. *Spitzberg*, 758 F.3d at 688–89.

321. *See* 15 U.S.C. § 78u-5(a) (2012); *Spitzberg*, 758 F.3d at 691.

322. *Spitzberg*, 758 F.3d at 691.

323. *Id.*; *see* Institutional Inv'r Grp v. Avaya, Inc., 564 F.3d 242, 255–56 (3d Cir. 2009); Makor Issues & Rights, Ltd. v. Tellabs Inc., 513 F.3d 702, 705 (7th Cir. 2008); *In re* Stone & Webster, Inc. Sec. Litig., 414 F.3d 187, 213 (1st Cir. 2005).

324. *See* 28 U.S.C. § 1658(b) (providing that the statute of limitations on a private right of action for violations of the EA runs either two years from discovery of facts or five years from the violation); *Spitzberg*, 758 F.3d at 692.

325. *Spitzberg*, 758 F.3d at 692.

326. *Id.* at 692–93.

ployer could bring suit against a defrauding employee under the separation agreement that also provided for consulting work with a non-disclosure provision and a non-competition provision. Because the agreement also contained a non-compete, the Covenants Not to Compete Act applied to legal fees, not the TSFA. For both the TSA and TSFA, the U.S. Supreme Court confirmed that non-covered securities backed by, but not secured by, covered securities did not trigger the preemptive effect of SLUSA.

The TSSB made several additions to its rules, mostly coordinating with the federal scheme. Since the SEC has recently finalized its crowdfunding rules, the TSSB adopted one to permit sales to Texans through a TSSB-approved crowdfunding portal, limited to those efforts that are exempt from the federal registration requirements through the intra-state exemption. The TSSB also adopted rules to correspond to SEC actions: one exempting certain mergers and acquisition dealers and the other exempting certain investment advisers to private funds. The TSSB's enforcement efforts for unregistered securities focused primarily on serial fraudsters advertising over the internet without disclosing their track record of securities law violations and criminal convictions. The enforcement efforts against market operators mostly dealt with multi-state actions against big brokerages and their failure to supervise their employees to insure their registration in the appropriate states. One Texas court of appeals revealed the importance of defendants hiring securities lawyers to handle appeals of TSSB orders since the TSA procedure is different from the one specified in the Administrative Procedures Act.

For the federal fraud action, the U.S. Supreme Court reversed a Fifth Circuit opinion on the rebuttable presumption of reliance, while the U.S. Court of Appeals for the Fifth Circuit dealt with two cases concerning the scienter requirement. The Supreme Court decided to permit introduction of price impact of the misrepresentation by the issuer at the class certification stage of a securities fraud class action lawsuit because the investors must show an efficient market and already introduce some price impact information for that purpose. The Fifth Circuit determined that allegations of circumstances for bankers following industry norms with respect to AAA rated investments does not give a strong inference of scienter. In contrast, using terms contrary to the industry norms, such as "reserves" by an oil and gas issuer, misleads investors, amounts to recklessness, and so gives a strong inference of scienter.