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SECURITIES REGULATION

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Securities regulation deals primarily with the laws preventing and providing remedies for fraud in the sale of stocks and bonds. Texas has two major statutes to combat securities fraud: The Texas Securities Act (TSA) and the Texas Stock Fraud Act (TSFA).[1] Because 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 TSA's similar language.[3] This article, therefore, includes the U.S. Court

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1. *See* TEX. REV. CIV. STAT. ANN. art. 581-1–581-600; TEX. BUS. & COM. CODE ANN. § 27.01.

2. *See* TEX. REV. CIV. STAT. ANN. art. 581-33 cmt. (Comment to 1977 Amendment); House Comm. of Fin. Insts., Tex. S.B. 469, 65th Leg., R.S. (1977).

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, 1130 n.3 (2013) (discussing *Highland Capital Mgmt., L.P.*); George Lee Flint, Jr., *Securities Regulation*, 60 SMU L. REV. 1293, 1299–302 (2007) (discussing *Anglo-Dutch Petroleum Int'l, Inc.*).

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 Texas developments of interest during the period of December 1, 2017 to November 30, 2018.

I. COVERAGE OF THE FEDERAL SECURITIES ACTS

The definitions, especially those relating to what constitutes a security and the persons liable, determine the fraudulent transactions subject to the securities acts.[4] The Fifth Circuit dealt with a securities broker seeking a reduced enhancement of his prison term, claiming he sold insurance products rather than the securities forbidden under a regulatory body's order.[5] The Fifth Circuit also confronted a buyer of bonds of a failed corporation claiming that his corporate broker and its parent had aided and abetted the corporate fraud engaged in by another corporate subsidiary.[6]

A. "Insurance Contracts" as Securities

The Federal Securities Act defines "securities" to include bonds, participations in profit-sharing agreements, and investment contracts.[7] Nevertheless, the federal public defender in *United States v. Blount*, representing a criminal defendant seeking a reduced enhancement on his imprisonment for marketing a Ponzi scheme while subject to a prior order of the Financial Industry Regulatory Authority (FINRA) barring him from selling "securities," claimed that certain investments sold in the Ponzi scheme by the defendant, a licensed insurance salesman, were insurance contracts and not securities.[8] The defendant advertised "himself as selling annuities, life insurance, long-term care insurance, disability income insurance, and employee health benefits planning."[9] However, he "primarily offered and sold discretionary IRA's" consisting of "Timber

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

5. United States v. Blount, 906 F.3d 381, 383 (5th Cir. 2018).

6. Giancarlo v. UBS Fin. Servs., Inc., 725 F. App'x 278 (5th Cir. 2018), *cert. denied*, 139 S. Ct. 199, 202.

7. 15 U.S.C. § 77b(a)(1) (2018).

8. *Blount*, 906 F.3d at 383, 385. The defendant had previously worked as a licensed securities broker selling unsuitable investments to investors for a decade by misrepresenting material information. *Id.* at 383. Consequently, FINRA issued an order banning him from the securities industry. *Id.* Nevertheless, the defendant resumed working as a licensed securities broker for an additional decade selling investments in his Ponzi scheme until FINRA reported him to government authorities who prosecuted him for wire fraud and obtaining his prison sentence, enhanced for violating a prior administrative order, which the defendant did not appeal. *Id.* at 383–84. The defendant later filed a motion to vacate the sentence due to ineffective counsel and obtained a slightly reduced prison sentence, which he appealed to the Fifth Circuit to remove the enhancement for violating the FINRA order. *Id.* at 384.

9. Original Brief for the Appellant John Steven Blount at 11, *Blount*, 906 F.3d 381 (No. 17-30623), 2018 WL 333378, at *11.

Investment Management Organization bonds, representing investments in timber companies who sell timber to other companies for profit," promising returns between 11% and 15%.[10] The defendant also sold fictitious "remodeling contracts" between one of his shell companies and major retail outlets, projecting returns of 15% to 19%.[11] It did not take long for the U.S. Court of Appeals for the Fifth Circuit to reject the defendant's contention. These investments were bonds and investment contracts, clearly included within the definition of securities.[12]

B. Corporate Subsidiaries as Aiders and Abettors

The United States Supreme Court does not impute securities fraud liability from one corporate entity to another related entity when they follow corporate formalities.[13] In *Giancarlo v. UBS Financial Services, Inc.*, the class action plaintiffs attempted to hold liable a corporate investment bank and two of its corporate subsidiaries—one an investment banker for the defrauding corporation and the other the retail brokerage dealing with the plaintiffs—for the investment bank subsidiary's structuring investment vehicles that enabled the defrauding corporation to mislead the public concerning its financial performance.[14] The trial court dismissed the action for failure to state a cause of action.[15] The enterprising plaintiffs' attorneys concocted a joint venture theory to impute the knowledge of the parent corporation and its investment banking subsidiary corporation concerning the fraud of the defrauding corporation to the other corporate subsidiary, the retail brokerage with which the plaintiffs had dealt.[16] The U.S. Court of Appeals for the Fifth Circuit quickly rejected

10. *Id.* The federal public defender's second argument for the defendant's non-violation of the FINRA order was that he made the sales as insurance products under an insurance license. *Id.* at *12.

11. Brief on Behalf of the Appellee at 5–6, *Blount*, 906 F.3d 381 (No. 17-30623), 2018 WL 921692, at *5–6.

12. *Blount*, 906 F.3d at 386. Consequently, the defendant had violated the FINRA order and his enhanced prison term was upheld. *Id.* at 386–87. The other issue in the case was whether the FINRA order was an administrative order for purposes of the enhancement, raised for the first time on appeal. *Id.* at 384. Since the Fifth Circuit had no precedents that FINRA, although a private self-regulatory entity, nevertheless mirrored a typical government oversight body, and any error of the district court was not "obvious" or "readily apparent." *See id.* at 385.

13. *See* Janus Capital Grp., Inc. v. First Derivative Traders, 564 U.S. 135, 137–46 (2011) (declining to disregard the corporate structure to impute securities fraud liability to a parent corporation and its subsidiary corporation serving as an investment advisor to a third entity, a mutual fund created by the parent corporation, that issued a false prospectus since corporate formalities were followed).

14. Giancarlo v. UBS Fin. Servs., Inc., 725 F. App'x 278, 279–80 (5th Cir. 2018), *cert. denied*, 139 S. Ct. 199, 202.

15. *Id.* at 278.

16. *See* Appellants' Brief at 19–22, *Giancarlo*, 725 F. App'x 278 (No. 16-20663), 2017 WL 896069, at *19–22. The trial court in a companion case to *Giancarlo* similarly refused to increase securities fraud liability by expanding it from one entity to another when the activities of the two entities are not overlapping. *See In re* Enron Corp. Sec., Derivative & "ERISA" Litig., 238 F. Supp. 3d 799, 900 (S.D. Tex. 2017).

The securities laws also require a Chinese wall between the investment banking portions and the retail brokerage departments of investment banks to prevent insider trading, which

the joint venture theory because the two subsidiaries were organized under Delaware law[17] and Delaware law required a sharing of both profits and losses among the joint venturers which was absent from the pleadings.[18]

The Fifth Circuit then examined the securities fraud elements[19] for the two entities with knowledge of the defrauding corporation, focusing on the presumption of reliance from the materiality of the omission, which requires a duty to disclose.[20] The plaintiffs' attorneys attempted to manufacture three duties. First was a National Association of Securities Dealers (NASD) rule requiring disclosure of an omission that would make a prior communication misleading, but there was no prior communication by the parent and the investment banking subsidiary.[21] Second was a duty to disclose inside information under a special relationship, but the Supreme Court had previously rejected a duty to disclose from the mere possession of inside information.[22] Third, the investment banker was a market maker, but the plaintiffs did not allege that they bought from that market maker, of which there were many.[23] For the brokerage subsidiary, the plaintiffs claimed a duty through the retail relationship, but the plaintiffs did not demonstrate the brokerage subsidiary had any knowledge to disclose.[24] Because plaintiffs' attorneys were unable to find any duty for the parent corporation and the investment banking subsidiary to disclose to the clients of the brokerage subsidiary, the Fifth Circuit affirmed the dismissal.[25]

II. REGISTRATION AND ENFORCEMENT

The TSA created the Texas State Securities Board (TSSB) to handle the registrations required by the TSA and to serve as an enforcement agency.[26] The basic rule of most securities laws is that securities must be

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if present would destroy the attribution of the knowledge of one to the other. *See generally* WILLIAM M. PRIFTI, 24 SECURITIES: PUBLIC AND PRIVATE OFFERINGS § 5:30 (2d ed. 2010).

17. *See* Brief of Appellees at 6, *Giancarlo*, 725 F. App'x 278 (No. 16-20663) (5th Cir. 2018), 2017 WL 6371456, at *6. The plaintiff also contended in oral argument that Delaware law governed. *Giancarlo*, 725 F. App'x at 283 n.4.

18. *Giancarlo*, 725 F. App'x at 284.

19. For the elements of securities fraud actions under the federal statutes, see *infra* note 72 and accompanying text.

20. *See* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 153–54 (1972) (for securities fraud based on failure to disclose rather than on a misrepresentation, all that need be shown for reliance is a duty to disclose material information that was breached); *Giancarlo*, 725 F. App'x at 283.

21. *Giancarlo*, 725 F. App'x at 284–85; *see* NASD Manual, Rule 2210(d)(1)(A) (now Financial Industry Regulatory Authority (FINRA) Rule 2210).

22. *Giancarlo*, 725 F. App'x at 285; *see* Chiarella v. United States, 445 U.S. 222, 230 (1980).

23. *Giancarlo*, 725 F. App'x at 285–86.

24. *Id.* at 286.

25. *Id.* at 289. The non-securities issue in the case involved the refusal to allow the plaintiffs to amend the complaint due to the failure to timely amend the complaint and the failure to explain their long delay in seeking to amend the complaint. *See id.* at 287–89.

26. *See* TEX. REV. CIV. STAT. ANN. art. 581-2.

registered with their corresponding regulatory agency unless they fall within an exemption.[27] Similarly, 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.[28] Enforcement actions generally focus on issuers failing to register their securities, and simultaneously their selling agents, and making misleading statements to aid their sales.

A. Registration of Securities

The TSSB updated its registration requirements to increase uniformity with other states in reviewing applications to register securities by amending its rules to conform to the recently updated North American Securities Administrators Association (NASAA) policies, principally permitting electronic offering documents and electronic signatures.[29]

B. Exempt Transactions

The Securities and Exchange Commission (SEC) recently amended its intrastate exemption from federal registration, principally by adopting Rule 147A to facilitate crowdfunding by not requiring issuers to be incorporated in the state where the securities are sold, provided their principal place of business is in that state, and not banning them from general solicitation, provided they make sure the purchasers are residents of that state.[30] The TSSB made a number of changes to its rules to facilitate a Rule 147A offering, by (1) adding a rule for the exemption[31]; (2) prescribing a form for the notice to the TSSB claiming the exemption[32]; (3) amending the crowdfunding portal rules to allow the portals to offer and sell the Rule 147A offering[33]; and (4) changing the crowdfunding portal forms to effect the changes.[34] The TSSB also amended its crowdfunding exemption rule to permit the use of segregated accounts up to $1 million in lieu of an escrow account because the escrow agent providing that ser-

27. *See id.* art. 581-7(A).
28. *See id.* art. 581-13(A).
29. *See* 2018 Tex. Reg. Text 476675 (NS), *adopted by* 2018 Tex. Reg. Text 476675 (NS) (codified at 7 Tex. Admin. Code Ann. § 113.14).
30. *See* 17 C.F.R. § 230.147A (2018).
31. *See* 2018 Tex. Reg. Text 476682 (NS), *adopted by* 2018 Tex. Reg. Text 476682 (NS) (codified at 7 Tex. Admin. Code Ann. § 139.26) (provided the issuer is not a public company or securities investor, the offer is made exclusively with a registered dealer or crowdfunding portal with specified information, receives no more than $5,000 from a single purchaser, uses an escrow account or segregated account up to $1 million, and files a notice with the TSSB).
32. *See* 2018 Tex. Reg. Text 476681 (NS), *adopted by* 2018 Tex. Reg. Text 476681 (NS) (codified at 7 Tex. Admin. Code Ann. § 133.21).
33. *See* 2018 Tex. Reg. Text 476676 (NS), *adopted by* 2018 Tex. Reg. Text. 476676 (NS) (codified at 7 Tex. Admin. Code Ann. §§ 115.19 & 115.20).
34. *See* 2017 Tex. Reg. Text 476679 (NS), *adopted by* 2018 Tex. Reg. Text. 476679 (NS) (retracting 7 Tex. Admin. Code Ann. § 133.15 & 133.20); 2017 Tex. Reg. Text 476680 (NS), *adopted by* 2018 Tex. Reg. Text 476680 (NS) (codified at 7 Tex. Admin. Code Ann. §§ 133.15 & 133.20).

vice decided to end its service.[35]

C. 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.[36] Registration infractions generally surface when applying or reapplying for registration.

The TSSB prosecuted several enforcement actions against dealers and selling agents for the failure of a registered agent to report various embarrassing required matters,[37] including (1) a discharge from employment as a selling agent for using an email account to solicit clients for the selling agent's side businesses as a financial advisor and insurance salesman[38]; (2) a criminal misdemeanor for theft of property valued between $50 and $500[39]; (3) six unsatisfied tax liens from the Internal Revenue Service (IRS)[40]; and (4) three compromises with creditors and two civil judgments while serving as a selling agent.[41] The TSSB also prosecuted enforcement actions against a provider of brokerage and technology services for failing to follow its supervisory procedures to learn that two investment advisers had failed to renew their registrations in Texas[42] and against a dealer for not having supervisory procedures in place governing fees for clients moved from brokerage to investment advisory accounts, resulting in overcharging some clients.[43]

The TSSB prosecuted several enforcement actions against investment advisers and investment-adviser representatives. These involved (1) failure to renew the registration resulting in practicing unregistered[44]; (2)

35. *See* 2017 Tex. Reg. Text 467148 (NS), *adopted by* 2017 Tex. Reg. Text 467148 (NS) (codified at 7 Tex. Admin. Code Ann. § 139.25).

36. *See* Tex. Rev. Civ. Stat. Ann. art. 581-13(A).

37. *See* 7 Tex. Admin. Code Ann. § 115.9(a)(6) (requiring dealers and their agents to report changes on previously filed forms within thirty days).

38. *See In re* Agent Registration of Mohamed H. Eldawy, No. REG18-SUS-03, 2018 WL 3972287, at *2–3 (Tex. St. Sec. Bd. Aug. 15, 2018) (suspension for sixty days).

39. *See In re* Inv. Adviser Representative Registration and the Agent Registration of John William Noey, No. IC18-CAF-01, 2018 WL 3972284, at *1–2 (Tex. St. Sec. Bd. Aug. 15, 2018) (reprimanded and administrative fine of $5,000).

40. *See In re* Inv. Adviser Representative Registration and the Agent Registration of Richard L. Havard, No. REG17-CAF-07, 2017 WL 6421021, at *1–2 (Tex. St. Sec. Bd. Dec. 1, 2017) (reprimanded and administrative fine of $7,500).

41. *See In re* Agent Registration of Octavio Tovar, No. REG17-CAF-06, 2017 WL 5689554, at *1–2 (Tex. St. Sec. Bd. Nov. 21, 2017) (reprimanded and administrative fine of $3,000).

42. *See In re* Dealer Registration of Trade-PMR Inc., No. IC18-CAF-03, 2018 WL 5911715, at *1–2 (Tex. St. Sec. Bd. Nov. 5, 2018) (reprimanded and administrative fine of $25,000).

43. *See In re* Dealer and Inv. Adviser Registration of Brazos Sec., Inc., No. IC18-CAF-04, 2018 WL 5911713, at *1–2 (Tex. St. Sec. Bd. Nov. 5, 2018) (reprimanded and administrative fine of $20,000).

44. *See In re* Inv. Adviser Registration of TK2 Advisers, No. IC18-CAF-02, 2018 WL 3972286 (Tex. St. Sec. Bd. Aug. 15, 2018) (reprimand and retention of a compliance auditor for two years).

engaging in inequitable securities sales practices by recommending an active trading strategy without considering trading costs and the rate of return needed to earn a profit[45]; (3) providing discretionary investment management services to five clients using their personal usernames and passwords to log into their retail brokerage accounts without registering with the TSSB in any capacity[46]; (4) failing to cooperate with a TSSB investigation into suspected solicitation of potential investors for private securities via email and refusal to provide the requested email records[47]; and (5) failing to report various required matters such as unsatisfied judgments.[48]

At its most recent session, the Texas Legislature enacted a bill to protect vulnerable adults (those over sixty-five years old or with disabilities) from financial exploitation (taking the vulnerable adult's property or depriving him or her of its use) by enlisting dealers and investment advisers in ferreting out securities fraud on vulnerable adults.[49] Dealers and investment advisers protect vulnerable adults by assessing suspected financial exploitation and submitting reports to the Texas Securities Commissioner, and placing holds on the vulnerable adult's accounts.[50] To implement this act, the TSSB adopted rules, one for dealers and one for investment advisers, requiring them to establish and implement written procedures for collecting and reporting information relating to the suspected financial exploitation of vulnerable adults and specifying the information for their written report submitted electronically to the TSSB.[51] And the TSSB prosecuted an enforcement action against a person who serviced the computer of an 88-year old and began trading securities from the elderly victim's securities account with a registered dealer; the dealer filed a report of suspected financial exploitation of the elderly person when $27,000 was transferred from the securities account to a linked account at a credit union.[52]

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45. *See In re* Inv. Adviser Representative Registration of Jason N. Anderson, No. REG18-SUS-01, 2018 WL 706291 (Tex. St. Sec. Bd. Jan. 30, 2018) (suspension for ninety days).

46. *See In re* Inv. Adviser Registration of Sunlight Invs., No. REG18-CAF-02, 2018 WL 3434714 (Tex. St. Sec. Bd. July 10, 2018) (reprimanded and administrative fine of $15,000).

47. *See In re* Inv. Adviser Registration of Jackson Financial Servs., No. IC17-REV-05, 2017 WL 6942368 (Tex. St. Sec. Bd. Dec. 29, 2017) (registration revoked).

48. *See In re* Inv. Adviser Representative Registration and the Agent Registration of Robin Curt Holcomb, No. REG18-CAF-03, 2018 WL 6307933 (Tex. St. Sec. Bd. Nov. 27, 2018) (reprimand and administrative fine of $3,000).

49. *See* TEX. REV. CIV. STAT. ANN. art. 581-45; *see also* George Lee Flint, Jr., *Securities Regulation*, 4 SMU ANN. TEX. SURV. 425, 434 (2018) (discussing the legislative amendment to the TSA to protect vulnerable adults).

50. *See* TEX. REV. CIV. STAT. ANN. art. 581-45.

51. For dealers, see 2017 Tex. Reg. Text 476677 (NS), *adopted by* 2018 Tex. Reg. 476677 (NS) (codified at 7 TEX. ADMIN. CODE ANN. § 115.21 (2018)); for investment advisors, see 2017 Tex. Reg. Text 476678 (NS), *adopted by* 2018 Tex. Reg. Text 476678 (NS) (codified at 7 TEX. ADMIN. CODE ANN. § 116.21 (2018)).

52. *See In re* Mike Chamley, No. ENF-18-CDO-1766, 2018 WL 3831002, at *1–2 (Tex. St. Sec. Bd. Aug. 6, 2018) (ordering a hold and a cease and desist).

D. Enforcement

The TSSB generally enforces its requirements for registration through emergency orders.[53] Because con artists exploit current news and technology to confound unwary investors, the TSSB enumerates the top threats to investors: (1) cryptocurrencies, because they are not backed by the government and their price is not set by a centralized authority; (2) oil and gas deals, because investors can't investigate the claim; and (3) foreign currency trading, because it is volatile and can result in significant losses in a few hours.[54] The TSSB's actions focus on these threats.

Due to the recent excitement involving cryptocurrency investments, the TSSB conducted a major investigation of the promoters of these investments who appeared to be illegally or fraudulently using "online advertisements, social media, and other public solicitations to attract Texas investors."[55] Consequently, the TSSB had numerous actions against purveyors of cryptocurrencies through public solicitations, resulting in cease and desist orders and charges of selling unregistered securities through unregistered dealers, engaging in fraud by failing to make disclosures, and making materially misleading statements. These schemes involved (1) an investment in a bitcoin exchange lending up to $100,000 for up to 40% interest per month[56]; (2) a solicitation of investor sales agents to offer a cryptocurrency for commissions[57]; (3) a new digital currency that could be traded and later used to purchase blockchain technology earning up to 48% per month[58]; (4) a cryptocurrency exchangeable into fiat currency using photos of purported partners taken from unrelated individuals on the internet[59]; (5) a cryptocurrency trading program delivering 8% returns each week and promissory notes tied to the sale of marijuana promising 100% guaranteed returns[60]; (6) a cloud-based cryptocurrency

53. *See* Tex. Rev. Civ. Stat. Ann. art. 581–23.

54. *See* Tex. St. Sec. Bd., *Top 10 Investor Threats (In Time for the Holidays)* (Nov. 29, 2017), https://www.ssb.texas.gov/news-publications/top-10-investor-threats-time-holidays [https://perma.cc/KH63-MN97].

55. *See* Tex. St. Sec. Bd., *Widespread Fraud Found in Cryptocurrency Offerings* (Apr. 10, 2018), https://www.ssb.texas.gov/news-publications/enforcement-report-widespread-fraud-found-cryptocurrency-offerings [https://perma.cc/PW2Y-GG8G]. The TSSB "was the first state securities regulator to enter an enforcement order against a cryptocurrency firm" and also has entered the most of any state. *See* Tex. St. Sec. Bd., *Cryptocurrency Resources*, https://www.ssb.texas.gov/cryptocurrency-resources.

56. *See In re* BitConnect, No. ENF-18-CDO-1754, 2018 WL 400434, at *2, *7 (Tex. St. Sec. Bd. Jan. 4, 2018) (emergency cease and desist order).

57. *See In re* R2B Coin, No. ENF-18-CDO-1756, 2018 WL 577735, at *2, *7 (Tex. St. Sec. Bd. Jan. 24, 2018) (emergency cease and desist order).

58. *See In re* Davorcoin, No. ENF-18-CDO-1757, 2018 WL 818566, at *2, *5–6 (Tex. St. Sec. Bd. Feb. 2, 2018) (emergency cease and desist order).

59. *See In re* LeadInvest, No. ENF-18-CDO-1760, 2018 WL 1157270, at *5–3, *10 (Tex. St. Sec. Bd. Feb. 26, 2018) (emergency cease and desist order).

60. *See In re* Estrada Trucking, Inc.; Caleb Estrada Vasquez; Venture Capital Cash aka Capital Cash Funding aka Capital Cash; Fin. Freedom Club, Inc., dba Millionaire Mentor Univ.; Mark J. Moncher; 911 Moneystore, Inc., and Frank Dalotto, No. ENF-18-CDO-1761, 2018 WL 1789734, at *2, *5, *10 (Tex. St. Sec. Bd. Apr. 5, 2018) (emergency cease and desist order).

mining program[61]; (7) two bitcoin trading programs that would increase ten-fold in twenty-one days with returns 100% guaranteed[62]; (8) a bitcoin trading program using an automatic trading bot offering high returns with a 100% guarantee and testimonials from famous persons[63]; (9) a cryptocurrency mining program claiming annual interest rate returns of 180% to 250%[64]; (10) bitcoin mining contracts providing consistent returns of up to 150% per year[65]; (11) crypto mining power contracts with guaranteed returns of 200%[66]; and (12) a crypto mining program advertised on LinkedIn.[67] Two additional actions involved fraudulent cryptocurrency schemes, linked to foreign scammers, to extract moneys from Texan investors. One, based in Volgograd, Russia, sent spam emails impersonating a California-based crypto exchange platform directing investors to a website containing its misleading marketing efforts, including a video misrepresenting a Fortune journalist as one of the promoters.[68] Another one, based in Belize, offered shares in a company developing a hack-proof custody solution for digital assets to facilitate anonymous and untraceable transfers of cryptocurrencies and fiat currencies using a video of former President Obama touting the technology of the company imbedded on its website.[69]

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61. *See In re* Bitcoin Trading & Cloud Mining Ltd., aka BTCrush, Jaylon Cross, Bruce Rodgerson, Robin Lozinski and Thomas A. Johnson, No. ENF-18-CDO-1762, 2018 WL 2200023, at *2, *5–6 (Tex. St. Sec. Bd. May 8, 2018) (emergency cease and desist order).

62. *See In re* Forex EA & Bitcoin Inv., LLC, aka My Forex EA & Bitcoin Inv. LLC, aka My Forex EA, James Butcher and Richard Dunn, No. ENF-18-CDO-1763, 2018 WL 2198712, at *1–2, *4 (Tex. St. Sec. Bd. May 8, 2018) (emergency cease and desist order); *see also In re* Ultimate Assets, LLC, Daniel Dishmon and John Jason Woodard, No. ENF-18-CDO-1769, 2018 WL 4567821, at *1–2, *4 (Tex. St. Sec. Bd. Sept. 18, 2018) (emergency cease and desist order).

63. *See In re* Wind Wide Coin, aka WWC, Inc., Charles Roman, Fred Andrew and John Anny, No. ENF-18-CDO-1764, 2018 WL 2296149, at *2–3, *5–6 (Tex. St. Sec. Bd. May 15, 2018) (emergency cease and desist order).

64. *See In re* Symatri LLC FKA Sivitas, LLC, Mintage Mining, LLC, BC Holdings and Invs. LLC dba Mintage Mining, Social Membership Network Holding, LLC, Nui Social, LLC, Darren Olayan, Wyatt McCullough and William Douglas Whetsell, ENF-18-CDO-1765, 2018 WL 3434548, at *2–3, *13 (Tex. St. Sec. Bd. June 11, 2018) (emergency cease and desist order).

65. *See In re* USI-Tech Ltd., Clifford "Cliff" Thomas and Michael "Mike" Rivera, No. ENF-17-CDO-1753, 2017 WL 6731508, at *1–2, *4 (Tex. St. Sec. Bd. Dec. 20, 2017) (emergency cease and desist order).

66. *See In re* AWS Mining Pty Ltd., Automated Web Services Mining aka AWS Mining, Daniel Beduschi, Alexandre Campos, Jessica Nunes Sivirino, Mycoindeal, AWS Elite, Josiah Kostek, West Texas Oilfield Cloud Miners Club and Kenneth Luster, No. ENF-18-CDO-1771, 2018 WL 5911712, at *2, *11 (Tex. St. Sec. Bd. Nov. 6, 2018) (emergency cease and desist order).

67. *See In re* EXY Crypto aka EXECrypto, Morgan Nolan, Rafael Logan and Melissa Spring, No. ENF-18-CDO-1772, 2018 WL 5911714, at *1, *6 (Tex. St. Sec. Bd. Nov. 6, 2018) (emergency cease and desist order).

68. *See In re* Coins Miner Inv. Ltd. aka Coins Miner and Ana Julia Lara, No. ENF-18-CDO-1767, 2018 WL 4567819, at *1, *6 (Tex. St. Sec. Bd. Sept. 18, 2018) (emergency cease and desist order).

69. *See In re* DGBK Ltd. aka DigitalBank, Tim Weiss, Ranka Romic and Kim Joseph Manning, No. ENF-18-CDO-1768, 2018 WL 4567820, at *2–3, *9 (Tex. St. Sec. Bd. Sept. 18, 2018) (emergency cease and desist order).

The TSSB also prosecuted enforcement actions against an oil and gas drilling program and a currency trading program. The oil and gas program was marketed without disclosing the drilling costs, that the SEC had prosecuted actions against the promoters for securities fraud under the federal laws, that prior investors filed several civil actions against the promoters, or that there were numerous IRS tax liens against the promoters.[70] The currency trading program used a fraudulent certificate of formation and fake testimonials on its website, and it failed to disclose the background and expertise of its financial professionals doing the trading.[71]

III. SECURITIES FRAUD COURT DECISIONS UNDER THE FEDERAL ACTS

One major reason legislatures passed securities acts was to facilitate investors' actions to recover their moneys through a simplified fraud action that removed scienter and privity, the most difficult elements to prove in a common-law fraud action. These securities act changes generally apply only to the primary market. When investors purchase on the secondary market, their actions reintroduce these obstacles.

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 the TSA provisions with similar language.[72] 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.[73] The last element comes from the Private Securities Litigation Reform Act (PSLRA).[74]

A. Converting Consumer Fraud into Securities Fraud

When an issuer engages in practices that adversely affect its customers and spawn lawsuits on behalf of consumers and state agencies, they are also likely to adversely affect the share price, triggering shareholder lawsuits for securities fraud. In *Employees' Retirement System v. Whole Foods Market, Inc.*, the issuer had mislabeled pre-packaged foods by in-

70. *See In re* Sourcerock Energy Phoenix Prospect, LP; Sourcerock Energy GP, LLC; Sourcerock Energy Partners, LP; J.A. Gilbert aka Jason A. Gilbert; and Parker Hallam, No. ENF-18-CDO-1758, 2018 WL 939784, at *2–5 (Tex. St. Sec. Bd. Feb. 9, 2018) (emergency cease and desist order).

71. *See In re* GoForex Grp. aka Go Forex Grp., Mary A. Scott, and Sharon Henderson, No. ENF-18-CDO-1770, 2018 WL 4964196, at *3–5, *7 (Tex. St. Sec. Bd. Oct. 10, 2018) (emergency cease and desist order).

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

73. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341 (2005) (discussing commission rule 10b-5, 17 C.F.R. § 240.10b-5 (2018)).

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

cluding the weight of the packaging in the weight of the food, thereby charging consumers for more food than the packages actually contained, violating national weights and measures standards and state laws incorporating those standards.[75] Two actions by states resulted in fines approximately one year before the price of the stock declined.[76] A major city's consumer affairs department issued a blistering report about the overcharging one month before that price decline; the report caused intense media attention during that month.[77] The stock price declined 10% the day after the issuer released its third quarter results, which missed the issuer's sales target and showed a noticeable slowdown in sales growth after the release of the city's report.[78] Shareholders then brought a class action securities fraud lawsuit under the Federal Securities Exchange Act based on three types of statements: (1) assertions that the issuer provided competitive pricing to consumers and was working to improve its pricing; (2) proclamations that the issuer held itself to high standards for transparency, quality, and corporate responsibility; and (3) published earnings statements with inflated earnings in violation of generally accepted accounting principles that require substantial performance before recording the earnings.[79] The district court dismissed the securities lawsuit for failure to state a claim because they failed to properly allege material misrepresentation, scienter, or loss causation.[80]

The U.S. Court of Appeals for the Fifth Circuit affirmed because the first type of statement was not a misrepresentation, the second type of statement was not material, and the third type[81] did not cause the shareholders' losses.[82] The allegations concerning competitive pricing and improving pricing were not misrepresentations, because there were no allegations as to the pricing of competitors and no allegations as to the prior pricing of the issuer.[83] The allegations relating to high standards and corporate quality were not material, because a reasonable investor would not rely on generalized, self-serving statements by the issuer, but would rely on facts to determine whether the statements were true.[84] And the allegations concerning the earnings statements did not follow the Fifth Circuit's framework for loss causation: a corrective disclosure, with a stock price drop shortly thereafter, and elimination of other possible ex-

75. Employees' Ret. Sys. v. Whole Foods Mkt., Inc., 905 F.3d 892, 894–95 (5th Cir. 2018).

76. *Id.* at 895.

77. *Id.*

78. *Id.* at 895–96.

79. *Id.* at 896–98.

80. *See* Markman v. Whole Foods Mkt., Inc., 269 F. Supp. 3d 779, 786–87 (W.D. Tex. 2017), *aff'd sub nom.* Employees' Ret. Sys. v. Whole Foods Mkt., Inc., 905 F.3d 892 (5th Cir. 2018).

81. Financial Statements filed with the SEC not in compliance with generally accepted accounting principles are presumed to be misleading. *See* 17 C.F.R. § 210.4-01(a)(1) (2018).

82. *Employees' Ret. Sys.*, 905 F.3d at 900.

83. *Id.* at 900–01.

84. *Id.* at 901–02.

planations for the stock drop.[85] The alleged corrective statement (release of the earnings) did not reveal information not already known to the market, because the mislabeling scandal had been known for a month prior to the earnings report.[86] Nor did the allegations indicate that the disappointing sales numbers reflected customer dissatisfaction with the issuer's accounting practices.[87] Consequently, the Fifth Circuit affirmed.[88]

B. Scienter for Enhancing Revenue with Understated Loss Reserves

For scienter, the heightened federal pleading rule requires the complainant to state with particularity the circumstances constituting the fraud while the PSLRA requires the complainant to specify the fraudulent statement, reasons why the statement is false, and facts giving rise to a strong inference that the fraudster had the requisite intent.[89] In the Fifth Circuit, scienter requires an "intent to deceive . . . or that severe recklessness in which the danger of misleading [investors] is either known to the defendant or is so obvious that the defendant must have been aware of it."[90] Moreover, the Fifth Circuit has rejected the group pleading doctrine, so the scienter must be of a specific issuer officer and scienter may not be implied from prospectuses, registration statements, and press releases.[91]

Attorneys for shareholders in securities class actions continue to have difficulty pleading facts giving a strong inference of scienter. Yet, in *Alaska Electrical Pension Fund v. Asar*, the U.S. Court of Appeals for the Fifth Circuit found a class action complaint sufficient even though the court admitted the absence of a strong inference.[92] The issuer was a leading provider of orthotic and prosthetic patient care services with most of its revenue coming from reimbursements for its services by public and private insurers.[93] Problems in accounting developed for the issuer after Congress expanded the Medicare audit program; many of the issuer's clinics failed to collect the required documentation, thereby failing the audit and forcing a return of the reimbursement which might be recovered after a lengthy appeal.[94] Consequently, the issuer did not increase its

85. *Id.* at 903–04. For the framework, see Pub. Employees' Ret. Sys. of Mississippi, Puerto Rico Teachers' Ret. Sys. v. Amedisys, Inc., 769 F.3d 313, 320–21 (5th Cir. 2014).
86. *Id.* at 904.
87. *Id.*
88. *Id.* at 905.
89. *See* Fed. R. Civ. P. 9(b) (2018); 15 U.S.C. § 78u-4(b)(2)(a) (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.").
90. Southland Secs. Corp. v. INSpire Ins. Sols., Inc., 365 F.3d 353, 366 (5th Cir. 2004) (internal quotations omitted) (citing Broad v. Rockwell Int'l Corp., 642 F.2d 929, 961–62 (5th Cir. 1981) (en banc)); *see* George Lee Flint, Jr., *Securities Regulation*, 58 SMU L. Rev. 1135, 1155–56 (2005) (discussing *Southland*).
91. *See Southland*, 365 F.3d at 365–66.
92. Alaska Elec. Pension Fund v. Asar, 898 F.3d 648, 662 (5th Cir. 2018).
93. *Id.* at 652.
94. *Id.* at 653.

reserve for disallowed Medicare sales.[95] Another problem arose for the issuer when it implemented a new data management system, which resulted in fewer sales because employees had to spend significant amounts of time transitioning patient data to the new system.[96] The alleged misstatements dealt with depicting the issuer with strong same-store sales, stating (1) that its Medicare reimbursements were more successful than they were and that reserves were adequate; (2) assuring investors that internal controls were sufficient; and (3) understating the scope and size of financial restatements.[97] The issuer finally issued several restatements of its financials over a year's time in the amount of $87 million. These restatements included several SEC filings which: (1) suggested that unidentified former officers and employees may have fabricated inventory records; (2) claimed the chief executive and financial officers set an inappropriate tone by urging certain financial targets; and (3) claimed the chief financial officer engaged in inappropriate accounting practices to enhance the issuer's reported earnings.[98] The class action was filed prior to the restatements with the amended complaint alleging violations of Exchange Act section 10(b) for securities fraud and section 20(a) for control person liability.[99] The district court dismissed for failure to satisfy the pleading requirements for scienter.[100]

The Fifth Circuit noted that the U.S. Supreme Court has established a three point test for determining whether scienter satisfies the statutory requirement of a strong inference of scienter: (1) take the allegations as true; (2) consider the complaint in its entirety; and (3) take into account plausible opposing inferences.[101] The class action plaintiffs alleged that a strong inference of scienter could be found from (1) the magnitude and time period of the restatements; (2) the stock sales of the insiders; (3) the issuer's certifications under Sarbanes Oxley Act[102]; (4) the problems with the Medicare audits and implementation of the new data management system; (5) and the issuer's audit committee report included in an SEC filing.[103] The Fifth Circuit quickly dismissed the first four. The timing and magnitude of the accounting errors alone cannot support a strong inference of scienter; the significance depends on the circumstances, the pleading of which was missing in this case.[104] Insider trading alone "cannot create a strong inference of scienter," especially where, as here, there

95. *Id.*
96. *Id.*
97. *Id.*
98. *Id.* at 654.
99. *Id.*
100. *See* City of Pontiac Gen. Employees' Ret. Sys. v. Hangar, Inc., 2017 WL 384072, at *13 (W.D. Tex. Jan. 26, 2017).
101. *Alaska Elec. Pension Fund*, 898 F.3d at 655–56; *see* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 581 U.S. 308, 322–23 (2007).
102. *See* 15 U.S.C. § 7241 (2012).
103. *Alaska Elec. Pension Fund*, 898 F.3d at 656.
104. *Id.* at 656, 664; *see* Owens v. Jastrow, 789 F.3d 529, 541 (5th Cir. 2015); *see also* George Lee Flint, Jr., *Securities Regulation*, 2 SMU ANN. TEX. SURV. 437, 473–75 (2016) (discussing *Owens*).

is a plausible non-culpable explanation such as covering tax expenses pursuant to a 10b-1 trading plan.[105] Similarly, Sarbanes Oxley filings do not support a strong inference of scienter in the absence of facts that the certifiers had reason to know, or should have suspected from "glaring accounting irregularities," that the financials contained "material misstatements or omissions[;]" again, the pleadings of such facts were absent in this case.[106] And, the pleadings alleging officers must have known of misstatements from their position with the issuer are insufficient without special circumstances, which were absent in this case.[107] But, as for the audit committee's report, the majority of the Fifth Circuit panel determined differently. The audit committee's report made no finding as to the chief operating officer's role in the accounting, so for him there was no strong inference of scienter.[108] Similarly, the Fifth Circuit majority found no strong inference of scienter with respect to the chief executive officer and chief financial officer setting an inappropriate tone by urging certain financial targets because these are goals that virtually all issuer insiders have, and it was undisputed that a lower-level employee had orchestrated most of the fraud.[109] But, as to the chief financial officer's and another employee's use of inappropriate accounting practices to enhance the issuer's reported earnings, the Fifth Circuit majority found supportive of the inference that the chief financial officer shared the objective of enhancing the issuer's financial results or knew that others were doing so, contributing to the inference of scienter.[110] The dissenting opinion of the remaining member of the Fifth Circuit panel correctly noted that being supportive and contributing to the inference of scienter do not satisfy the statutory requirement for a strong inference of scienter.[111] Nevertheless, the Fifth Circuit reversed the trial court's decision with respect to the chief financial officer, affirmed the dismissal with respect to the chief executive officer and chief operating officer, and remanded to consider whether to dismiss the controlling person claims.[112]

105. *Alaska Elec. Pension Fund,* 898 F.3d at 657; *see* Cent. Laborers' Pension Fund v. Integrated Elec. Servs. Inc., 497 F.3d 546, 553 (5th Cir. 2007); *see also* George Lee Flint, Jr., *Securities Regulation*, 61 SMU L. REV. 1107, 1124–25 (2008) (discussing *Cent. Laborers' Pension Fund*).

106. *Alaska Elec. Pension Fund*, 898 F.3d 648 at 662–63; *see* Indiana Elec. Workers' Pension Tr. Fund IBEW v. Shaw Grp., Inc., 537 F.3d 527, 545 (5th Cir. 2008).

107. *Alaska Elec. Pension Fund*, 898 F.3d at 663–64; *see* Neiman v. Bulmahn, 854 F.3d 741, 750 (5th Cir. 2017); *see also* George Lee Flint, Jr., *Securities Regulation*, 4 SMU ANN. TEX. SURV. 425, 446–48 (2018) (discussing *Neiman*).

108. *Alaska Elec. Pension Fund*, 898 F.3d at 659–60.

109. *Id.* at 660–62.

110. *Id.* at 662.

111. *Id.* at 668 (Ho, J., dissenting).

112. *Id.* at 666–67. The defendants raised a second element of the fraud as mandating dismissal, loss causation. Unfortunately, when each corrective disclosure was made, the stock dropped 25% on the first correction, 18% on the second correction, and 80% on the third correction. *Id.* at 665. Since there was no contravening negative event, these stock drops adequately pleaded the loss causation element. *Id.* at 666.

C. Insider Short-Swing Profits: Choice of Cash or Stock to Pay Withholding

The Federal Securities Exchange Act, in order to provide a deterrent to insider trading, also contains a cause of action for issuers, or shareholders on behalf of the issuer, to force insiders to disgorge to the issuer any profits made on short-swing trades with the sale and purchase less than six months apart.[113] The SEC, by rule, has provided an exemption to this disgorgement to facilitate the offering of employee benefit plans by the issuer by exempting transactions involving a disposition to the issuer if the transaction is not discretionary and is pre-approved by the issuer's board of directors, a committee of the board, or a majority of the shareholders.[114]

In *Jordan v. Flexton*, the shareholder, as a pro se litigant,[115] brought suit on behalf of the issuer to recover for shares issued to the issuer's officers under a long-term incentive compensation plan approved by the shareholders.[116] Under the plan, employees received restricted stock unit awards approved by a board committee; however, the plan authorized the issuer to deduct taxes required to be withheld by the Internal Revenue Code.[117] In making the grants, the board committee required the employee to pay cash to enable the issuer to meet the withholding requirements or the issuer would retain sufficient shares to meet the withholding.[118] The plaintiff shareholder contended that the award and subsequent retention constituted the purchase and sale.[119] The district court dismissed the suit for failure to state a claim.[120] Before the Fifth Circuit, the plaintiff shareholder contended that the participant's choice of paying the withholding in cash or in retained stock meant that the transaction was discretionary, in violation of the exemption rule.[121] The Fifth Circuit noted that the officers had no control over the timing of the transaction, the amount of the withholding to be made to the issuer, or the price at which the withheld shares were sold, all of which supported the non-discretionary aspect of the transaction.[122] Consequently, the Fifth Circuit affirmed the dismissal.[123]

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113. *See* 15 U.S.C. § 78p(b) (2012).

114. *See* 17 C.F.R. § 240.16b-3(d) (2018).

115. Jordan v. Flexton, 729 F. App'x 282, 285 n.19 (5th Cir. 2018).

116. *See* Brief of Appellees at 7, *Jordan*, 729 F. App'x 282 (No. 17-20346), 2017 WL 3670505, at *7.

117. *Id.* at *8.

118. *Id.* at *9.

119. *Id.* at *9–12.

120. *Jordan*, 279 F. App'x at 282.

121. *Id.* at 285.

122. *Id.* at 285 n.18.

123. *Id.* at 286. The plaintiff shareholder also contended that the transaction was not approved under the exemption rule, but did not raise the matter in his opening brief and under Fifth Circuit law forfeits the issue.

IV. CONCLUSION

The Fifth Circuit addressed some scope issues under the federal acts relevant to similar language in the TSA and TSFA. The Fifth Circuit in a criminal case recognized that bonds and investment contracts marketed by a licensed insurance salesman are nevertheless securities. The Fifth Circuit also determined that to impute the aiding and abetting of fraud from one subsidiary and corporate parent required a sharing of both profits and losses by the entities.

The TSSB updated its rules to comport with the new NASAA policy concerning electronic submissions and electronic signatures. The TSSB also enacted a new rule and amended several rules to permit intrastate offerings under the SEC's new Rule 147A allowing intrastate offerings to use crowdfunding provided the issuer's principal office is in the state and the issuer takes precautions to ensure sales only to in-state investors. Further, the TSSB enacted rules to implement the legislature's enactment to provide protection for vulnerable adults (those over age sixty-five or disabled) by requiring agents of dealers and representatives of investment advisers to monitor their client records and report any suspected financial exploitation of vulnerable adults to their dealers and investment advisers, who are to investigate and report to the TSSB.

The TSSB's enforcement efforts against dealers focused on failing to report embarrassing matters such as employment firings, criminal misdemeanors, tax liens, and civil judgments. The enforcement efforts against investment advisors concerned recommending a trading strategy without considering the costs or prospects of success, trading client portfolios without registration, and failing to cooperate with TSSB investigations.

The TSSB's enforcement efforts against threats to investors involved numerous actions dealing with cryptocurrencies, all for selling unregistered securities through unregistered agents and involving fraudulent statements and omissions of material facts.

For the federal fraud action, the Fifth Circuit affirmed the dismissal of an attempt to convert fraud committed by the issuer on its customers into a securities fraud case against the issuer's shareholders, but failed to allege sufficient misstatements as the ones alleged were not a misrepresentation, or not material, or did not cause the loss. The Fifth Circuit also dealt with the issue of scienter for an issuer's inability to quickly adjust to changes in Medicare documentation resulting in insufficient loss reserves for reported earnings. The court unconvincingly found a strong inference of scienter for an audit committee report claiming the chief financial officer engaged in inappropriate accounting practices without identifying the inappropriate practices since they supported the inference and contributed to the inference. The Fifth Circuit also dealt with statutory insider trading under the federal rules for short swing profits and found that the insider's choosing to pay the withholding tax with cash or shares did not make the sale discretionary in violation of the SEC's rule providing an exception to the short swing profit disgorgement.