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Securities Regulation

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SECURITIES REGULATION

*George Lee Flint, Jr.**

TABLE OF CONTENTS

I. COVERAGE OF THE FEDERAL AND TEXAS SECURITIES ACTS	364
A. JOINT VENTURE INTERESTS AS SECURITIES	364
B. THE IMPACT OF A SERVICE AGREEMENT ON DETERMINING WHETHER LIMITED PARTNERSHIP INTERESTS ARE SECURITIES	366
C. A GRANT OF EMPLOYEE OPTIONS IS NOT A "SALE" OF SECURITIES	367
D. LIFE SETTLEMENTS AS SECURITIES	368
E. THE IMPACT OF FREE SPEECH ON AIDERS AND ABETTORS UNDER THE TSA	369
II. REGISTRATION AND ENFORCEMENT	370
A. RULEMAKING	370
B. LICENSING OF CERTAIN INDIVIDUALS	371
C. REMOVAL OF REGISTRATION FOR BRANCH OFFICES ..	371
D. MARKET OPERATORS	371
E. ENFORCEMENT	373
III. SECURITIES FRAUD COURT DECISIONS UNDER THE FEDERAL AND TEXAS SECURITIES ACTS	376
A. ADEQUATELY PLEADING MISSTATEMENTS UNDER THE FEDERAL SECURITIES ACTS	377
B. SCIENTER FOR PUBLICLY DISCLOSING DETRIMENTAL INFORMATION UNDER THE FEDERAL SECURITIES ACTS	378
C. INVESTOR ERRORS UNDER THE TEXAS SECURITIES ACT	382
IV. CONCLUSION	384

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

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

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 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 Texas developments of interest during the period of December 1, 2018 to November 30, 2019.

I. COVERAGE OF THE FEDERAL AND TEXAS 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 With respect to the transactions constituting securities, the Securities and Exchange Commission (SEC) brought before the Court of Appeals for the Fifth Circuit two oil and gas investments, both designed as joint ventures seeking to avoid compliance with the securities laws since their investment vehicle did not involve a security.⁵ The Fifth Circuit also considered whether the grant of employee options constituted a "sale" of a security for purposes of the securities laws.⁶ The Fifth Circuit in addition joined the Texas Supreme Court in finding life settlements as securities when dealing with an investment advisor advising clients on investments in life settlements.⁷ With respect to the persons liable for improperly selling securities, a Second Fort Worth Court of Appeals considered the impact of free speech on aiders and abettors under a Texas statute.⁸

A. JOINT VENTURE INTERESTS AS SECURITIES

The SEC brought two actions against oil and gas drilling ventures that used cold-calling methods to attract investors then subsequently provided them with a private placement memorandum and a joint venture agree-

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. 1129-30 n.3 (2013) (discussing *Highland Capital Mgmt.*); George Lee Flint, Jr., *Securities Regulation*, 60 SMU L. REV. 1293-1302 (2007) (discussing *Anglo-Dutch Petroleum Int'l, Inc.*).

4. See 15 U.S.C. § 77b(a)(1)-(3) (2012); TEX. CIV. STAT. ANN. art. 581-4(A)-(B).

5. See Sec. & Exch. Comm'n v. Sethi, 910 F.3d 198 (5th Cir. 2018), *cert. denied*, 140 S. Ct. 95 (2019); Sec. & Exch. Comm'n v. Arcturus Corp., 928 F.3d 400, 400 (5th Cir. 2019).

6. Lampkin v. UBS Fin. Servs., Inc., 925 F.3d 727, 727 (5th Cir. 2019).

7. In the Matter of Living Benefits Asset Mgmt., LLC, 916 F.3d 528, 528 (5th Cir. 2010).

8. Smith v. Crestview NUV, LLC, 565 S.W.3d 793, 793 (Tex. App.—Fort Worth 2018, pet. denied).

ment.⁹ In both cases, the SEC filed for violation of the fraud rules of the Securities Act and Exchange Act.¹⁰ In both cases the district court granted summary judgment for the SEC.¹¹ The U.S. Court of Appeals for the Fifth Circuit affirmed the first one in *SEC v. Sethi*,¹² and reversed and remanded the second one in *SEC v. Arcturus Corp.*¹³

The Fifth Circuit noted that in the Fifth Circuit general partnership interests usually are not securities because the general partners are actively involved in the enterprise and are able to protect their own interests; however, it also noted that a general partnership can be a security if the general partners lack managerial powers.¹⁴ In the Fifth Circuit, this latter situation is determined by examining three factors and if one is present shows the general partner interest is a security: whether (1) the agreement leaves general partners with little managerial powers; (2) the general partners are so inexperienced or unknowledgeable that they cannot exercise their powers; or (3) the general partners are so dependent on the manager they cannot replace the manager.¹⁵ In *Sethi*, the joint venture satisfied this first factor test. Although the agreement gave the joint venturers power to call meetings on a 20% vote, develop rules on a 50% vote, and veto the manager's decisions, these powers were illusory since the manager never called any meetings, blocked any attempt to call meetings, failed to inform the general partners of management's decisions, or blocked any attempt to obtain information.¹⁶

But in *Arcturus Corp.*, the joint venture failed the first factor test that the joint venturers lacked the ability to exercise control. The joint venturers had the power to remove and veto the manager, and the joint venturers actually met, voted, and managed the drilling projects.¹⁷ The agreement included a provision allowing a joint venturer to vote for completion of a well or opt out of the joint venture, depicted by the SEC as a requirement to follow the recommendation of the manager, rather than as a method to cut a joint venturer's loss before incurring completion costs.¹⁸ The SEC also claimed the joint venturers had to rely on little information supplied by the manager; however, the record showed the joint venturers had several sources of information, including daily drilling

9. *Sethi*, 910 F.3d at 201; *Arcturus Corp.*, 928 F.3d at 405–06 (investment adviser also determining whether the investors were accredited).

10. 15 U.S.C. §§ 77q, 78j (2019).

11. *Sethi*, 910 F.3d at 198; *Arcturus Corp.*, 928 F.3d at 400.

12. *Sethi*, 910 F.3d at 208.

13. *Arcturus Corp.*, 928 F.3d at 424.

14. *Sethi*, 910 F.3d at 203 (citing *Youmans v. Simon*, 791 F.2d 341, 346 (5th Cir. 1986)); *Arcturus Corp.*, 928 F.3d at 410 (citing *Youmans*, 791 F.2d at 346).

15. *Sethi*, 910 F.3d at 204 (citing *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir. 1981)); *Arcturus Corp.*, 928 F.3d at 410–11 (citing *Williamson*, 645 F.2d at 424).

16. *Sethi*, 910 F.3d at 205. On the securities fraud issue, the manager had made claims of prior relations with major oil companies, the misstatement, which relations he knew he lacked, providing the scienter, so the Fifth Circuit affirmed the district court's finding of securities fraud. *Id.* at 207–08.

17. *Arcturus Corp.*, 928 F.3d at 412–13.

18. *Id.* at 413–15.

reports, email updates, and visits to the drilling site.¹⁹ The SEC further claimed the joint venturers could not contact each other since the manager protected joint venturer contact information as confidential under privacy laws, but the record showed the joint venturers contacted each other at joint venturer meetings and thereafter by phone.²⁰ The Fifth Circuit left it for the district court to determine whether 160 joint venturers was too many for them to exercise their management rights.²¹

With respect to the second factor test that the joint venturers were inexperienced and unknowledgeable, the SEC claimed advertising in large-city newspapers and the cold-calling technique of recruitment led to inexperienced joint venturers.²² Although the record showed four inexperienced joint venturers, it also showed that several joint venturers had past experience or had advisers helping them make decisions and that the manager required the joint venturers to be accredited investors, but information on only 25 of 340 joint venturers was insufficient for a decision.²³

With respect to the third factor test that the joint venturers were dependent on the manager, the SEC contended the manager was irreplaceable as being the party to the subcontracts and controlling all the joint venturers' invested funds.²⁴ The Fifth Circuit found insufficient evidence on this factor in the record; nothing showed the funds belonged to the manager and not the joint venture and there was no evidence the joint venture could not enforce the contracts with the subcontractors.²⁵ So, the Fifth Circuit reversed and remanded.²⁶

B. THE IMPACT OF A SERVICE AGREEMENT ON DETERMINING WHETHER LIMITED PARTNERSHIP INTERESTS ARE SECURITIES

Generally, the ability to participate in the management of a limited partnership by a limited partner means the limited partnership interest is not a security.²⁷ In *Masel v. Villarreal*, the U.S. Court of Appeals for the Fifth Circuit considered an unusual situation where the securities fraud defendants were the limited partners or investors, while the plaintiffs were the general partners and had set up the business.²⁸ The defendant investors had induced the plaintiff businessmen to enter into a joint business enterprise for a medical billing service for a particular medical test,

19. *Id.* at 415–16.

20. *Id.* at 416–17.

21. *Id.* at 417.

22. *Id.* at 418–19.

23. *Id.* at 418–21.

24. *Id.* at 422.

25. *Id.* at 422–24.

26. *Id.* at 424.

27. *See Frazier v. Manson*, 651 F.2d 1078, 1080 (5th Cir. 1981). The Frazier limited partnership had a limited partner who was also a general partner in the entity that served as the general partner of the limited partnership so that partner's limited partnership interest was not a security. *See Frazier v. Manson*, 484 F. Supp. 449, 450–51 (N.D. Tex. 1980).

28. *Masel v. Villarreal*, 924 F.3d 734, 744 (5th Cir. 2019).

and so, the plaintiff businessmen established a number of limited partnerships to provide the medical procedures and hired the defendant investors to manage the billing in exchange for limited partnership interests in the various limited partnerships.²⁹ The district court, in dismissing the case for failure to state a securities fraud claim, did not address the issue of whether the limited partnership interests were securities.³⁰ The Fifth Circuit noted that limited partnership interests ordinarily are securities as an investment contract where the investor depends on the efforts of third parties to make a return, and that investors who had managerial rights as a general partner could not claim their related limited partnership interests were securities.³¹ But in distinguishing the latter situation, the Fifth Circuit noted that those managerial powers came from the limited partnership formation documents, whereas in the current situation the managerial powers came from a separate service contract rather than from the limited partnership formation documents.³² Consequently, the Fifth Circuit concluded that the defendants' limited partnership interests were securities.³³ The fraud aspects of the case will be discussed below.³⁴

C. A GRANT OF EMPLOYEE OPTIONS IS NOT A "SALE" OF SECURITIES

In the long ongoing Enron Corporation litigation, the U.S. Court of Appeals for the Fifth Circuit was presented with a lawsuit by former employees of Enron Corporation who had been granted employee stock options that they had not exercised. In *Lampkin v. UBS Financial Services, Inc.*, the former employees sued the underwriter's retail brokerage under the Securities Act³⁵ and the underwriter's investment banker under the Exchange Act³⁶ to recover from Enron Corporation's underwriter for failing to disclose material non-public information about Enron Corporation's financial manipulations in Enron Corporation's prospectuses and registration statements while acting as a retail seller and investment banker of Enron Corporation securities.³⁷ The underwriter's retail brokerage served as the exclusive broker for the stock option exercises and was tasked with facilitating the option exercises and providing record-keeping services related to the exercise of the options.³⁸ The district court

29. *Id.* at 739–41.

30. *Id.* at 742.

31. *Id.* at 743–45.

32. *Id.* at 745–46.

33. *Id.* at 746.

34. *See infra* notes 103–14 and accompanying text.

35. 15 U.S.C. §§ 77k (underwriter under a registration statement), 77l (2019) (offering or selling a security). The TSA has similar provisions. *See* TEX. REV. CIV. STAT. ANN. arts. 581-33A(1) (untrue statement in a registration), 581-33A(2) (untrue statement in an offer or sale of a security).

36. 15 U.S.C. § 78j (2019).

37. *Lampkin v. UBS Fin. Servs., Inc.*, 925 F.3d 727, 731 (5th Cir. 2019), *cert. denied*, 140 S. Ct. 389 (2019).

38. *Id.*

dismissed both actions.³⁹ For the retail brokerage, the issue was whether the grant of the option did not constitute a “sale” of a security since no investment of money occurred.⁴⁰ The Fifth Circuit noted that the U.S. Supreme Court had previously determined that a noncontributory, compulsory pension plan is not an investment contract (within the definition of a “security”) since the purported investment on the part of the employee is a relatively insignificant part of the total and indivisible compensation package of the employee.⁴¹ The Fifth Circuit noted further that the SEC, following the Supreme Court’s ruling, had determined that there is no sale of a security when shares of stock are contributed to the employee plan without cost to the employee, and that courts have applied the doctrine to employee stock option plans.⁴² Consequently, the Fifth Circuit found that the grant of options is not a sale since labor is insufficient consideration in the context of a compulsory, noncontributory option plan.⁴³ The Fifth Circuit left open the issue of the exercise of the employee stock option, since the employees expressly disclaimed any reliance on the exercise of the employee stock options.⁴⁴

D. LIFE SETTLEMENTS AS SECURITIES

The U.S. Court of Appeals for the Fifth Circuit became another Texas court to face investments in life settlements. In *In the Matter of Living Benefits Asset Management, L.L.C.*, a bankrupt provider of consulting services to a corporate client in connection with the purchase of life settlements to use as collateral in corporate debt offerings brought an action to recover for breach of contract when the corporate client failed to pay the agreed fee.⁴⁵ The bankruptcy court found the contract breached, but that the bankrupt was required to register as an investment adviser under the Investment Advisers Act of 1940 (IAA), had not registered, and so the contract was voidable under the IAA and the bankrupt could not recover the fee, an action affirmed by the district court.⁴⁶ The bankrupt

39. *Id.* at 729.

40. *Id.* at 733–35.

41. *Id.* at 734 (first citing *Int’l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 558–60 (1979)).

42. *Id.* at 734–35 (first citing *Employee Benefits Plans*, Exchange Act Release No. 33-6281, 21 SEC Docket 1372 (Jan. 15, 1981); then citing *Interpretive Release on Regulation D*, Exchange Act Release No. 33-6455, 48 F.R. 100045 (Mar. 3, 1983); and then citing *In re Cendant Corp. Sec. Litig.*, 76 F. Supp. 2d 539, 544–45 (D. N.J. 1999)).

43. *Id.* at 737.

44. *Id.* at 736–37. The securities fraud issue against the underwriter’s investment banker also failed for failing to establish a joint venture between the underwriter’s retail brokerage and the underwriter’s investment banker. *Id.* at 737–40 (following *Giancarlo v. UBS Fin. Servs., Inc.*, 725 F. App’x 278 (5th Cir. 2018), *cert. denied*, 139 S. Ct. 199, 202 (2018)); *see also* George Lee Flint, Jr., *Securities Regulation*, 5 SMU ANN. TEX. SURV. 391, 393–94 (2019) (discussing *Giancarlo*).

45. *In the Matter of Living Benefits Asset Mgmt., LLC*, 916 F.3d 528, 531–32 (5th Cir. 2019).

46. *Id.* at 532. The IAA makes it unlawful to practice as an investment adviser without being registered and any contract in violation of the act is void. 15 U.S.C. §§ 80b-3(a) (registration), 80b-15(b) (2019) (voidness).

consulting provider contended it was not an investment adviser since life settlements were not securities.⁴⁷ The Fifth Circuit noted that the issue was whether the life settlement was a security as an investment contract which had three requirements, namely, an investment of money, second a common enterprise, and third profits solely derived from the efforts of others than the investors.⁴⁸ The Fifth Circuit then noted that there was a split amongst the U.S. Court of Appeals for the D.C. Circuit and the U.S. Court of Appeals for the Eleventh Circuit only for the third factor on whether profits came from the efforts of others before or after purchase.⁴⁹ The Fifth Circuit also observed that most courts follow the Eleventh Circuit's ruling, including Texas under the comparable TSA,⁵⁰ and so concluded that life settlements were securities; the bankrupt had therefore failed to register as an investment adviser, and so the contract with the corporate client was void, thereby affirming the district court.⁵¹

E. THE IMPACT OF FREE SPEECH ON AIDERS AND ABETTORS UNDER THE TSA

Texas has a statute against strategic lawsuits against public participation (the Anti-SLAPP statute) to protect both the constitutional rights to free speech and association but also protect the right to file meritorious lawsuits for demonstrable injury.⁵² This is done by shifting the burden of proof upon a motion to dismiss with the movant first providing evidence the action relates to its exercise of free speech, to petition, or to associate and then the non-movant providing prima facie evidence of its claim.⁵³ In *Smith v. Crestview NUV, LLC*, the Second Fort Worth Court of Appeals received a motion under this statute against a claim for aiding and abet-

47. *In the Matter of Living Benefits Asset Mgmt., LLC*, 916 F.3d at 533. The bankrupt also contended that it was not in the business of advising others as to the value of investing in life settlements since it gave only general advice and not specific advice about specific securities. *Id.* The Fifth Circuit rejected this claim since the SEC has determined the IAA applies to those giving generalized advice on the advantages and disadvantages of investing in securities and the act specifically covers advising others as to the advisability of investing in securities. *Id.* at 534–35; Applicability of the Inv. Advisers Act to Fin. Planners, Pension Consultants, and Other Persons Who Provide Inv. Advisory Serv. as a Component of Other Fin. Servs., SEC Interpretive Letter, 52 F.R. 38400-01 (1987); 15 U.S.C. § 80b-2(a)(11) (2019).

48. *In the Matter of Living Benefits Asset Mgmt., LLC*, 916 F.3d at 535 (citing Sec. & Exch. Comm'n v. W.J. Howey, 328 U.S. 293 (1946)).

49. *Id.* at 537; Sec. & Exch. Comm'n v. Mut. Benefits Corp., 408 F.3d 737, 743–45 (11th Cir. 2005) (finding life settlements as securities by including presale efforts since such efforts resemble the efforts made for bonds which are securities); Sec. & Exch. Comm'n v. Life Partners, Inc., 87 F.3d 536, 545–48 (D.C. Cir. 1996) (a less than competent jurist failing to find life settlements as securities by failing to consider presale efforts, thereby triggering a dissent).

50. *See* Life Partners, Inc. v. Arnold, 464 S.W.3d 660, 681 (Tex. 2015); George Lee Flint, Jr., *Securities Regulation*, 2 SMU ANN. TEX. SURV. 437, 439–45 (2016) (discussing *Life Partners*).

51. *In the Matter of Living Benefits Asset Mgmt., LLC*, 916 F.3d at 538–39, 543.

52. TEX. CIV. PRAC. & REM. CODE ANN. §§ 27.002, 27.011(b).

53. *Id.* §§ 27.005(b), 27.005(c).

ting a securities fraud under the TSA.⁵⁴ The perpetrator of the securities fraud got the investor to invest in the perpetrator's company in developing a rejuvenation product derived from human amniotic cells, indicating the aider and abettor had agreed to be the provider of the product and had injected the product in the perpetrator, which investment was spent on the perpetrator's personal expenses.⁵⁵ The petition against the aider and abettor referred to acts of assistance in clandestine testing of the product, failing to keep medical records of the testing, and violations of Texas medical laws.⁵⁶ The district court denied the aider and abettor's motion to dismiss under the Texas Anti-SLAPP statute.⁵⁷ The appellate court quickly found that the Anti-SLAPP statute did not apply to this securities fraud action since it did not contain allegations about communications necessary for an exercise of free speech and affirmed the trial court.⁵⁸ The court left open the issue of whether a petition for a TSA violation by making a statement or submitting a document would be subject to the Anti-SLAPP statute.⁵⁹

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.⁶⁰ The basic rule of most securities laws is that securities must be registered with their corresponding regulatory agency unless they fall within an exemption.⁶¹ 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.⁶² 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. RULEMAKING

At its most recent session, the Texas Legislature enacted a bill to provide for negotiated rulemaking for the TSSB under which the TSSB meets with entities to be affected by a proposed rule and gets their input into the proposed rule.⁶³ Consequently, the TSSB adopted a rule to provide for the negotiated rulemaking process.⁶⁴

54. *Smith v. Crestview NUV, LLC*, 565 S.W.3d 793, 793 (Tex. App.—Fort Worth 2018, pet. denied).

55. *Id.* at 794–95.

56. *Id.* at 796.

57. *Id.*

58. *Id.* at 798–99.

59. *Id.* at 799.

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

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

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

63. *See* TEX. REV. CIV. STAT. ANN. art. 581-2-8, *added by* 2019 Tex. Sess. Law Serv. Ch. 772 (H.B. 1535).

64. *See* 44 Tex. Reg. 4789 (2019), *adopted by* 44 Tex. Reg. 6857 (2019) (codified at 7 TEX. ADMIN. CODE § 103.6 (2020)) (Tex. State Sec. Bd.).

B. LICENSING OF CERTAIN INDIVIDUALS

The Texas legislature recently enacted two bills applicable to the licensing of dealers and investment advisers. One bill enables potential applicants with a criminal conviction to apply for an occupational license when the criminal conviction does not relate to the occupation.⁶⁵ The TSSB amended its licensing rules to alter the factors that must be considered in determining registration eligibility for dealers,⁶⁶ investment advisers,⁶⁷ and to allow these persons to obtain preliminary information regarding their eligibility for an occupational license before they begin a training program for the occupation.⁶⁸ The other bill permits military spouses to engage in a business requiring a license without the applicable license provided they have a current license from another jurisdiction.⁶⁹ So, the TSSB amended its rule for military applicants to reflect the legislative changes for dealers⁷⁰ and investment advisers⁷¹ with a new form concerning the waiver and requesting recognition of the license from that other jurisdiction.⁷²

C. REMOVAL OF REGISTRATION FOR BRANCH OFFICES

The Texas legislature at its most recent session also enacted a bill to remove the requirement to register branch offices of dealers and investment advisers and remove branch office registration fees.⁷³ Consequently, the TSSB amended its rules instead to require notice filing of branch offices without a registration fee for both dealers⁷⁴ and investment advisers.⁷⁵

D. 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

65. See TEX. OCC. CODE ANN. § 53, amended by 2019 Tex. Sess. Law Serv. Ch. 765 (H.B. 1342).

66. See 44 Tex. Reg. 4796 (2019), adopted by 44 Tex. Reg. 6859 (2019) (codified at 7 TEX. ADMIN. CODE § 115.6 (2020)) (Tex. State Sec. Bd.).

67. See 44 Tex. Reg. 4802 (2019), adopted by 44 Tex. Reg. 6864 (2019) (codified at 7 TEX. ADMIN. CODE § 116.6 (2020)) (Tex. State Sec. Bd.).

68. See 44 Tex. Reg. 4790 (2019), adopted by 44 Tex. Reg. 6857 (2019) (codified at 7 TEX. ADMIN. CODE § 104.7 (2020)) (Tex. State Sec. Bd.).

69. See TEX. OCC. CODE ANN. § 55.0041(a), added by 2019 Tex. Sess. Law Serv. Ch. 622 (S.B. 1200).

70. See 44 Tex. Reg. 4797 (2019), adopted by 44 Tex. Reg. 6861 (2019) (codified at 7 TEX. ADMIN. CODE § 115.18 (2020)) (Tex. State Sec. Bd.).

71. See 44 Tex. Reg. 4804 (2019), adopted by 44 Tex. Reg. 6865 (2019) (codified at 7 TEX. ADMIN. CODE § 116.18 (2020)) (Tex. State Sec. Bd.).

72. See 44 Tex. Reg. 4810 (2019), adopted by 44 Tex. Reg. 6869 (2019) (codified at 7 TEX. ADMIN. CODE §§ 133.22 & 133.23 (2020)) (Tex. State Sec. Bd.).

73. See TEX. REV. CIV. STAT. ANN. art. 581-35B(1), amended by 2019 Tex. Sess. Law Serv. Ch. 772 (H.B. 1535).

74. See 44 Tex. Reg. 4794 (2019), adopted by 44 Tex. Reg. 6839 (2019) (codified at 7 TEX. ADMIN. CODE §§ 115.1, 115.2, 115.4 (2020)) (Tex. State Sec. Bd.).

75. See 44 Tex. Reg. 4801 (2019), adopted by 44 Tex. Reg. 6861 (2019) (codified at 7 TEX. ADMIN. CODE §§ 116.1, 116.2, 116.4 (2020)) (Tex. State Sec. Bd.).

the state, and to register as an investment adviser before rendering investment advice.⁷⁶ Registration infractions generally surface when applying or reapplying for registration.

The TSSB prosecuted an enforcement action against a dealer for the failure of a registered agent to report various embarrassing required matters such as a felony offense.⁷⁷ The TSSB also participated with securities regulators in other states against a dealer for offering and selling unregistered securities in Texas, failing to invest sufficient resources in personnel, systems, and operations to comply with state securities laws, failing to supervise the flow of information to comply with state securities laws, failing to supervise employees to ensure compliance with state securities laws, and failing to maintain records necessary to ensure compliance with state securities laws.⁷⁸

The TSSB had several enforcement actions against investment advisers and investment-adviser representatives. These involved: (1) failure to update disclosure of fees and expenses, conflicts of interests, disciplinary information, and business background of the investment adviser to clients as required by TSSB rules;⁷⁹ (2) failure to enforce supervisory procedures requiring monthly review of discretionary accounts with the result of investments in short term leveraged exchange traded funds requiring daily monitoring for several years causing 90% losses of investor funds;⁸⁰ (3) engaging in inequitable practices such as recommending stream of income investments (periodic pension payments of distressed pensioners) without disclosing the risks to clients and ignoring administrative orders of other state securities boards and the SEC against the companies setting up the stream of income investments⁸¹ or recommending to an elderly couple that they invest 40% of their funds in illiquid real estate investment trusts sold by private placement and 50% of their funds in a single private placement that failed even though each private placement had

76. See TEX. REV. CIV. STAT. ANN. art. 581-13(A).

77. See Tex. State Sec. Bd., *In re Agent Registration of Raymond Cui*, No. REG19-CAF-02, 2019 WL 861144 (Feb. 19, 2019) (reprimanded and administrative fine of \$5,000.00); see also 7 TEX. ADMIN. CODE § 115.9(a)(2) (2018) (Tex. State Sec. Bd.) (requiring dealers and their agents to report felony criminal charges within thirty days).

78. See Tex. State Sec. Bd., *In re Dealer Registration of LPL Fin., LLC*, No. IC19-CAF-01, 2019 WL 1587111 (Apr. 10, 2019) (cease and desist order, administrative fine of \$450,000.00, contribution of \$45,000.00 to the Investor Education Fund to educate Texas investors, and a lengthy undertaking).

79. See Tex. State Sec. Bd., *In re Inv. Adviser Registration of Grove Capital Mgmt., Inc.*, No. IC19-CAF-03, 2019 WL 3083354 (July 9, 2019) (reprimanded, administrative fine of \$5,000.00, and an undertaking); see also 7 TEX. ADMIN. CODE § 116.11 (2019) (Tex. State Sec. Bd.) (requiring disclosure of certain items to clients).

80. See Tex. State Sec. Bd., *In re Inv. Adviser Registration of Lowell & Co.*, No. REG19-CAF-04, 2019 WL 3782736 (Aug. 2, 2019) (reprimand and administrative fine of \$40,000.00); see also 7 TEX. ADMIN. CODE § 116.10 (2019) (Tex. State Sec. Bd.) (requiring supervision).

81. See Tex. State Sec. Bd., *In re Inv. Adviser Registration of LFS RIA, LLC and the Inv. Adviser Representative Registration of Clair Crossland*, No. IC9-CAF-01, 2019 WL 2501791 (June 6, 2019) (reprimanded and undertaking to pay back \$89,000.00 to clients whose income streams defaulted); see also TEX. REV. CIV. STAT. ANN. art. 581-14(A)(3) (punishment of dealers and investment advisers for inequitable practices).

been approved by the employer investment adviser;⁸² (4) selling promissory notes of the adviser's wife's business that went bankrupt to clients of his employer investment adviser and serving as the business's chief financial officer without disclosing the relationship to his employer investment adviser;⁸³ (5) advising more than five Texas residents within a year for a fee without registration in Texas as an investment adviser although registered in another state and maintaining no place of business in Texas;⁸⁴ and (6) engaging in fraudulent business practices such as recommending stream of income investments and using the client moneys to pay other clients when their stream of income investments became due or for personal expenses while failing to disclose this use and collecting unreasonable management fees based on a percentage of assets in addition to commissions on the sale of the stream of income investments.⁸⁵

E. ENFORCEMENT

The TSSB generally enforces its requirements for registration through emergency orders.⁸⁶ Because con artists exploit current news and technology to confound unwary investors, the TSSB enumerates among the top threats to investors: (1) cryptocurrencies since they are not backed by the government and their price is not set by a centralized authority; (2) oil and gas deals since investors can't investigate the claim; and (3) foreign currency trading since it is volatile and can result in huge losses in a few hours.⁸⁷ The TSSB's actions focus on these threats.

Due to the recent excitement involving cryptocurrency investments, the TSSB conducts investigations of the promoters of these investments

82. See Tex. State Sec. Bd., *In re Inv. Adviser Representative Registration of Mark A. Trewitt*, No. REG19-SUS-04, 2019 WL 2501793 (June 6, 2019) (suspended for ninety days and an undertaking).

83. See Tex. State Sec. Bd., *In re Inv. Adviser Registration of Jason Hyson LeBlanc*, No. IC19-SUS-06, 2019 WL 5874364 (Oct. 31, 2019) (suspended for one year, placed on probation for five years, and undertaking to repay \$366,000.00 to the investors in the promissory notes).

84. See Tex. State Sec. Bd., *In re Inv. Adviser Registration of Glob. Asset Mgmt. Grp., Inc.*, No. REG19-CAF-01, 2019 WL 861143 (Feb. 19, 2019) (reprimanded and administrative fine of \$7,500.00); Tex. State Sec. Bd., *In re Inv. Adviser Registration of Integrity RIA, LLC*, No. REG19-CAF-03, 2019 WL 1587110 (Apr. 1, 2019) (reprimanded and administrative fine of \$7,500.00); Tex. State Sec. Bd., *In re Inv. Adviser Registration of FRA Wealth Mgmt., LLC*, No. REG19-CAF-05, 2019 WL 3083353 (July 9, 2019) (reprimanded and administrative fine of \$20,000.00); Tex. State Sec. Bd., *In re Inv. Adviser Registration of Frugal Fin. Ret. Plan Servs., LLC*, No. REG19-CAF-06, 2019 WL 5874363 (Nov. 5, 2019) (reprimanded and administrative fine of \$5,000.00); see also 7 TEX. ADMIN. CODE § 116.1(b)(2)(A)(iv) (2019) (Tex. State Sec. Bd.) (exempting from registration investment advisers that have no office in Texas and in the last year fewer than six clients that are Texas residents).

85. See Tex. State Sec. Bd., *In re Inv. Adviser Representative Registration of Marwieh Advisory Servs., LLC*, and the *Inv. Adviser Representative Registration of George Augustus Marwieh*, No. IC19-REV-05, 2019 WL 5306636, at *2, *3 (Oct. 11, 2019) (registration revoked and cease and desist order).

86. See TEX. REV. CIV. STAT. ANN. art. 581-23.

87. See *Top 10 Investor Threats (Just in Time for the Holidays)*, TEX. ST. SEC. BD. (Nov. 29, 2017), <https://www.ssb.texas.gov/news-publications/top-10-investor-threats-just-time-holidays> [<https://perma.cc/KH63-MN97>].

who appeared to be using illegally or fraudulently online advertisements, social media, and other public solicitations to attract Texas investors.⁸⁸ 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. One cryptocurrency mining program involved an online Facebook advertisement directing investors to an online platform to permit passive investment in industrial Bitcoin mining approximating ten-fold returns within three months without disclosing the identity, business repute, qualifications of the principles, impact of future government legislation, impact of technical failure, impact of hacking, or impact of competition with other cryptocurrencies, and claiming they were registered when they were not.⁸⁹ Another cryptocurrency mining program concerned a social media solicitation to invest in a cryptocurrency trading and mining operation returning 10% every four weeks, claiming six years of operations, cryptocurrency experience of ten years when the trader in a prior deal lost more than 99% of the investors' money, and thirty years of experience in information technology, while using unregistered dealers, and failing to disclose the strategies, cost of the mining hardware, the security of the hardware and software, the impact of technical failure, hacking, and competition from other cryptocurrencies.⁹⁰ A third cryptocurrency trading program dealt with social media solicitations through Twitter, LinkedIn, and Facebook, selling cryptocurrency investment plans purchased with Bitcoin with returns in Bitcoin, falsely claiming to be registered in the United Kingdom, to be traded over the counter, to have a Texas office when not registered with the Texas Secretary of State, to be a registered investment company, to have a law firm and auditing firm, and failing to disclose the trading strategy, the company's financial information, the impact of future government legislation, technical failure, hacking, or competition with other cryptocurrencies.⁹¹ A fourth cryptocurrency mining program dealt with an online global marketplace solicitation, directing investors to a webpage of the mining company to fund their cryptocurrency wallet with

88. See *Widespread Fraud Found in Cryptocurrency Offerings*, TEX. ST. SEC. BD. (Apr. 10, 2018), <https://www.ssb.texas.gov/news-publications/enforcement-report-widespread-fraud-found-cryptocurrency-offering> [<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 *The Investor's Guide to Cryptocurrency Offerings*, TEX. ST. SEC. BD., <https://www.ssb.texas.gov/cryptocurrency-resources> [<https://perma.cc/TL7Z-YWPR>].

89. See Tex. State Sec. Bd., *In re TintXMiningPool and Maxi Samantha Fortune*, No. ENF-19-CDO-1781, 2019 WL 2911642, at *2 (June 28, 2019) (emergency cease and desist order).

90. See Tex. State Sec. Bd., *In re My Crypto Mine and Mark Steven Royer*, No. ENF-18-CDO-1771, 2018 WL 6307934, at *3 (Nov. 27, 2019) (emergency cease and desist order).

91. See Tex. State Sec. Bd., *In re PK Crypto Inv. aka PK-Crypto Inv., Peggy Kay Brendan, and Janet A. Osborn*, No. ENF-20-CDO-1791, 2019 WL 5306638, at *1 (Oct. 14, 2019) (emergency cease and desist order).

Bitcoin for lucrative profits over a short term, falsely claiming to be registered in the United Kingdom and to only have qualified investors for a private placement exempt from the federal securities acts without qualifying potential investors or filing the required forms with the SEC, using investors and recruit representatives to solicit new investors without registration as agents, and failing to disclose the identities of the principals, their qualifications, the type of hardware to mine cryptocurrencies, the costs of the mining hardware, the procedures for overcoming hardware failures, and the impact of future government legislation, technical failure, hacking, or competition with other cryptocurrencies.⁹²

The TSSB also had enforcement actions against several oil and gas drilling programs. One oil and gas drilling program for oil in Oklahoma involved unsolicited electronic mail messages to Texas residents promising annualized rates to return between 50–70% and directed investors to a website (1) touting the business repute of the principal without disclosing he had two prior oil and gas programs declare bankruptcy and was sued for a third; (2) claiming lucrative profits if the drilling duplicated the enormous productivity of a nearby well failing to disclose the much lower true productivity of that well; and (3) without disclosing a foreign state action against another principal.⁹³ Another involved an oil and gas drilling program in Illinois through the social media platform LinkedIn that promised Texas investors lucrative returns of 100% the first two years and monthly income for twenty years, with the right to exit the investment after three years, by touting an individual with several honors as the operator without disclosing that the actual operator was another company or disclosing any information about it. The venture also failed to disclose risks associated with the exploration, to register the agents as dealers or the interests as securities, and to disclose any information about the entity that would repurchase the working interests after three years.⁹⁴

The TSSB also had several enforcement actions against currency trading programs. One currency trading program made online promises of a ten-fold return in fourteen days, sold unregistered investments through unregistered dealers, failed to explain the identity of the traders and their qualifications and experience, failed to disclose the risks of foreign interest rates and currency exchange rates on the currency's value, and failed to disclose the risks of leverage and information on the insurance policy

92. See Tex. State Sec. Bd., *In re* Crypto Miner Ltd. aka Cyp Miner Ltd. aka Cyp Miner and Elizabeth Frazier, No. ENF-20-CDO-1790, 2019 WL 5306633, at *1–4 (Oct. 14, 2019) (emergency cease and desist order).

93. See Tex. State Sec. Bd., *In re* Woodland Res., LLC; Woodland Operating, LLC, aka WY Woodland Operating, LLC; Michael E. Patman; Jeremy Bryan Yowell aka JB Yowell; and Brett Kroh, No. ENF-19-CDO-1783, 2019 WL 3083355, at *4–5 (July 10, 2019) (emergency cease and desist order).

94. See Tex. State Sec. Bd., *In re* Kelcas Corp.; Kelcas Ohio River Oil, LLC; OIK Global Consulting Ptd Ltd. aka HOK Glob. Consulting Ptd Ltd.; Wilhelm B. Lilliehook; and Hok-Lam Chan aka Hok Lam Chan, No. ENF-20-CDO-1787, 2019 WL 4597384, at *3–4 (Sept. 16, 2019) (emergency cease and desist order).

guaranteeing the return.⁹⁵ Another currency trading program made on-line promises of eleven-fold returns in one week, guaranteeing the profitability and claiming that no risk was involved, without being registered as a dealer and not registering the investment plans, and failing to disclose the agent's qualifications, experience, strategies, or financials.⁹⁶ A third currency trading program was similar to phishing, using a Facebook listing to advertise and get access to the investor's Bitcoin accounts to transfer the Bitcoins to the trader's account and not disclosing trading qualifications, trading experience, trading strategies, or risks, and falsely claiming to be registered.⁹⁷

The TSSB also had an action triggered by a registered agent reporting suspected financial exploitation of an elderly person who liquidated their accounts to invest in precious metals.⁹⁸ The perpetrator was using unsolicited telephone calls and an internet website to solicit those aged sixty-five to ninety requesting information about their securities holdings, advising them securities holdings were not safe, to sell their securities and invest in precious metals, claiming not to charge any fees for the purchase of precious metals when the perpetrator pocketed the spread between the sales price and the wholesale price of the precious metals, while not being registered as an investment adviser and failing to disclose the principals, their qualifications and experience in determining suitable products, any complaints from investors, and any risks in investing in precious metals.⁹⁹

III. SECURITIES FRAUD COURT DECISIONS UNDER THE FEDERAL AND TEXAS SECURITIES ACTS

One major reason legislatures passed securities acts was to facilitate investors' actions to recover their monies 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 in 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.¹⁰⁰ As a result,

95. See Tex. State Sec. Bd., *In re* Forex and Bitcoin Trader aka Forex and Bitcoin Traders aka FX & Bitcoin Trader aka FX & Bitcoin, No. ENF-19-CDO-1785, 2019 WL 3782735, at *1–2 (Aug. 6, 2019) (emergency cease and desist order).

96. See Tex. State Sec. Bd., *In re* Madeline O'Farrell, No. ENF-19-CDO-1780, 2019 WL 2911640, at *2 (June 28, 2019) (emergency cease and desist order).

97. See Tex. State Sec. Bd., *In re* Mikhail Rania Safiya, No. ENF-19-CDO-1779, 2019 WL 2911641, at *1–2 (June 28, 2019) (emergency cease and desist order).

98. See Tex. State Sec. Bd., *In re* TMTE, Inc., aka Metals.com, Chase Metals, LLC, and Chase Metals, Inc.; Walter Vera; Michael Kendall, and Athena Hunter, No. ENF-19-CDO-1777, 2019 WL 1988529, at *1–2 (May 1, 2019) (emergency cease and desist order).

99. *Id.* at *3.

100. See *Highland Capital Mgmt., LP, 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. 1129–30 n.3 (2013) (discussing *High-*

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.¹⁰¹ The last element comes from the Private Securities Litigation Reform Act (PSLRA).¹⁰²

A. ADEQUATELY PLEADING MISSTATEMENTS UNDER THE FEDERAL ACTS

The PSLRA requires a higher standard of pleading misstatements and omissions than the ordinary standard under the Federal Rules of Civil Procedure.¹⁰³ The Fifth Circuit requires plaintiffs to identify the speaker, the misleading statement, when the statement was made, where the statement was made, and why the statement was misleading.¹⁰⁴ In *Masel v. Villarreal*, the Fifth Circuit dealt with a doctor and his business partner who were induced to join a business enterprise through material misrepresentations and omissions about the effectiveness of the perpetrators’ medical billing service.¹⁰⁵ The district court had dismissed for failure to state a claim of securities fraud.¹⁰⁶ The Fifth Circuit examined the seven misstatements and three omissions to determine whether they were actionable. The statement that the defendants had superior billing procedures capable of generating the highest payouts failed the PSLRA’s particularity test since there was no allegation the statement was false when made.¹⁰⁷ Two other misstatements failed the particularity test since they failed to specify the place where the statements were made.¹⁰⁸ With respect to two omissions, that the defendants intended to set up competing businesses and plaintiffs would not receive compensation for most claims, the plaintiffs failed to disclose when a given disclosure should have been made.¹⁰⁹ The third omission, that there would be conflicts of interest, failed since the pleading did not allege that the conflict existed at the time it should have been disclosed (when asked by the plaintiff doctor).¹¹⁰

land Capital Mgmt.); George Lee Flint, Jr., *Securities Regulation*, 60 SMU L. REV. 1293–1302 (2007) (discussing *Anglo-Dutch Petroleum Int’l, Inc.*).

101. *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)).

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

103. *See id.*; FED. R. CIV. P. 12(b)(6).

104. *See Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 866 (5th Cir. 2003).

105. *Masel v. Villarreal*, 924 F.3d 734, 739–40 (5th Cir. 2019).

106. *Id.* at 739.

107. *Id.* at 748.

108. *Id.* at 748–49 (plaintiffs claimed they were made in unspecified correspondence since they had typos, but this was not particular enough).

109. *Id.* at 749. The court followed the reasoning in *Carroll v. Fort James Corp.*, 470 F.3d 1171, 1174 (5th Cir. 2006), which required disclosure of when omissions should have appeared under the Federal Rules of Civil Procedure.

110. *Masel*, 924 F.3d at 749.

However, the remaining four misstatements, two relating to the capacity of the defendants to perform and two relating to the profits defendants could generate, were adequately plead since the failure to perform and generate profits indicated doubt that the defendant had the requisite skills or ability to generate profits initially.¹¹¹ With respect to the four properly alleged misstatements, the Fifth Circuit considered the scienter pleadings.¹¹² With respect to the defendant who ran the medical billing services company, the Fifth Circuit found scienter was adequately plead since that defendant knew the representations were based on metrics and information under that defendant's control, but with respect to the other defendant, the plaintiffs failed to establish the defendant understood the algorithm, how it worked, or even if it existed.¹¹³ Consequently, the Fifth Circuit reversed the district court with respect to the four adequately pleaded misstatements and affirmed the removal of one of the defendants.¹¹⁴

B. SCIENTER FOR PUBLICLY DISCLOSING DETRIMENTAL INFORMATION UNDER THE FEDERAL ACTS

For scienter, the federal heightened pleading rule requires the complaint to state with particularity the circumstances constituting the fraud while the PSLRA requires the complaint 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.¹¹⁵ 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."¹¹⁶ 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.¹¹⁷

Attorneys for shareholders in securities class action continue to have difficulty pleading facts giving a strong inference of scienter when dealing with corporations trying to properly disclose meaningful information during a trying event such as a bear attack while trying to develop software to help sell oilfield products, handle an oil pipeline spill, trying to switch to online selling of products, or adjust to government changes in a Medi-

111. *Id.* at 749–51.

112. *Id.* at 751–52.

113. *Id.*

114. *Id.* at 752.

115. *See* FED. R. CIV. P. 9(b); 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.”).

116. *See* *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*).

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

caid audit program. And the U.S. Court of Appeals for the Fifth Circuit continues to use the PLSRA as Congress intended, to eliminate illegitimate securities fraud lawsuits.¹¹⁸

In *Alaska Electrical Pension Fund v. Flotek Industries, Inc.*, the Fifth Circuit dealt with a pleading relying solely on misstatements as evidence of scienter for a company whose stock price significantly declined after a financial publication reported that data released earlier by the company was in error.¹¹⁹ The company marketed an oilfield product to improve the productivity of oil and gas wells and had developed software to compare the productivity of oil and gas wells that used the company's product and those that did not.¹²⁰ Before the release of the financial publication, the company's chief executive officer had conducted several investor conference calls in which he used the word "conclusive" to describe the software's results, described the software's data as "un-adjusted" when it used an algorithm to compare single wells with other wells under lease, used incorrect data in comparing wells, and claimed that the data was "back checked and validated" when there were no internal controls to insure the integrity of the data from a third party.¹²¹ Immediately after the release of the financial publication, the company issued a press release conceding the financial publication was correct and ascribing the error to data provided by that third party.¹²² A class action on behalf of the shareholders was filed alleging violations of Exchange Act Section 10(b) for securities fraud and Section 20(a) for control person liability.¹²³ For scienter, the investors pled the actions of the chief executive officer at the various investor conference calls. The district court dismissed for failure to satisfy the pleading requirements for scienter.¹²⁴ The Fifth Circuit affirmed.¹²⁵ The word "conclusive" is subject to many interpretations and does not contribute to a strong inference of scienter, especially when the software did have some economic benefit.¹²⁶ The other offered pleadings lacked a pleading that the chief executive officer knew at the time of the investor conference calls that the software used an algorithm, that the data was incorrect, or that the company lacked quality controls over third-party data and such misstatements were not sufficiently obvious to infer scienter as severely reckless.¹²⁷

In *Police and Fire Retirement System of Detroit v. Plains All American Pipeline, LP*, the U.S. Court of Appeals for the Fifth Circuit confronted a pipeline company dealing with an oil spill in California that contended it

118. See, e.g., H.R. CONF. REP. NO. 104-369, at 31-32 (1995).

119. *Alaska Elec'l Pension Fund v. Flotek Indus., Inc.*, 915 F.3d 975, 980 (5th Cir. 2019).

120. *Id.* at 979.

121. *Id.* at 982.

122. *Id.* at 980.

123. *Id.* at 981; 15 U.S.C. §§ 78j(b), 78t(a) (2012).

124. *Flotek Indus., Inc.*, 915 F.3d at 981.

125. *Id.* at 987.

126. *Id.* at 983. The court followed the reasoning in *Ind. Elec. Workers' Pension Tr. Fund IBEW v. Shaw Grp., Inc.*, 537 F.3d 527, 538 (5th Cir. 2008).

127. *Flotek Indus., Inc.*, 915 F.3d at 983-85.

was in compliance with applicable laws and regulations, during which time the stock of the company declined and after which the company was indicted for several felonies and misdemeanors by the federal and state governments for violation of those laws and regulations.¹²⁸ The investors sued under the Securities Act for misstatements in the company's SEC filings and under the Exchange Act for fraud.¹²⁹ The district court dismissed the action for failing to plead scienter with particularity.¹³⁰ The Fifth Circuit affirmed.¹³¹ The court found most of the alleged misstatements not misleading, including those in filings with the SEC such as aspirational statements about the company's commitment to safety, belief statements that the company was in compliance with law also broadly applicable to the other pipelines of the company, statements of internal procedures that did exist although they failed to function for the oil spill, recitation of facts at a moment in time that further investigation later contradicted, third-party statements, and opinion statements.¹³² The Securities Act claim has no scienter requirement, but since the court found all of those statements made in SEC filings not misleading, the dismissal of the Securities Act claim was affirmed.¹³³ The only two false statements were not made in SEC filings so the Exchange Act's scienter requirement applied.¹³⁴ The investors failed to tie the misstatements made on the company's website to any specific officer and the court found the misstatement not of a technical nature requiring senior level corporate officers to have been involved in its creation.¹³⁵ With respect to a misstatement made by a corporate officer to a legislative committee that there was no indication that anything was wrong with the pipeline, when the company knew that over 50% of the pipeline wall had corroded, since there was no allegation about that corporate officer's level of knowledge concerning the matter.¹³⁶

In *Municipal Employees' Retirement System of Michigan v. Pier 1 Imports, Inc.*, the U.S. Court of Appeals of the Fifth Circuit considered an investor lawsuit against a retailer of home furnishings for failing to disclose that the retailer's inventory was flooded with excess merchandise created in response to consumer demand for online shopping that carried a significant markdown risk because it had inventory that was too seasonal and subject to changing consumer tastes.¹³⁷ The investors sued for securities fraud under the Exchange Act after a series of partial correc-

128. *Police & Fire Ret. Sys. of Detroit v. Plains All Am. Pipeline, LP*, 777 F. App'x 726, 727–28 (5th Cir. 2019) (per curiam).

129. *Id.* at 728; 15 U.S.C. §§ 77k(a), 78j(b) (2012).

130. *Plains All Am. Pipeline, LP*, 777 F. App'x at 732.

131. *Id.* at 733.

132. *Id.* at 731–33.

133. *Id.* at 730, 733.

134. *Id.* at 731.

135. *Id.* at 731–32.

136. *Id.* at 732.

137. *Mun. Emps. Ret. Sys. of Mich. v. Pier 1 Imps., Inc.*, 935 F.3d 424, 427–28 (5th Cir. 2019).

tive disclosures, such as announcing the company had higher costs because of unplanned supply chain expenses, that the company had to turn to clearance activity to sell off the extra inventory, and that it would take eighteen months before inventory would be in line with demand, causing the stock price to eventually plummet 75%.¹³⁸ The district court dismissed the action for failure to plead a strong inference of scienter.¹³⁹ The Fifth Circuit affirmed.¹⁴⁰ The investors relied on three categories of scienter allegations concerning motive, knowledge of high inventory, and knowledge of markdown risk.¹⁴¹ For motive allegations, the investors relied on job protection and incentive compensation, both previously held insufficient by the Fifth Circuit.¹⁴² For knowledge of high inventory allegations, the investors contended that such knowledge equated with knowledge of the markdown risk, but the Fifth Circuit rejected this since the officers could reasonably believe that they could solve the inventory problem without resorting to markdowns.¹⁴³ Moreover, the high inventory allegations suffered from other defects, such as being based on knowledge outside the class period, publicly disclosed information so the officers were not trying to hide the problem, and vague statements of confidential witnesses without explaining what the problems were.¹⁴⁴ With respect to the knowledge of markdown risk, the investors pleaded (1) the company was a trend-based retailer, but it also had long standing collections of products; (2) the company had extraordinary markdown sales shortly after saying there was no markdown risk, but temporal proximity is weak evidence of fraud; (3) there were numerous red flags of impending markdowns, but these were from an expert report stricken from the record; and (4) the theory that the SEC rules requiring disclosure of known trends¹⁴⁵ includes disclosure of markdown risk, which the Fifth Circuit refused to adopt.¹⁴⁶

In a case reported last year, *Alaska Electrical Pension Fund v. Asar*, in which the U.S. Court of Appeals for the Fifth Circuit found a class action complaint sufficient with respect to one of the perpetrators, the chief financial officer, the Fifth Circuit withdrew and substituted a new opinion.¹⁴⁷ The issuer was a leading provider of orthotic and prosthetic

138. *Id.* at 428–29; 15 U.S.C. § 78j(b) (2012).

139. *Pier 1 Imps., Inc.*, 935 F.3d at 429.

140. *Id.* at 437.

141. *Id.* at 430.

142. *Id.* at 431 (citing *Abrams v. Baker Hughes Inc.*, 292 F.3d 424, 434 (5th Cir. 2002)).

143. *Id.* at 432.

144. *Id.* at 432–34.

145. The rule is Item 303 of Regulation S-K, 17 C.F.R. § 229.303(a)(3)(ii) (2019). The Second Circuit accepts the theory, while the Ninth Circuit rejects it. *See Stratte-McClure v. Morgan Stanley*, 776 F.3d 94, 102 (2d Cir. 2015); *In re NVIDIA Corp. Sec. Litig.*, 768 F.3d 1046, 1056 (9th Cir. 2014).

146. *Pier 1 Imps. Inc.*, 935 F.3d. at 435–37.

147. *Alaska Elec. Pension Fund v. Asar*, 768 F. App'x 175, 176 (5th Cir. 2019), *withdrawing* *Alaska Elec. Pension Fund v. Asar*, 898 F.3d 648, 662 (5th Cir. 2018). *See* George Lee Flint, Jr., *Securities Regulation*, 5 SMU ANN. TEX. SURV. 391–404 (2019) (discussing the original 2018 case).

patient care services with most of its revenue coming from reimbursements for its services by public and private insurers.¹⁴⁸ The issuer developed accounting problems after Congress expanded the Medicare audit program by failing to collect the required documentation forcing a return of the reimbursements and by implementing a new data management system resulting in fewer sales since employees had to spend significant amounts of time transitioning patient data to the new system.¹⁴⁹ For both of these accounting problems, the issuer failed to increase its reserve for disallowed Medicare sales.¹⁵⁰ The document containing the properly pleaded misstatements related to the issuer's audit committee report submitted to the SEC on Form 8-K suggesting that the chief financial officer and others had engaged in inappropriate accounting practices to enhance the issuer's reported earnings.¹⁵¹ The district court had found these statements as not adequately pleading a strong inference of scienter.¹⁵² Although the Fifth Circuit found them supportive of and contributing slightly to an inference of scienter, they did not arise to the level of a strong inference of scienter, and so the Fifth Circuit affirmed the district court's dismissal.¹⁵³

C. INVESTOR ERRORS UNDER THE TEXAS SECURITIES ACT

Lawyers representing investors and defendants fared no better under the TSA. They made several errors in bringing their lawsuits and in drafting their pleadings.

In *Goughnour v. Patterson, Trustee of Deborah Patterson*, the Twelfth Tyler Court of Appeals dealt with a trust beneficiary contending the trustee and his business partner had pilfered the trust for his own benefit and engaged in subterfuge to keep it hidden.¹⁵⁴ The securities fraud action under the TSA involved an equity interest in a private limited company developing a residential subdivision made in July 2007 that failed, losing all the investment and later described as a loan.¹⁵⁵ The trustee disclosed that the trust received no ownership interest in the private limited company in March 2011.¹⁵⁶ The beneficiary brought suit for violation of the TSA in November 2015, which the district court dismissed in granting the trustee's motion for summary judgment.¹⁵⁷ The court of appeals affirmed noting that the TSA requires investors to bring suit within three years of

148. *Asar*, 768 F. App'x at 177.

149. *Id.*

150. *Id.*

151. *Id.* at 178.

152. *Id.* at 179.

153. *Id.* at 188–89.

154. *Goughnour v. Patterson, Tr. of Deborah Patterson*, No. 12-17-00234-CV, 2019 WL 1031575, at *1–2 (Tex. App.—Tyler Mar. 5, 2019, pet. denied) (mem. op.) (also suing for breach of fiduciary duty, misuse of trust property, breach of personal guaranty, and breach of contract).

155. *Id.* at *1, *11.

156. *Id.* at *11.

157. *Id.* at *1, *11 (misstatement or omission in connection with the sale of a security); TEX. REV. CIV. STAT. ANN. art. 581-33A(2).

discovery (here four years ago) and no more than five years after sale (here eight years ago).¹⁵⁸

In *Matter of Life Partners Holdings*, the U.S. Court of Appeals for the Fifth Circuit confronted a bankruptcy trustee suing, on behalf of investors, those licensees that aided the bankrupt entities in marketing securities (life settlements, namely interests in life insurance contracts of terminally ill elderly) that used inaccurate life expectancies to set the price of the life settlements that failed to return the amounts claimed while disseminating the bankrupt's statements that their predictions were accurate and took commissions and fees far in excess of the standard commission.¹⁵⁹ The complaint, however, failed to allege which sections of the TSA the licensees violated, which licensees violated the TSA failing to give them notice of the claims against them, and which investors still owned fractional interests in the life settlements to determine whether the remedy was rescission or damages.¹⁶⁰ Consequently, the Fifth Circuit affirmed the district court's dismissal of the securities fraud action as proper.¹⁶¹

Lawyers representing securities fraud defendants similarly made erroneous assertions. In *Kubbernus v. ECAL Partners, Ltd.*, the First Houston Court of Appeals encountered investors who invested in a Delaware limited partnership that was to buy stock and convertible debentures in a Delaware corporation whose sole subsidiary was a Texas corporation operating a satellite telecommunication operation in Houston.¹⁶² Although the private placement memorandum stated the limited partnership would acquire ownership in the Texas corporation and convert the debentures, the promoters formed a competing group, acquired the Texas corporation and the debentures for the competing group, leaving the investors with nothing.¹⁶³ The perpetrators brought in two subsequent groups of investors, one set mostly foreign, and the others shareholders of a public company through an exchange of stock without disclosing the fraud on the initial group of investors.¹⁶⁴ The investors brought a securities fraud action under the TSA and after a jury trial judgment was entered in their favor.¹⁶⁵ The perpetrators defense against the foreign investors was that the TSA did not provide a remedy for foreign investors.¹⁶⁶ This is con-

158. *Goughnour*, 2019 WL 1031575, at *11; TEX. REV. CIV. STAT. ANN. art. 581-33H(2).

159. *In re Life Partners Holdings, Inc.*, 926 F.3d 103, 111–13 (5th Cir. 2019). The case also dealt with claims of actual fraudulent transfer, constructive fraudulent transfer, preferential transfer, avoidance and disallowance, equitable subordination, and breach of fiduciary duty. *Id.* at 117, 119, 121, 122, 125. See also George Lee Flint, Jr., *Securities Regulation*, 2 SMU ANN. TEX. SURV. 437, 439–48 (2016) (securities fraud litigation against Life Partners, Inc., one of the bankruptcies).

160. *Life Partners Holdings, Inc.*, 926 F.3d at 124.

161. *Id.*

162. *Kubbernus v. ECAL Partners, Ltd.*, 574 S.W.3d 444, 451–53 (Tex. App.—Houston [1st Dist.] 2018, pet. denied).

163. *Id.* at 453–54.

164. *Id.* at 455.

165. *Id.* at 450.

166. *Id.* at 471–73.

trary to the Texas Supreme Court's opinion that the TSA's registration provisions even apply to prohibit the sale of unregistered securities from Texas, to non-Texas residents.¹⁶⁷ In the case at hand, the offices and activities of the Delaware entities were in Houston, Texas, and the stock and debentures were Texas based securities.¹⁶⁸ Another perpetrator defense was that the evidence did not show that their misrepresentations and omissions caused the damages to the investors.¹⁶⁹ But it is well known that the TSA does not have loss causation as an element of the securities fraud action.¹⁷⁰ Consequently, the court of appeals affirmed the district court.¹⁷¹

IV. CONCLUSION

The U.S. Court of Appeals for the Fifth Circuit dealt with several attempts by promoters to design investments in such a manner to avoid compliance with the securities laws claiming the investments were not securities. For two joint ventures, the Fifth Circuit found one joint venture did involve a security since the co-venturers had no effective power to exercise control over the joint venture, while for the other one the Fifth Circuit found a joint venture interest not a security because the co-venturers actually participated in controlling the joint venture. For a limited partnership, the Fifth Circuit found that the limited partner that managed the limited partnership through a separate service agreement did not destroy the security nature of his limited partnership interest since the ability to manage the limited partnership was not in the limited partnership's formation documents. The Fifth Circuit also determined that a grant of an employee option is not a "sale" of a security since the employee does not part with anything of value. And the Fifth Circuit joined the Texas Supreme Court in determining that life settlements are securities as investment contracts since their return depends on the presale efforts of the creator of the life settlements just as is the case with bonds.

In contrast, the Second Fort Worth Court of Appeals' scope issue dealt with the impact of free speech in connection with aiders and abettors under the TSA. Unfortunately, the Texas Anti-SLAPP statute did not apply in the current case since there was no communication constituting the exercise of free speech. So, the court of appeals left that issue open for some future day.

167. *Id.* at 474 (citing *Citizens Ins. Co. of Am. v. Daccach*, 217 S.W.3d 430, 435, 439–40 (Tex. 2007)). The court of appeals noted that it had also so ruled in *Rio Grande Oil Co. v. State*, 539 S.W.2d 917, 921–22 (Tex. Civ. App.—Houston [1st Dist.] 1976, writ ref'd n.r.e.), as had the U.S. District Court of the Southern District of Texas in *Baron v. Strassner*, 7 F. Supp. 2d 871, 872 (S.D. Tex. 1998).

168. *Kubbernus*, 574 S.W.3d at 475–76.

169. *Id.* at 485.

170. *Id.* (citing *Duperier v. Tex. State Bank*, 28 S.W.3d 740, 753–54 (Tex. App.—Corpus Christi–Edinburg 2000, pet. dism'd by agr.).

171. *Id.* at 490.

The TSSB made a number of changes to its rules to comply with recent legislation. One statute called for the administrative bodies to negotiate with interested parties in making rules so the TSSB set up a procedure for that participation. Another statute permitted those with criminal convictions not relating to the occupational license to obtain an occupational license, so the TSSB revised its rules to permit such individuals to obtain a preliminary determination before training and to allow such individuals to be licensed as dealers and investment advisers. A third statute allowed resident military spouses to use out of state occupational licenses in Texas so the TSSB revised its rules to allow those military spouses to become dealers and investment advisers. A fourth statute removed the registration requirements for branch offices of dealers and investment advisers, so the TSSB set up a notice procedure for such branches.

The TSSB's enforcement efforts against dealers focused on failing to report embarrassing matters such as felony convictions and on failing to follow supervisory procedures of employed dealer agents. The enforcement efforts against investment advisers concerned failure to disclose conflicts and business background to clients, failure to enforce supervisory procedures, recommending stream of income investments without disclosing the risks to clients, engaging in a side business without disclosing it to the employing investment adviser firm, advising more than five Texas residents without registering, and using client moneys to pay other clients.

The TSSB's enforcement efforts against threats to investors involved numerous actions dealing with (1) cryptocurrency mining programs without disclosing the miners' backgrounds and the risks involved; (2) oil and gas drilling projects without disclosing the driller's past failures and the risks involved; (3) currency trading programs without disclosing the risks and the traders' qualifications; and (4) an exploitation of the elderly getting them to swap their safe investments for investments in precious metals without disclosing the risks involved with precious metals.

For the federal fraud action, the Fifth Circuit treated several poorly pleaded petitions. The case dealing with misstatements, the petitioner for the fraudulent statements failed to allege where the statements were made and that the statements were false when made and for the omissions when they should be disclosed. The cases involving a strong inference of scienter dealt with corporations trying to properly disclose meaningful information during a trying event. For the case of the issuer trying to develop software to help sell oilfield products, the petitioner did not allege the officer knew the statement was false when made. For the case of handling an oil pipeline spill, the petitioner failed to identify which officer made the statements made online, failed to allege the officer testifying before the legislature knew the statement was false and most of the alleged misstatements were aspirational and belief. For the issuer trying to adjust to online retailing, the Fifth Circuit noted that knowledge of a high inventory is not equivalent to knowledge of the risk

of a markdown and that some of the misstatements came outside the class period, and refused to adopt a theory that the SEC requirement to disclose trends includes disclosure of the risk of markdowns. For the issuer adjusting to changes in Medicare procedures, the auditor committee's report that the chief financial officer engaged in appropriate accounting practices to enhance reported earnings, although supportive and contributing slightly to scienter, was not the required strong inference of scienter.

For the fraud actions under the TSA, the parties fared no better. For the dispute of the trust funds, the statute of limitations had expired for the petitioner. For the life settlement case, the petitioner failed to allege which section of the TSA was violated, which defendant violated the TSA, and which investors still owned their life settlements to determine whether the remedy was for damages or rescission. And for the Delaware issuer operating in Texas, the defendant claimed erroneously that the TSA does not apply to foreign investors when the investment is sold from Texas and that the TSA requires a causation element.