SMU | Dedman School of Law

SMU Law Review

Volume 59
Issue 3 *Annual Survey of Texas Law*

Article 23

January 2006

Securities Regulation

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Recommended Citation
George Lee, Flint, *Securities Regulation*, 59 SMU L. Rev. 1541 (2006)
https://scholar.smu.edu/smulr/vol59/iss3/23

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SECURITIES REGULATION

*George Lee Flint, Jr.**

SECURITIES regulation deals primarily with the laws preventing and providing remedies for fraud in the sale of stocks and bonds. Although this Article includes Fifth Circuit cases under federal law, the author has attempted to limit the material to that involving state law[1] and only briefly touches federal securities law.[2] The author does not intend this Article to be an exhaustive survey of securities regulation, but rather an update regarding developments of interest to the Texas based securities practitioner.

I. COVERAGE OF THE SECURITIES ACTS

The definitions, especially those relating to the issues of what constitutes a security, who may recover, and the territorial reach, determine the scope of the securities acts. The Fifth Circuit issued one decision concerning standing to sue under section 11 of the Securities Act of 1933.[3] The decision narrows who may recover under the federal act for false registration statements. This group of potential plaintiffs is even narrower under the Texas Securities Act ("TSA") since it has a privity provision.[4]

In *Krim v. PCOrder.com*,[5] the Fifth Circuit had an opportunity to cut back the number of "after-market" investors that could bring a lawsuit under section 11 of the Securities Act of 1933[6] for misstatements and omissions in a registration statement. The Fifth Circuit had previously

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1. Texas has two major statutes to combat securities fraud: the Texas Securities Act [hereinafter TSA] and the Texas Stock Fraud Act [hereinafter TSFA]. *See* TEX. REV. CIV. STAT. ANN. art. 581 (Vernon Supp. 2004) (TSA); TEX. BUS. & COM. CODE ANN. § 27.01 (Vernon 2002) (TSFA).

2. Since the Texas Legislature based portions of the TSA on the federal securities statutes and Texas courts rely on federal decisions to interpret the corresponding sections of the TSA, this Article also examines federal developments in the Fifth Circuit. *See* TEX. REV. CIV. STAT. ANN. art. 581-33 cmt. to 1977 Amendment (Vernon Supp. 2004).

3. *See* Krim v. PCOrder.com, 402 F.3d 489 (5th Cir. 2005).

4. *Compare* 15 U.S.C. § 77k (1997) ("any person acquiring such security") *with* TEX. REV. CIV. STAT. ANN. art. 581-33A(1) ("the person buying the security from him") *and* Comments on Specific Sections ("§ 33A(1) . . . is a privity provision") (Vernon Supp. 2004).

5. *Krim*, 402 F.3d at 489 (from the Western District of Texas).

6. *See* 15 U.S.C. § 77k (1997).

determined that "any person acquiring such security" issued under the erroneous registration statement included purchasers in the after-market, provided that they could trace their shares back to shares sold under the registration statement.[7] *Krim* dealt with the traceability of shares purchased in the after-market in street name.[8] Street-name shares are listed on the issuer's shareholder list in the name of the nominee for a depository. That certificate includes all the shares held in street name by the numerous brokerage houses using that depository so that transfers in street name between clients of two brokerage houses using the same depository need not require new certificates.[9]

Krim involved two sorts of lead plaintiffs. One sort purchased their shares at a time when the street name certificate included only shares purchased in the initial public offering under the registration statement.[10] The district court found these traceable.[11] When there is only one offering into the public market and it is through the registration statement, all stock necessarily traces to the faulty registration statement.[12] Nevertheless, the district court dismissed the lawsuit as to the first sort since the issuer had offered them a settlement equal to their potential recovery.[13] The second sort purchased their shares at a time when the street-name certificate included a few shares (0.15%) from insiders selling after the initial public offering.[14] The plaintiff investors used binomial probability to show that the odds that at least one share held by the second sort came from the initial public offering was very nearly 100%, much greater than the 51% presumedly required by the preponderance-of-the-evidence rule. The district court, nevertheless, found these shares not traceable and dismissed the lawsuit.[15] The investors challenged this second dismissal, but the Fifth Circuit affirmed.[16] The chosen method of statistical tracing would result in each share purchased in the after-market conferring standing to sue despite language in section 11 limiting the lawsuit to "any person acquiring such security."[17] This would be the case whenever more than 50% of the available shares were issued under the defective registration statement or whenever sufficient additional shares were purchased while the registration statement shares number less than 50%.[18]

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7. *See* Rosenzweig v. Azurix Corp., 332 F.3d 854, 873 (5th Cir. 2003), *see also* George L. Flint, Jr., *Securities Regulation*, 57 SMU L. REV. 1207, 1238-39 (2004) (discussing *Rosenzweig*).

8. *Krim*, 402 F.3d at 492.

9. *Id.*

10. *Id.*

11. *Id.*

12. This is the *Rosenzweig* situation. *See Rosenzweig*, 332 F.3d at 873.

13. *Krim*, 402 F.3d at 493.

14. *Id.* at 492.

15. *Id.* at 492-93.

16. *Id.* at 491.

17. *Id.* at 496-97.

18. For the calculations, see *Krim*, 402 F.3d at 496 n.36 (showing that a purchase of 35 shares would be sufficient when the registration statement shares are only 2% of the outstanding shares in the public market).

The Fifth Circuit also refused to broaden the standing to bring a section 11 lawsuit due to changed circumstances, namely the development of widespread holding of securities in street name in the 1960s, a practice uncommon in the 1930s when Congress passed the Securities Act of 1933, leaving such revision to Congress. The Fifth Circuit noted that other courts had rejected similar attempts to broaden section 11 standing using tracing[19] or the fungible-mass method of tracing whereby the purchaser is deemed to own a pro rata portion of the shares purchased under the registration statement.[20]

II. ORGANIZATION OF THE STATE SECURITIES BOARD

The TSA created a regulatory body, the State Securities Board ("Board") to handle the registrations required by those laws, as well as to serve as an enforcement mechanism.

The Board amended its form for public information charges and billing detail to reflect current fees for public information established by the Texas Building and Procurement Commission in accordance with the Public Information Act[21] and to accurately apprise persons requesting public information of the associated charges.[22]

III. REGISTRATION OF SECURITIES

The basic rule of most securities laws is that securities either need to be registered with the regulatory agency or fall within an exemption to registration. The Board reconsidered two of its exemptions from registration.

The Board adopted new rules reorganizing the exemption for sales to financial institutions and certain institutional investors under the TSA.[23] The investment advisor portion of the exemption corresponds to a new federal Securities and Exchange Commission ("SEC") registration exemption.[24] The Board rule, however, does not parallel the federal rule. The Board feels that entities composed partially or entirely of natural persons are not institutions, and private investment entities similarly composed are not institutional investors. Consequently, the Board's defi-

19. *See* Barnes v. Osofsky, 373 F.2d 269, 271-72 (2d Cir. 1967).

20. *See Krim*, 402 F.3d at 499; Kirkwood v. Taylor, 590 F. Supp. 1375, 1381 (D. Minn. 1984), *aff'd* 760 F.2d 272 (8th Cir. 1985) (table case).

21. *See* TEX. GOV'T CODE ANN. § 552 (Vernon 2004).

22. 30 Tex. Reg. 3990 (2005), *adopted* 30 Tex. Reg. 1383 (2005) (to be codified as an amendment to 7 TEX. ADMIN. CODE § 133.2) (without comment) (amending 7 TEX. ADMIN. CODE § 133.2) (without comment).

23. 30 Tex. Reg. 3987 (2005) (to be codified as an amendment to 7 TEX. ADMIN. CODE § 109.3) (confining the rule to sales to savings institutions and deleting the portions moved to new rules at 7 TEX. ADMIN. CODE §§ 109.4-.6); 30 Tex. Reg. 3987 (2005) (to be codified as an amendment to 7 TEX. ADMIN. CODE §§ 109.4 (registration of the securities), 109.5 (registration of the dealers), & 109.6 (registration of the investment advisors)); 30 Tex. Reg. 1383 (2005) (proposed Mar. 11, 2005). *See* TEX. REV. CIV. STAT. ANN. art. 581-5H (Vernon 2004) (providing an exemption for sales to banks, savings banks, insurance companies and the like).

24. 17 C.F.R. § 275.203(b)(3)-1(d) (2005) (defining "private fund" for the definition of client of an investment adviser).

nition of private fund does not exclude those funds allowing natural persons to redeem within two years of purchase for extraordinary events as does the federal rule. The Board also amended its rule concerning sales to accredited investors to clarify the requirement that an issuer reasonably believes the purchases are made with investment intent.[25]

The Board has taken numerous enforcement actions[26] against issuers who did not register their securities,[27] many involving the internet.[28] Sev-

25. 30 Tex. Reg. 3990 (2005), *adopted* 30 Tex. Reg. 1389 (2005) (to be codified as an amendment to 7 TEX. ADMIN. CODE § 139.16) (without comment).

26. The Board's top ten list of threats to Texas investors includes (1) Ponzi schemes, (2) unlicensed securities sellers, (3) unregistered investment products, (4) promissory notes issued by those unable to deliver promised returns, (5) fraudulent or unsuitable opportunities targeted toward senior citizens, (6) high-yield investments, (7) internet fraud, (8) affinity fraud, (9) variable annuity sales practices, and (10) oil and gas scams. *See, e.g.*, Meena Thiruvengadam, *Scammers Drilling for Oil Investors*, SAN ANTONIO EXPRESS NEWS, Apr. 7, 2005, at 1E.

27. *See In re* Provision Interactive Tech., Inc., No. ENF-05-CDO/FIN 1589, 2005 WL 1421388, at *1-2 (Tex. St. Sec. Bd. June 7, 2005) (agreed cease and desist order to California company for selling unregistered limited partnership interests through unregistered dealer without registration of the securities); *In re* In Touch Parents, Inc., No. ENF-05-CDO-1585, 2005 WL 584973, at *1 (Tex. St. Sec. Bd. Mar. 10, 2005) (emergency cease and desist order to Nevada company for selling unregistered founders stock through unregistered dealers without registration of the securities and without disclosing a Wisconsin Order of Prohibition against one selling dealer for sales of stock in another company); *In re* Revelle Res., Inc., No. ENF-05-CDO/FIN-1583, 2005 WL 513366, at *1-2 (Tex. St. Sec. Bd. Mar. 1, 2005) (agreed cease and desist order for selling unregistered working interests in an Illinois oil well without registration as a dealer and ordering an administrative fine of $500); *In re* Cornerstone Ministries Invs., Inc., No. ENF-05-CDO/FIN-1592, 2005 WL 389682 (Tex. St. Sec. Bd. Feb. 14, 2005) (agreed cease and desist order for selling unregistered common stock and bonds with material misrepresentations in SEC filings of a listing on the Chicago Stock Exchange; claiming in state Board filings an unawareness of major adverse business developments when the Chicago Stock Exchange denied a listing since the issuer did not meet the minimum requirements and indicated that future applications would likely be denied; and claiming in the prospectus that no legal proceedings were pending despite Michigan having given notice to show compliance for various misleading statements and ordering a $20,000 administrative fine).

28. *See In re* Fat Franks Chicago Style Hot Dogs LLC, No. ENF-05CDO-1593, 2005 WL 2416039, at *1-2 (Tex. St. Sec. Bd. Sept. 27, 2005) (emergency cease and desist order to company selling unregistered investment programs; one program split profits after bills were paid from profits at all locations and another program invested in iceberg harvesting, renewable forestry, and pen ocean fish farming through the internet without registering as a dealer and without disclosing a $58,000 default judgment against one principal, the risks of the investments, and financial information); *In re* Frank Torres Castillo, No. ENF-05-CDO-1594, 2005 WL 2416040, at *1 (Tex. St. Sec. Bd. Sept. 27, 2005) (emergency cease and desist order to Mexican real-estate-investment trust selling limited liability company shares through the internet without registering as a dealer and without disclosing the risks of the investment, thus rendering the return figure of 73% over 5 years misleading); *In re* Tyche Global Investors, Inc., No. ENF-05-CDO 1590, 2005 WL 1695943, at *1 (Tex. St. Sec. Bd. July 14, 2005) (agreed cease and desist order to company for selling unregistered money-market mutual fund interests offering a return of 13% through the internet without registering as a dealer); *In re* Aransas Oil Co., Inc., No. ENF-05-CDO-1588, 2005 WL 1387561, at *1 (Tex. St. Sec. Bd. May 31, 2005) (emergency cease and desist order to company selling unregistered working interests in oil and gas leases for Texas land without registering as dealers); *In re* Pureinvestor.com Inc., No. ENF-05-CDO-1587, 2005 WL 858205, at *1-2 (Tex. St. Sec. Bd. Apr. 6, 2005) (emergency cease and desist order to company selling unregistered interests in a 5-year trust plan through the internet without disclosing financial data, the principals, information needed to compute a return, and the risks; misleading the public by describing the investment as licensed when not registered and the company

eral involved a challenge to an emergency cease and desist order,[29] and one involving taped telephone offers made over the Board's undercover telephone line.[30]

IV. REGISTRATION OF MARKET OPERATORS

One of the underpinnings of state regulation of securities is the requirement to register as a seller of securities before selling securities in the state and as an investment advisor before rendering investment advice.[31] Registration infractions generally surface when applying or reapplying for registration.

A. DEALERS

The Board amended its rules concerning both dealer and agent examinations[32] and investment advisor representative examinations[33] to provide an examination waiver for an applicant whose prior Texas registration has lapsed for more than two years, but who has continuously been registered with the National Association of Securities Dealers ("NASD") and the state securities regulator of the state where the applicant maintains its principal place of business.

The Board has had numerous enforcement actions against selling agents and dealers. Dealer infractions included failure to have a regis-

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as incorporated when not registered to do business in Texas, all without registering as dealers); *In re* ATM Alliance Corp., No. ENF-05-CDO-1586, 2005 WL 656156, at *1-2 (Tex. St. Sec. Bd. Mar. 17, 2005) (emergency cease and desist order to company selling unregistered passive interests in an ATM-terminal business through the internet without disclosing bankruptcies of principals, financial information, risks, and the failure rate of other such businesses; misleading the public by claiming 12 years experience for a company formed 1 year ago, all without registering as dealers).

29. *See In re* Complete Estate Serv. LLC, No. 312-05-4069, 2005 WL 1995574, at *1-3 (Tex. St. Sec. Bd. Aug. 15, 2005) (confirming cease and desist order against investment program guaranteeing annual return of 10% for 5 years and 13.2% for 10 years through the internet without disclosing the identities of the principals, their financials and past records, and the risks of the investment until the securities are registered and the dealers are registered), *aff'g in part In re* Tri-Forex Int'l, Ltd., No. ENF-05-CDO-1581, 2005 WL 236650 (Tex. St. Sec. Bd. Jan. 25, 2005); *see also In re* Lyle Energy Group, Inc., No. 312-05-4097, 2005 WL 704329, at *1 (Tex. St. Sec. Bd. Mar. 23, 2005) (affirming emergency cease and desist order when issuer failed to appear at requested hearing), *aff'g*, No. ENF-04-CDO-1579, 2004 WL 2980010 (Tex. St. Sec. Bd. Dec. 13, 2004).

30. *See In re* Dunwell Corp., No. 312-05-0553, 2005 WL 1713074, at *4, *7 (Tex. St. Sec. Bd. July 19, 2005) (confirming cease and desist order against company selling oil and gas working interests in Alabama well without disclosing the minimum needed to initiate the program and orally misrepresenting an 8 to 1 return contained in sales literature as a 35 to 1 return), *aff'g*, No. ENF-04-000-1569, 2004 WL 1925428 (Tex. St. Sec. Bd. Aug. 20, 2004).

31. *See* TEX. REV. CIV. STAT. ANN. art. 581-13 (Vernon Supp. 2004).

32. 30 Tex. Reg. 3988 (2005), *adopted* 30 Tex. Reg. 1385 (2005) (to be codified as an amendment to 7 TEX. ADMIN. CODE § 115.3) (without comment).

33. 30 Tex. Reg. 3989 (2005), *adopted* 30 Tex. Reg. 1386 (2005) (to be codified as an amendment to 7 TEX. ADMIN. CODE § 116.3) (without comment).

tered qualified designated officer,[34] required by the rules,[35] material misrepresentations to the Texas Securities Commissioner in connection with information required to determine a dealer's qualifications,[36] selling unregistered securities without registering as a dealer,[37] and inequitable

34. *See In re* Omega Research Corp., No. IC05-FIN-20, 2005 WL 1986002, at *2 (Tex. St. Sec. Bd. Aug. 11, 2005) (ordering an administrative fine of $1,450 for failing to file for registration of new designated officer within 30 days of resignation of old officer and failing to respond to Board requests to do so a year later); *In re* Dealer Registration of Aegis Capital Corp., No. IC05-CAF,-17, 2005 WL 1327365, at *1-2 (Tex. St. Sec. Bd. June 2, 2005) (ordering an administrative fine of $3,500 for failing to file for registration of new designated officer within 30 days of old officer becoming a non-control person, and failing to respond to two Board requests to do so 2½ years later); *In re* Dealer Registration of Great E. Sec., Inc., No. IC05-CAF-12, 2005 WL 1068602, at *1-2 (Tex. St. Sec. Bd. May 4, 2005) (reprimanding and ordering an undertaking to appoint a new designated officer and an administrative fine of $4,000 for failing to file for registration of new designated officer within 30 days of removal as a control person of old designated officer and failing to respond to two Board requests to so do 3 years later); *In re* Dealer Registration of Scudder Investor Servs., Inc., No. IC05-CAF-11, 2005 WL 985189, at *1-2 (Tex. St. Sec. Bd. Apr. 22, 2005) (reprimanding and ordering an undertaking to file information on new designated officer and an administrative fine of $700 for failing to file for registration of new designated officer within 30 days of registration termination of old designated officer and failing to respond to two Board requests to so); *In re* Dealer Registration of Stuart Sec., Inc., No. IC05-CAF-09, 2005 WL 740126, at *1-2 (Tex. St. Sec. Bd. Mar. 29, 2005) (reprimanding and ordering an undertaking to file information on new designated officer and an administrative fine of $900 for failing to file for registration of new designated officer within 30 days of termination of old designated officer and failing to respond to two Board requests to do so); *In re* Dealer Registration of Zahorik Co., Inc., No. IC05-CAF-08, 2005 WL 641328, at *1-2 (Tex. St. Sec. Bd. Mar. 16, 2005) (reprimanding and ordering an undertaking to file information on new designated officer and an administrative fine of $250 for failing to file for registration of new designated officer within 30 days of termination of old designated officer); *In re* Dealer Registration of C.E. Unterberg, Towbin, LLC, No. IC05-CAF-05, 2005 WL 494434, at *1-2 (Tex. St. Sec. Bd. Feb. 28, 2005) (reprimanding and ordering an undertaking to file information on new designated officer and an administrative fine of $1,500 for failing to file for registration of new designated officer within 30 days of termination of old designated officer); *In re* Dealer Registrations of Benfield Advisory Inc., No. IC05-CAF-03, 2005 WL 389683, at *1-2 (Tex. St. Sec. Bd. Feb. 14, 2005) (reprimanding and ordering an undertaking to file information on changes in designated officer and an administrative fine of $1,450 for failing to file change information within 30 days of registration termination of old designated officer and failing to respond to three Board requests to so).

35. *See* 7 TEX. ADMIN. CODE § 115.2(b) (2004).

36. *See In re* Dealer Registration of Flexvest Sec. Group, Inc., No. IC05-CAF-16, 2005 WL 1328164, at *3-4 (Tex. St. Sec. Bd. May 27, 2005) (reprimanding, suspending for 120 days, ordering an administrative fine of $10,000, and ordering compliance with an undertaking to implement procedures to insure maintenance of new account information, not to create a pool of investor funds for 2 years, and to notify the Commissioner within 120 days of creating any such fund, all for representing to the NASD, the SEC, and the Commissioner that new account forms were complete when they were not, selling unregistered hedge fund interests, using an unregistered selling agent, and failing to update filed information concerning another selling agent).

37. *See In re* William Erik Byrne, No. ENF-05-CDO-1584, 2005 WL 584972, at *1-2 (Tex. St. Sec. Bd. Mar. 10, 2005) (agreed cease and desist order to unregistered dealer who sold unregistered corporate promissory notes and unregistered variable annuity policies not filed with the Texas Department of Insurance and gave compensated investment advice while unregistered); *In re* Applications for the Agent and Inv. Adviser Representative Registrations of Russell Kent Childs, No. IC05-SUS-01, 2005 WL 80292, at *3 (Tex. St. Sec. Bd. Jan. 3, 2005) (granting registration, reprimanding the agent, suspending the agent for 15 days plus tolling periods of nonregistration, and ordering a $50,000 administrative fine for selling numerous unregistered limited partnership units while registered with another entity).

practices in the sale of unregistered securities.[38] Selling-agent violations involved unsuitable recommendations[39] and failing to properly disclose a felony offense.[40]

B. Investment Advisers

The Board amended its rule concerning supervision of investment advisors by clarifying that supervisory systems must be in writing and registered investment advisors must be informed of their supervisory systems.[41]

The Board had several enforcement actions against investment advisers. These actions primarily involved rendering compensated service after registration lapsed and before renewal[42] or without registration.[43]

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38. *See In re* Dealer Registration of LH Ross & Co., Inc., No. 04-IC02, 2005 WL 389684, at *2-3 (Tex. St. Sec. Bd. Feb. 14, 2005) (default order revoking dealer registration for selling the dealer's unregistered preferred stock by representing the dealer was going public when it had taken no steps to go public and representing that a 6% quarterly dividend would be paid when the dealer had no intention of resuming dividends; violating suitability requirements by selling to investors not understanding the illiquid nature of the securities and providing the private placement after the sale; violating the dealer's written procedures to supervise its agents by accepting new accounts without the signature of the designated principal, using an unlicensed principal, failing to review suitability profiles, and failing to sign subscription agreements).

39. *See In re* Agent Registration of Stafford Fabian Lucky, No. IC05-SUS-15, 2005 WL 1244572, at *1 (Tex. St. Sec. Bd. May 24, 2005) (reprimanding, suspending for 31 days plus tolling periods of nonregistration for recommending to a Texas investor to take out a home equity loan and invest the proceeds in two mutual funds, unsuitable based on the investor's disclosed financial position and needs); *In re* Agent Registration of Alfonso Roberto Asencio, No. IC05-SUS-07, 2005 WL 627979, at *1-2 (Tex. St. Sec. Bd. Mar. 13, 2005) (granting registration, reprimanding, suspending for 50 days plus tolling periods of nonregistration, and ordering an undertaking to cooperate with investigation by the Board and NASD, all for recommending to a Texas investor excessive use of margin).

40. *See In re* Agent & Inv. Adviser Representative Registrations of Brian Christopher MacMaster, No. IC06-CAF-14, 2005 WL 1244571, at *2-3 (Tex. St. Sec. Bd. May 20, 2005) (reprimanding, ordering an administrative fine of $4,000, and ordering an undertaking to properly disclose the felony conviction and an administrative action on the agent's next registration, to withdraw the agent's current registration, and not to file a registration for 24 months; all for describing a 10-year-old guilty plea for possession of cocaine as "taking the rap" for others' possession in the car that the agent was driving and as "final" when misrepresentations about it was the reason for denial of an application to the Texas Department of Insurance the year before).

41. 30 Tex. Reg. 3989 (2005), *adopted* 30 Tex. Reg. 1387 (2005) (to be codified as an amendment to 7 Tex. Admin. Code § 116.10) (without comment).

42. *See In re* Investment Adviser Registration of Teakwood Fin. Advisors, Inc., No. IC05-CAF-06, 2005 WL 575514, at *1-2 (Tex. St. Sec. Bd. Mar. 8, 2005) (reprimanding and ordering administrative fines totaling $2,000 for rendering compensated investment advice in a five-month gap between registrations as an investment advisor).

43. *See In re* Applications for Inv. Adviser Registration of BAMC Inv. Mgmt., Inc., No. IC05-CAF-26, 2005 WL 2406949, at *2-3 (Tex. St. Sec. Bd. Sept. 22, 2005) (granting application while reprimanding and ordering administrative fines totaling $12,000 for giving compensated advice without registration); *In re* Inv. Adviser Representative Registration of Dallas Leigh Jones, No. IC05-CAF-23, 2005 WL 2405222, at *2 (Tex. St. Sec. Bd. Sept. 16, 2005) (reprimanding and ordering administrative fine of $4,000 for giving compensated advice on behalf of his employer without registration); *In re* Inv. Adviser Representative Registration of Maco Stewart Fowlkes, No. IC05-CAF-24, 2005 WL 2405223, at *2 (Tex. St. Sec. Bd. Sept. 16, 2005) (same, but fine of $10,000); *In re* Inv. Adviser Representative Registration of Jay Wallace Branson, No. IC05-CAF-25, 2005 WL 2405224, at *2

One involved misleading advertising, an inequitable practice,[44] and the use of prohibited testimonials.[45] Another involved the failure to report a changed address, discovered when the Board attempted an inspection at the old address.[46]

V. SECURITIES FRAUD

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

A. COURT DECISIONS UNDER THE TEXAS ACTS

The Texas Supreme Court reversed two courts of appeals decisions, one dealing with the misrepresentation required for a fraud action involving the sale of a quitclaim deed and the other expounding on the scienter requirement for aider and abetter liability.[47] Additionally, one appellate

(Tex. St. Sec. Bd. Sept. 16, 2005) (same, and granting the application); *In re* Applications for the Inv. Adviser Registration of Kaizen Mgmt., LP, No. IC05-SUS-22, 2005 WL 2277081, at *2-3 (Tex. St. Sec. Bd. Sept. 15, 2005) (granting registration, reprimanding, suspending the registration for 15 days plus tolling periods of nonregistration, and ordering administrative fines totaling $20,000 for rendering compensated advice without registration); *In re* Inv. Adviser Registration of David Lee Borders, No. IC05-SUS-19, 2005 WL 1874439, at *2 (Tex. St. Sec. Bd. Aug. 4, 2005) (granting registration, reprimanding, suspending the registration for 60 days, and ordering administrative fine of $2,000 for rendering compensated advice for 3 years without registration); *In re* Applications for the Inv. Adviser Registration of Bond Fund Res. Mgmt., L.P., No. IC05-CAF-13, 2005 WL 1123353, at *3 (Tex. St. Sec. Bd. May 10, 2005) (reprimanding, ordering administrative fines totaling $2,700, and ordering an undertaking not to render investment advice until registered for providing compensated investment advice); *In re* Inv. Advisor Registration of Hawthorn Fin. Advisors, Inc., No. IC05-CAF-10, 2005 WL 858206, at *2 (Tex. St. Sec. Bd. Apr. 11, 2005) (reprimanding, ordering an administrative fine of $2,500, and ordering an undertaking to hire an outside compliance specialist if not registered for a two-year period); *In re* Tarpon Capital Mgmt., L.P., No. IC05-CAF-02, 2005 WL 236649, at *3 (Tex. St. Sec. Bd. Jan. 25, 2005) (granting one investment advisor representative application, reprimanding the two investment advisor representatives, and ordering an administrative fine against the investment advisor in the amount of $80,000 for numerous compensated investment advice without registration).

44. *See* TEX. REV. CIV. STAT. ANN. art. 581-14A(3) (Vernon 2004) (providing remedies for inequitable practices).

45. *See In re* Investment Adviser Registration of Ryan Edward Parker, No. IC05-SUS-21, 2005 WL 1986003, at *1-2 (Tex. St. Sec. Bd. Aug. 15, 2005) (reprimanding, suspending registration for 10 days plus tolling periods of nonregistration, and ordering administrative fine of $7,000 for using testimonials and creating the appearance that a major financial publication had published an article about the investment adviser's website when it had not); *see also* 7 TEX. ADMIN. CODE § 116.15(1)(a) (2006) (prohibiting testimonials in advertising by investment advisers and investment adviser representatives).

46. *See In re* Inv. Adviser Registration of Michael David Scott, No. IC05-CAF-18, 2005 WL 1414351, at *1-2 (Tex. St. Sec. Bd. June 14, 2005) (reprimanding and ordering administrative fine of $2,500 for delaying 7 months to report a changed address); *see also* 7 TEX. ADMIN. CODE § 116.9(a)(6) (2006) (requiring report of changed information previously disclosed to the Board within 30 days).

47. Geodyne Energy Income Prod. P'ship I-E v. Newton Corp., 161 S.W.3d 482 (Tex. 2005) (misrepresentations under the TSA); Sterling Trust Co. v. Adderley, 168 S.W.3d 835 (Tex. 2005) (scienter for aider or abaiter liability).

court's decision involved the evidence needed to show rescission damages under the TSA and Texas Stock Fraud Act ("TSFA").[48]

1. *Misrepresentation under the TSA*

In *Geodyne Energy Income Production Partnership I-E v. Newton Corporation*, the Texas Supreme Court determined that a sale at an auction by a quitclaim deed of a 10% working interest in an oil and gas lease did not violate the TSA.[49] The operator had sued the nonoperators for their portion of the cost of plugging a non-producing well.[50] The issue was whether the purchaser or the seller of the interest would pay the $72,000 cost of plugging the well. Since the purchase of the interest involved a security,[51] the purchaser sought to escape the plugging-cost liability by obtaining rescission of the $300 sale under the TSA, which allows an action against a seller who sells a security by means of an untrue statement of a material fact or failing to state a material fact. The only alleged misrepresentation was the identification of the property in the auction catalog as a "GWI.10000000," a gross working interest, from which the purchaser assumed a valid lease.[52]

The lease had expired by its terms the year before the auction since production had dwindled below paying quantities and reworking operations had not commenced within the sixty-day period called for in the lease. The operator, however, neglected to inform the nonoperating interests of the expiration until after the auction.[53] The appellate court supported the jury finding of an omission[54] from the failure to supply the purchaser with billing statements indicating that the operator had performed no reworking operations.[55] The Texas Supreme Court dismissed this argument since the same information appeared in other documents supplied to the purchaser.[56] The Texas Supreme Court then determined that the securities in this oil and gas lease could be sold by a quitclaim deed, noting that this was a traditional method of transferring such interests in the oil and gas industry and that the legislature had expressed that

48. Reardon v. Light Path Techs., Inc., 183 S.W.3d 429 (Tex. App.—Houston [14th Dist.] 2005, pet. denied) (rescission damages).

49. *Geodyne Energy*, 161 S.W.3d at 484.

50. *See* TEX. NAT. RES. CODE ANN. §§ 89.011 (operator liability), 89.012 (nonoperator liability), & 89.081 (cause of action for portion) (Vernon 2001).

51. *See* TEX. REV. CIV. STAT. ANN. art. 581-4A (Vernon Supp. 2004).

52. *Geodyne Energy*, 161 S.W.3d at 486.

53. Geodyne Energy Income Prod. P'ship I-E v. Newton Corp., 97 S.W.3d 779, 782 (Tex. App.—Dallas 2003), *rev'd in part*, 161 S.W.3d 482 (Tex. 2005).

54. *See Geodyne Energy*, 97 S.W.3d at 787; *see also* George L. Flint, Jr., *Securities Regulation*, 57 SMU L. REV. 1207, 1230-31 (2004) (discussing *Geodyne Energy*). The court of appeals focused on the causation/reliance elements of the fraud action, a matter the Supreme Court did not reach since it found no misrepresentation or omission.

55. *See Geodyne Energy*, 97 S.W.3d at 787.

56. Appellate courts only report facts sufficient to support their opinions. *See, e.g.*, KARL LLEWELLYN, THE BRAMBLE BUSH: ON OUR LAW AND ITS STUDY 35 (Oceana Publications, Inc. 1960) (1930). The court of appeals never mentioned the fact that disclosure was made in other documentation that the Texas Supreme Court determined dispositive of the case.

one of the purposes of the TSA was to encourage capital formation and minimize regulatory burdens, especially for small businesses.[57]

As for the misrepresentation claim, the Texas Supreme Court found no misrepresentation as a result of the quitclaim deed.[58] The purchaser got title to a ten-percent interest, albeit in liabilities rather than assets.[59] A quitclaim deed contains no representation concerning title, in the absence of prior representations amounting to fraudulent inducement, accident, or mistake.[60] The manner of conducting the auction (limiting the bidders to those warranting their substantial experience and investments in the oil and gas industry and obtaining purchaser signatures to a buyer's conditions of sale that contained explanations that the seller was making no representations as to any warranties of title, merchantability, or fitness for purpose, that the buyer needed to conduct its own verification of information, and that the buyer acknowledged a review and understanding of the conveyancing documents) defeated any assumption that the auction listing represented the lease's validity.[61] The buyer's admission of reviewing files showing virtually no production for the well and the auctioneer's announcement that the well had no production destroyed any assumption concerning the lease's validity. Consequently, the Texas Supreme Court reversed and rendered that the buyer take nothing on its TSA claim against the seller.[62]

2. *Scienter for Aider-Abbetter Liability under the TSA*

In *Sterling Trust Co. v. Adderley*,[63] the Texas Supreme Court outlined the scienter requirement for aiding and abetting liability under the TSA[64] and explained how it differs from the corresponding provision of the Uniform Securities Act adopted in some other states.[65] In *Sterling Trust*, an investment advisor and broker operated an illegal Ponzi scheme by con-

57. *See* TEX. REV. CIV. STAT. ANN. art. 581-10-1(B) (Vernon Supp. 2004) (added in 1983; "This Act may be construed and implemented to effectuate its general purposes to protect investors and consistent with that purpose, to encourage capital formation, job formation, and free and competitive securities markets and to minimize regulatory burdens on issuers and persons subject to this Act, especially small businesses."). This language appears in the section relating to registration with the Board and not in the private remedies section; however, there is another analogous provision for registration. *See infra* note 35.

58. *Geodyne Energy*, 161 S.W.3d at 490.

59. *Id.*

60. *See* Commercial Bank, Unincorporated v. Satterwhite, 413 S.W.2d 905, 909 (Tex. 1967) (attempted real-estate-deed reformation disallowed in absence of fraud, accident, or mistake); Alvarado v. Bolton, 749 S.W.2d 47, 48 (Tex. 1988) (Deceptive Trade Practices Act action not barred if deed contradicted earnest money-contract).

61. *Geodyne Energy*, 161 S.W.3d at 490-91.

62. *Id.* at 491.

63. 168 S.W.3d 835 (Tex. 2005). The courts did consider one other aider and abettor case during the Survey period; however, the court only had the opportunity to consider jurisdictional issues under the long-arm statute. *See* IRA Res., Inc. v. Griego, 161 S.W.3d 248 (Tex. App.—Corpus Christi 2005, no pet. h.).

64. *See* TEX. REV. CIV. STAT. ANN. art. 581-33F(2) (Vernon Supp. 2004).

65. UNIF. SECURITIES ACT § 410(b), 7C U.L.A. 266 (1956); *see, e.g.*, MASS. GEN. LAWS ANN. ch. 110A, § 410(b) (West 2005).

vincing elderly investors to invest their retirement savings in companies that the investment advisor owned. Maintaining the favored tax status of the retirement funds required a third-party trustee to hold the funds. After the SEC shut down the Ponzi scheme, rendering the investors' investments worthless, the investors sued the third-party trustee as an aider and abettor. The investors provided evidence that the third-party trustee (1) was aware that the perpetrator of the fraud commingled investors' funds by allowing one entity pay on debt of another entity, and (2) failed to follow its own internal policies by holding defaulted promissory notes, failing to obtain stock certificates, original promissory notes, and copies of security agreements, and allowing the perpetrator of the fraud to direct new investments without investor approval. The jury found the third-party trustee liable as an aider and abettor.[66] The trial court awarded $6 million in actual damages, which the appellate court affirmed.[67] The third-party trustee presented two errors of the appellate court: (1) failure to include in the jury instruction the requirement of a general awareness of the aider and abettor's role in the securities law violation,[68] and (2) failure to permit the aider and abettor a due-diligence defense.[69] The Texas Supreme Court found the first point an error and reversed and remanded, but it did not find the second point an error.[70]

For the first point, the Texas Supreme Court focused on irrelevant language in the TSA that specifically authorizes, but does not mandate, construction of the statute to coordinate with federal law when dealing with registrations and exemptions under the TSA.[71] This language, however, omits any mention of its application to the civil actions such as the fraud action in question. This approach also overlooks the long-standing procedure of Texas courts to use federal decisions interpreting those parts of the TSA that are extremely similar in language to the federal acts, but not where there are differences,[72] such as with the fraud action in question.

66. *Sterling Trust*, 168 S.W.3d at 837-39.

67. *See* Sterling Trust Co. v. Adderley, 119 S.W.3d 312, 316, 325 (Tex. App.—Fort Worth 2003), *rev'd in part*, 168 S.W.3d 835 (Tex. 2005). *See also* Flint, *supra* note 54, at 1210-11 (discussing *Sterling Trust*). The jury also found the third-party trustee liable for breach of fiduciary duty, which the appellate court affirmed and the Supreme Court reversed for defective jury instructions.

68. On this point the Fort Worth Court of Appeals differed from its fellow circuits. *See* Goldstein v. Mortenson, 113 S.W.3d 769, 776 (Tex. App.—Austin 2003, no pet.); Crescendo Inv., Inc. v. Brice, 61 S.W.3d 465, 472 (Tex. App.—San Antonio 2001, pet. denied); Frank v. Bear, Stearns & Co., 11 S.W.3d 380, 384 (Tex. App.—Houston [14th Dist.] 2000, pet. denied); *see also* Flint, *supra* note 54, at 1211 (discussing *Goldstein*).

69. *Sterling Trust*, 119 S.W.3d at 318.

70. *Id.* at 325.

71. *See* TEX. REV. CIV. STAT. ANN. art. 581-10-1(A) (Vernon Supp. 2004) ("This act may be construed and implemented to effectuate its general purpose to maximize coordination with federal and other states' law and administration, particularly with respect to (1) procedure, reports, and forms; and (2) exemptions.").

72. *Compare* Searsy v. Commercial Trading Corp., 560 S.W.2d 637, 639-40 (Tex. 1978) (using the federal *Howie* test to interpret "investment contract"); Campbell v. C.D. Payne & Geldermann Sec. Inc., 894 S.W.2d 411, 417-18 (Tex. App.—Amarillo 1995, writ denied) (using the federal family-resemblance test to interpret "note"); Star Supply Co. v. Jones, 665 S.W.2d 194, 196 (Tex. App.—San Antonio 1984, no writ) (using the economic-reality

The problem, of course, is that the federal securities statutes have no civil liability provision regarding aiding and abetting.[73] The Texas Legislature obtained its 1977 aider and abettor provision from the Uniform Securities Act, a proposed model for state-law provisions.[74] Nevertheless, the Texas Supreme Court seized upon erroneous pre-1977 federal common-law cases imposing aiding and abetting liability under the SEC's Rule 10b-5[75] since those cases occurred before the 1977 Texas amendment and were constructively known by the legislators. Those cases required a general awareness on the part of the aider and abettor that its role was part of an overall activity that is improper.[76]

The Texas Supreme Court then addressed the language of the aiding and abetting provision to confirm its conclusion. The investors contended that the provision's "reckless disregard of the truth or the law" standard did not require a subjective general awareness, but allowed liability for the objective failure to investigate.[77] The Texas Supreme Court responded that this language in other contexts meant a subjective intent, that the legislative intent was to impose a subjective scienter requirement,[78] and that the scholarly debate of the time suggested that imposing the objective investigation, a lower negligence standard, would work too great a burden on those engaging only in ordinary business activities such as loaning money, managing corporations, preparing financial statements, completing brokerage transactions, or, most importantly, rendering legal advice.[79] Although the jury instruction contained the "reckless disregard" language, repeated arguments by the investors' attorneys at trial that the third-party trustee exercised reckless disregard by ignoring its own policies rendered the jury charge harmful error since the jury may have thought that "reckless disregard" could be based on evidence of mere negligence.[80]

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test for a sale of a business as "stock"); *with* Anheuser-Busch Cos. v. Summit Coffee Co., 934 S.W.2d 705, 708 (Tex. App.—Dallas 1996, no writ) (refusing a narrow federal interpretation for a misrepresentation in a sale since the TSA omits "by means of a prospectus or oral communication").

73. *See, e.g.*, Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, 511 U.S. 164, 179 (1994) (sections 11 and 12 of the Securities Act and sections 9, 16, 18, and 20A of the Exchange Act provide for no express aiding and abetting offense, so the Supreme Court refused to imply one under Rule 10b-5); SEC v. Coffee, 493 F.2d 1304, 1316 (6th Cir. 1974) (secondary securities liability as aider and abettor is borrowed from the common law; the only statutory provision concerning secondary liability is the controlling-person provision).

74. *See* TEX. REV. CIV. STAT. ANN. art. 581-33 cmt. to 1977 Amendment (Vernon Supp. 2004); *see also* UNIF. SECURITIES ACT § 410(b), 7C U.L.A. 266 (1956).

75. *See* 17 C.F.R. § 240.10b-5 (2005).

76. *See, e.g.*, First Interstate Bank of Denver N.A. v. Pring, 969 F.2d 891, 898 (10th Cir. 1992), *rev'd*, Cent. Bank of Denver, 511 U.S. at 179 (banning aider and abettor liability for private actions under Rule 10b-5).

77. *Sterling Trust*, 168 S.W.3d at 841.

78. *See* TEX. REV. CIV. STAT. ANN. art. 581-33 cmt. to 1977 Amendment (Vernon 2004).

79. *Sterling Trust*, 168 S.W.3d at 842.

80. *Id.* at 842-43.

For the second point, the Texas Supreme Court noted that the legislature divided the perpetrators into three categories, each with a different scienter requirement and hence different due-diligence defense.[81] Investors need not show that sellers have scienter for a misrepresentation or omission, but sellers have a defense that they did not know and in the exercise of reasonable care could not have known of the untruth or omission.[82] Investors similarly need not show that control persons, those directly or indirectly in control of the seller, have scienter, but control persons also have a lack-of-knowledge defense albeit different from that of sellers. Control persons must show that they did not know, and in the exercise of reasonable care could not have known, of the facts creating liability.[83] The TSA, however, differs from the Uniform Securities Act in its treatment of aiders and abettors. The Uniform Securities Act treats aiders and abettors the same as control persons, but limits the class of aiders and abettors to employees, brokers, or agents.[84] The TSA broadens the class of aiders and abettors to any person who aids the sale, but imposes a scienter requirement—the intent to deceive or reckless disregard for the truth or the law—that the investor must prove. This change to the source for the Texas aider and abettor provision indicated that the legislature considered scienter and lack-of-knowledge defense, and therefore, the Texas Supreme Court refused to alter that balance laid out in the statute.

3. *Rescission Damages*

In *Reardon v. Lightpath Technologies, Inc.*,[85] the court dealt with investors who brought a fraud action under the TSA and TSFA against a technology company making optical glass for the telecommunications industry. As preparation for an initial public offering ("IPO"), the company had a 1:5.5 reverse stock split coupled with a dividend offering of class E shares to the pre-IPO shareholders. The class E shares were convertible into class A shares provided that the company achieved certain milestones, otherwise they were redeemable for nominal value in 2000. The IPO was successful, but the company failed to meet the milestones. Upon the redemption of the class E shares, the investors brought suit for rescission damages claiming that the company failed to disclose in the proxy materials for the reverse stock split material facts that would have shown the company was unlikely to meet the class E milestones. The trial court granted summary judgment to the company, dismissing the action, because the shareholders failed to produce evidence that they suffered recoverable damages.[86]

81. *Id.* at 845.
82. *See* TEX. REV. CIV. STAT. ANN. art. 581-33A(2) (Vernon Supp. 2004).
83. *See* TEX. REV. CIV. STAT. ANN. art. 581-33F(1) (Vernon Supp. 2004).
84. *See* UNIF. SECURITIES ACT § 410(b), 7C U.L.A. 266 (1956).
85. 183 S.W.3d 429 (Tex. App.—Houston [14th Dist.] 2005, pet. denied).
86. *Id.* at 429-30.

The investors's evidence included a statement of post-IPO company value contained in the proxy statement for the reverse stock-split, a statement in an officer's deposition confirming the investors' method of calculating damages, and expert-witness testimony on rescission damages. The proxy statement claimed post-IPO market value of $33 million, but the IPO infused only $8 million. The investors claimed the $25 million difference came from a $5 valuation of the class E shares. Unfortunately, the proxy statement as a matter of law did not state a post-IPO value for the class A or class E shares and merely recited the rights of the class E shares, and stated that the class E shares were non-transferable, could not be converted to class A shares unless certain milestones were met, and were redeemable for nominal value in 2000 if not converted by then.[87] The court did not waver from this conclusion when considering the officer's conclusory testimony. The officer stated she had no recollection of how the $33 million was calculated, although counsel, through leading questions, obtained an affirmative answer to the investors' method of determining the $5 valuation. One expert calculated rescission damages as the number of class E shares surrendered for redemption multiplied by the price of the class A shares the day before. Another expert calculated rescission damages by speculating on a renegotiation of the class E dividend, claiming that the investors would have gotten IPO warrants, then proceeded to calculate the value of the warrants based on the price of the class A shares the day before. The court rejected both methods as not returning the investors to their position before the alleged fraud as is necessary for rescission damages.[88] Consequently, there was no genuine issue of material fact as to the investors' damages, a necessary element of their fraud cause of action, so the appellate court upheld the summary judgment for the company.[89]

B. Arbitration under the Texas Acts

Securities fraud is also a method for investors to reach their own brokers; however, these actions are usually subject to arbitration as provided in their broker contracts. Since securities transactions are "transactions involving commerce," the Federal Arbitration Act, rather than the Texas Arbitration Act, applies.[90] Since 1989, the Supreme Court has permitted arbitration of securities fraud actions under the federal act.[91] There were several arbitrations against brokers conducted by the NASD involving

87. *Id.* at 436.

88. *Id.* at 442.

89. *Id.*

90. 9 U.S.C. § 1 (1999); Tex. Civ. Prac. & Rem. Code Ann. § 171.001 (Vernon Supp. 2004); *see, e.g., In re* Mony Sec. Corp., 83 S.W.3d 279, 282 (Tex. App.—Corpus Christi 2002, orig. proceeding).

91. *See* Rodriguez de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477 (1989) (under the Securities Act of 1933); Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220 (1987) (under the Exchange Act of 1934).

the TSA and the TSFA.[92] Arbiters seldom explain their decisions as appellate courts do and need not follow the rules of law.[93] As a result, investors also sue under the Texas Deceptive Trade Practices Act.[94] Yet, some trends are ascertainable.

Arbitrations almost invariably deal with investments that declined in value—typically more than $200,000. Investor complaints involved wrongful recommendations,[95] unauthorized trading,[96] mismanagement of managed accounts,[97] and unsuitability.[98] Other reported actions did not

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92. *See* TEX. BUS. & COM. CODE ANN. § 27.01 (Vernon 2002). For causes of action under the Texas Acts, *see* Nelson S. Ebaugh & Grace D. O'Malley, *From the Lone Star State Picking Your Battles: A Guide to Selecting Causes of Action Under Texas Law to Recover for Suitability Violations*, 12 PUB. INV. ARB. BAR ASS'N BAR J. 43 (Spring 2005).

93. *See, e.g.*, Wilko v. Swan, 346 U.S. 427, 435-37 (1952) (arbiters are not required to explain their reasons; arbiters are reversed only for manifest disregard of the law).

94. *See* TEX. BUS. & COM. CODE ANN. §§ 17.50 (for sale of goods and services) & 17.506 (damages and defenses) (Vernon 2002) [hereinafter DPTA]. The DPTA's application to a transaction otherwise covered by the TSA is doubtful. *See* Portland Sav. & Loan Ass'n v. Bevill, Bresler & Schulman Gov't Sec., Inc., 619 S.W.2d 241, 245 (Tex. Civ. App.—Corpus Christi 1981, no writ) (securities are not goods because they are not tangible); *compare* Allais v. Donaldson, Lufkin & Jenrette, 532 F. Supp. 749, 751-52 (S.D. Tex. 1982) (investment advice is not a service to a consumer due to coverage by the TSA with its due-diligence defense), *with* Frizzell v. Cook, 790 S.W.2d 41, 43-45 (Tex. App.—San Antonio 1990, writ denied) (investment advice is a service, but the due diligence defense of the TSA is allowed); *see generally* Mark C. Watter, *The Applicability of the Texas Deceptive Trade Practices Act to Securities Cases*, 64 TEX. B.J. 542, 551 (2001) (Texas Supreme Court yet to make a pronouncement, but such a decision is irrelevant to securities arbitrations where arbiters routinely consider it); *see* E.F. Hutton & Co., Inc. v. Youngblood, 741 S.W.2d 363, 364 (Tex. 1987) (refusing to decide whether investment advice is a service).

95. For respondent dismissals, *see* Brown v. IMS Sec., Inc., No. 03-01611, 2005 WL 2333985, at *1 (N.A.S.D. Sept. 2, 2005) ($39,000 claim for amount paid in income tax for recommending change of life insurance policies under the DPTA); Rhoden v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 04-00937, 2005 WL 1712090, at *1-2 (N.A.S.D. July 4, 2005) ($50,000 claim for unsuitable purchases and recommendations, including disproportionate purchase of in-house Merrill Lynch products under the TSA, TSFA, and DPTA).

96. For claimant recoveries, *see* Nugent v. Villalba, No. 01-04336, 2005 WL 1712112, at *2, *4-5 (N.A.S.D. July 6, 2005) ($309,000 claim for excessive, unauthorized, and unsuitable trading in investors' accounts under TSA, TSFA, and DTPA; awarded $309,000 with $31,000 interest and $73,000 attorneys' fees). For respondent dismissals, *see* Cardenas-Zavala v. Citigroup Global Markets, Inc., No. 03-05989, 2005 WL 1529492, at *1-2 (N.A.S.D. June 13, 2005) ($250,000 claim for unauthorized trading under DTPA; settled).

97. For claimant recoveries, *see* Gilliland v. Lorio, No. 03-05803, 2005 WL 1384735, at *2, *4 (N.A.S.D. May 26, 2005) ($2,804,000 claim for purchasing unsuitable investments in his managed account under the DPTA; awarded $289,000).

98. For claimant recoveries, *see* Andre v. Banc of Am. Inv. Servs., Inc., No. 04-01055, 2005 WL 770846 (N.A.S.D. Mar. 14, 2005) ($77,000 claim for purchasing variable annuity and several aggressive growth mutual funds under TSA, TSFA, and DPTA; awarded $27,000).

For respondent dismissals, *see* Margaret Jan Kemp IRA Rollover v. Morgan Stanley DW, Inc., No. 04-04246, 2005 WL 1712114, at *1-2 (N.A.S.D. July 6, 2005) ($216,000 claim for losses far exceeding properly balanced portfolio of 50% equities and 50% fixed income for account of disabled elderly investor with unsophisticated guardians under TSA, TSFA, and DPTA); Hall v. Sw. Sec., Inc., No. 03-04001, 2005 WL 1287088, at *1 (N.A.S.D. May 17, 2005) ($200,000 claim for concentrating life savings in a few speculative high-tech stocks with little diversification under the TSA, TSFA, and DTPA); Hinderliter v. Citigroup Global Mkts., Inc., No. 02-05812, 2005 WL 1249115, at *1 (N.A.S.D. May 5, 2005) ($3,000,000 claim for purchase of unsuitable stocks and variable annuity under TSA and DPTA); Richard Dale Relyea Ltd. P'ship v. Donaldson Lufkin & Jenrette Sec. Corp., No.

specify the offense.[99]

C. Court Decisions under the Federal Acts

The fraud provisions of the TSA are modeled on the federal statutes.[100] As a result, Texas courts interpreting the TSA frequently look to the federal decisions.

1. Pleading Misrepresentation and Scienter under the PSLRA

The Fifth Circuit considered three cases involving the pleading requirements of the Private Securities Litigation Reform Act ("PSLRA") of 1995. Each of the three cases involved private securities fraud actions under Rule 10b-5,[101] which requires (1) a misstatement or omission, (2) of a material fact, (3) in connection with a sale or purchase of a security, (4) made with scienter, (5) on which the investor reasonably relied, and (6) that proximately caused the investor's injury.[102] The PSLRA requires pleading for private securities-fraud actions under the federal statutes to apprise each defendant as to their particular part in the fraud.[103] The PSLRA accomplishes this task by requiring the petition to specify: each misleading statement; the reasons that the statement is misleading; if the misstatement or omission is based on information and belief, the facts on which the belief is formed; and facts giving rise to a strong inference that the perpetrator acted with the required state of mind.[104] The Federal

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04-01092, 2005 WL 267604, at *1-2 (N.A.S.D. Jan. 20, 2005) ($3,346,000 claim for various unsuitable high-yield bond purchases under TSA and TSFA).

99. For claimant recoveries, *see* George v. Prudential Equity Group, LLC, No. 04-01128, 2005 WL 522031, at *1-3 (N.A.S.D. Feb. 4, 2005) ($650,000 claim under TSA and TSFA; awarded $115,000). For respondent dismissals, *see* Allen v. Lindekugel, No. 03-05402, 2005 WL 2170571, at *1-2 (N.A.S.D. Aug. 15, 2005) ($200,000 claim under TSA and DTPA, settled); Baker v. AXA Advisors, LLC, No. 04-01513, 2005 WL 2044618, at *1-2 (N.A.S.D. Aug. 9, 2005) ($162,000 claim under TSA, TSFA, and DTPA, settled); Pounds v. Merrill Lynch, Pierce, Fenner & Smith Inc., No. 04-01380, 2005 WL 1881411, at *1 (N.A.S.D. July 18, 2005) ($918,000 claim under TSA and DPTA, settled); Alexander v. Merrill Lynch, Pierce, Fenner & Smith Inc., No. 03-04691, 2005 WL 1866009, at *1-2 (N.A.S.D. July 19, 2005) ($300,000 claim under TSA, TSFA, and DPTA, settled); Ware v. Merrill Lynch, Pierce, Fenner & Smith Inc., No. 03-04490, 2005 WL 1712053, at *1-2 (N.A.S.D. June 30, 2005) ($500,000 claim under TSA and DTPA, settled); Beauregard Inv., L.P. v. Credit Suisse First Boston LLC, No. 03-05675, 2005 WL 1712056, at *1-2 (N.A.S.D. June 28, 2005) ($656,000 claim under TSA, TSFA, and DTPA, settled); Mitchell v. Morgan Stanley DW Inc., No. 04-00325, 2005 WL 1287101, at *1-2 (N.A.S.D. May 20, 2005) (unspecified claim under DTPA, settled); Bullard v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 99-04820, 2005 WL 1140249, at *1 (N.A.S.D. Apr. 25, 2005) ($200,000 claim under DTPA, settled); Small v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 03-07664, 2005 WL 704177 (N.A.S.D. Mar. 9, 2005) ($337,000 claim under DPTA, settled); Flowers v. A.G. Edwards & Sons, Inc., No. 03-08425, 2005 WL 124131, at *1-2 (N.A.S.D. Jan. 7, 2005) ($490,000 claim under TSA, TSFA, and DPTA for mutual fund investments).

100. *See supra* note 2.

101. *See* 17 C.F.R. § 240.10b-5 (2005).

102. *See* Rubinstein v. Collins, 20 F.3d 160, 166 (5th Cir. 1994).

103. Defendants contributed to the author's early teaching career in the late 1980s by hiring him to read securities fraud petitions to explain what they were being sued for. Pre-PSLRA petitions were so general as to provide few clues as to the misdeed.

104. *See* 15 U.S.C. § 78u-4(b)(1) - (2) (1997).

Rules of Civil Procedure similarly require particular allegations of the circumstances constituting the fraud,[105] which the Fifth Circuit has determined includes the time, place, and identity of the speaker of the misstatement.[106] These pleading requirements as to misstatements and scienter are regarded as difficult, designed to rid the court of time-consuming fishing expeditions using the federal discovery rules since the PSLRA requires dismissal for pleading errors before discovery.[107] Consequently, when the Fifth Circuit began to find some pleadings sufficient in these three cases, one commentator described the development as resulting from either the plaintiff's bar finally learning how to plead correctly or the Fifth Circuit's easing its requirements.[108]

In *Barrie v. Intervoice-Brite, Inc.*,[109] the Fifth Circuit dealt with a NASDAQ issuer, a software company, that reported a successful 1999 merger, cited impressive revenues, projected strong earnings, and then announced it would report a loss and lower-than-projected revenues and earnings. The resulting class-action lawsuit alleged misleading statements, based on improper accounting methods contained in reports filed with the SEC, press releases, and other corporate statements, relying on insider sales as evidence of scienter. The district court dismissed the lawsuit as not meeting the pleading requirements of PSLRA.[110] The Fifth Circuit, however, reversed in part and affirmed in part, finding that some misstatements did satisfy the pleading requirements.[111]

With respect to the SEC reports, the issuer had recognized income during fiscal year 2000 when it shipped the software to a buyer before acceptance, delivery, and customization, rather than after acceptance by and delivery to a buyer from which collectability is probable, as required by Generally Accepted Accounting Principles ("GAAP") for fiscal years starting after 1997 and the SEC after 1999.[112] When announcing the accounting-method change, the SEC stated that it would allow a one-time cumulative adjustment for those improperly reporting. The issuer made its $18-million adjustment in the first-quarter report for fiscal year 2001. Consequently, the district court viewed the fiscal year 2000 financial statements, signed by the issuer's chief executive officer, chief financial officer, and a director and submitted in the issuer's annual report to the SEC, as proper when made. Thus, the petition failed to explain why the financial statements were false.[113] This conclusion, however, ignored the

105. *See* FED. R. CIV. P. 9(b).
106. *See* Williams v. WMX Techs., Inc., 112 F.3d 175, 177-78 (5th Cir. 1997).
107. *See* 15 U.S.C. § 78u-4(b)(3) (1997).
108. *See* Anon, *Another Plaintiff Meets PSLRA's Pleading Requirements*, 23 Fletcher Law Advisor No. 6 (June 2005), at 8-9.
109. 397 F.3d 249 (5th Cir. 2005) (from the Northern District of Texas).
110. *Id.* at 254.
111. *Id.* at 264.
112. *See* American Institute of Certified Public Accountants, Statement of Position No. 97-2, Software Revenue Recognition; SEC Staff Accounting Bulletin No. 101, 64 Fed. Reg. 68,936 (Dec. 9, 1999) (to be codified at 17 C.F.R. pt. 211).
113. *Barrie*, 397 F.3d at 256-58.

investors' identification of confidential witnesses who claimed the issuer's chief financial officer knew about the alleged fraud, with one claiming that he had submitted projections of revenues using the non-GAAP method for fiscal year 2000 to that officer and that the officer used those projections to decide whether to delay the one-time adjustment to the following fiscal year, which the issuer did. Thus, this misstatement survived.[114]

With respect to the press releases and other documents, the district court properly dismissed most of the misstatements. As for the misstatement concerning an $8 million improper-revenue recognition on a purchase order, the investors failed to identify any issuer official responsible for the misstatements. For most of the others, the Fifth Circuit accepted the issuer's explanation concerning the meaning of the statements so that they were not misstatements. One, however, quoted the president speaking of meeting financial goals. Since the financial targets involved the fraudulent earnings, the statement was false.[115] The president's scienter was supported by allegations concerning his bonus of 175% of his salary for meeting those financial goals. A few other misstatements involved statements by one officer made in the presence of another, who failed to correct the misstatement. The allegation failed to designate which officer made the misstatement and which officer failed to correct the misstatement.[116] Although the Fifth Circuit does not accept the group-pleading doctrine holding issuer officers liable for unattributed corporate statements,[117] the Fifth Circuit found no reason to require a designation of which officer made the statement and which officer failed to correct the statement when only two are named. So these misstatements also survived. With respect to misstatements contained in analyst reports, the investors failed to allege the facts needed for the conduit theory, namely, which issuer officer supplied the misinformation to the analyst, how the analyst received the information, and how the issuer officer manipulated the information or analyst.[118]

In *R2 Investments LDC v. Phillips*,[119] the Fifth Circuit dealt with $300 million in notes issued in connection with a 1999 merger for which the issuer was obligated to make a tender offer to repurchase $160 million of the notes on January 2, 2001. The issuer made the tender offer on the agreed date in the proper amount, giving the holders two months to tender. At that time, the investor held about $6 million of the debt instruments. The following week, the issuer issued a press release announcing that it would not complete an anticipated acquisition, followed by a

114. *Id.* at 258.
115. *Id.* at 260.
116. *Id.* at 261.
117. *See* Southland Sec. Corp. v. Inspire Ins. Solutions, Inc., 365 F.3d 353, 365 (5th Cir. 2004); *see also* George Lee Flint, Jr., *Securities Regulation*, 58 SMU L. REV. 1135, 1155 (2005) (discussing *Southland Sec. Corp.*).
118. *See Southland*, 365 F.3d at 373-74.
119. 401 F.3d 638 (5th Cir. 2005) (from the Northern District of Texas).

report to the SEC of the acquisition agreement's termination and an announcement that financial projections were no longer an indication of anticipated performance and that the issuer was reviewing its business plan. The investor acquired more notes in the following month. Then the issuer announced that it had agreed with other note holders that it would only purchase $70 million notes in the tender. The investor refused to agree with the reduction, and the issuer filed for bankruptcy. The investor brought a lawsuit for securities fraud under Rule 10b-5, controlling-person liability, and various state-law claims. The district court dismissed the Rule 10b-5 claim, without which the controlling-person-liability claim also failed, and refused to exercise supplemental jurisdiction over the state-law claims. The Fifth Circuit affirmed.[120]

The alleged misstatements, contained in numerous SEC filings, concerned the obligation to repurchase the notes without disclosing that the issuer lacked the cash to make the repurchase or was relying on risky contingencies to provide the cash. The Fifth Circuit quickly concluded that this omission lacked a logical connection to the statement made. Inability to complete the tender offer on time does not make the statement that the issuer has an obligation misleading.[121] The petition also lacked a strong inference of scienter, merely revealing that the issuer's officers were aware of a cash shortage. The main evidence of scienter consisted of a cash forecast showing insufficient cash, but clearly labeled a "worst case" scenario, and an email concerning orders for cash transfers from foreign subsidiaries.[122] The Fifth Circuit relied on its past decisions[123] that mere knowledge of an omission does not raise a strong inference of scienter. Without allegations of a clear motive, the circumstantial evidence of scienter needs to be more than documents that merely indicate an awareness of a cash-liquidity problem readily interpreted as an awareness of various contingency plans to solve the problem.[124] Other evidence of scienter concerned the chief financial officer's alleged knowledge that the issuer's tender offer would fail without a successful merger with another entity. Unfortunately, the investor could not tie the financial officer to any such statement, and the statements made by the financial officer merely indicated a groping for cash from a variety of sources.[125] Similarly, the officers' informing the board of the failure to complete the acquisition, their proposal to reduce the tender-offer size, and their efforts to convert payables into preferred stock failed to raise a strong inference of scienter.[126]

120. *Id.* at 639-41.

121. *Id.* at 642-43.

122. *Id.* at 644.

123. *See* Shivangi v. Dean Witter Reynolds, Inc., 825 F.2d 885, 889 (5th Cir. 1987); SEC v. Sw. Coal & Energy Co., 624 F.2d 1312, 1321 n.17 (5th Cir. 1980).

124. *R2 Invs.*, 401 F.3d at 644.

125. The Fifth Circuit refuses to attribute corporate statements without attribution to officers merely because of their position. *See Southland Sec. Corp.*, 365 F.3d at 363.

126. *R2 Invs.*, 401 F.3d at 645-47.

In *Plotkin v. IP Axess Inc.*,[127] the Fifth Circuit faced an issuer that mislabeled transactions as normal commercial sales rather than agreements on a trial basis. The investor contended that the issuer, which had decreasing revenues over several years, sought to attract new investment through three press releases. The first two releases described the issuer's granting of an exclusive dealership involving a commitment to purchase $25 million annually of the issuer's product and a sale of $6.5 million to the dealership. The release described one dealer as a leading international provider of telecommunications services and the other as one of North America's fastest-growing application providers. Within four months, the issuer sent its product and booked $700,000 in sales, as was its custom. The auditors disputed the action due to their belief that the dealership could not pay. The issuer accepted the auditors' advice and withdrew the $700,000 from its revenue, yet the auditors resigned. The issuer's release concerning the dealership's collapse failed to indicate that one dealer had filed for bankruptcy three weeks earlier. The third press release announced agreements with major big-name customers to ship product within one month on a trial basis under which, if the customer decided to keep the product, would lead to a sale after the trial period. None of these agreements generated ongoing business for the issuer. An investor brought a lawsuit for securities fraud under Rule 10b-5, controlling-person liability, and various Illinois state-law claims.[128] The district court adopted the magistrate's reports that the court should dismiss the actions for failure to meet the pleading standards of PSLRA, failure to identify a factual basis making the press releases false or misleading, failure to adequately allege scienter, and the inactionability of the statements under the safe-harbor rule for forward-looking statements due to the accompaniment of sufficient cautionary language.[129]

The Fifth Circuit, however, did not agree with respect to the first two press releases. Adopting a rule that later facts generally do not make earlier statements misleading,[130] this case fit an exception. When a deal collapses so quickly, one can infer something was amiss initially. The investor had alleged that one dealer had small revenues and the other related one had been incorporated only six months before the transaction. One dealer declared bankruptcy within eight months of the transaction. The auditors were so concerned within four months of the transaction that they resigned, touting that the dealers created an impression that substantial revenues would flow from the transaction. For these two press releases, the Fifth Circuit also found a strong inference of scienter. The issuer was at least reckless in not doing sufficient due diligence for a transaction that would increase revenues thirty-fold to discover that the dealers were incredibly small and newly incorporated.[131] Moreover, the

127. 407 F.3d 690 (5th Cir. 2005) (from the Eastern District of Texas).
128. *Id.* at 693-95.
129. *Id.* at 695-96; *see also* 15 U.S.C. § 78u-5(c)(1)(A) (1997).
130. *Id.* at 698 (quoting Lain v. Evans, 123 F. Supp. 2d 344, 350 (N.D. Tex. 2000)).
131. *See id.* at 700.

issuer's annual report described the transaction as a testing agreement, not the normal commercial sale described in the press releases, suggesting a motive for the omission. The Fifth Circuit, however, did agree with the district court with respect to the third press release. It expressly described the transactions as on a trial basis rather than a commercial sale.[132]

2. *Proof of Reliance for Fraud on the Market under Rule 10b-5*

The Fifth Circuit considered two class-action certifications involving the "fraud on the market theory" and joined the Third, Fourth, and Ninth Circuits in tightening the standard of proof necessary to justify class certification. The "fraud on the market theory" dispenses with the requirement to prove reliance for the implied fraud action under SEC Rule 10b-5.[133] The "fraud on the market theory" presumes that, in an open and developed securities market, the information available in that market determines an issuer's stock price. Consequently, misstatements or omissions will defraud investors of that issuer's securities, even if the investors did not directly rely on the misstatements or omissions.[134] To support this presumption, the investors must prove that the security at issue trades in an efficient market.[135] In the absence of an efficient market, the class fails, and each investor must prove reliance separately. Since the issue of an efficient market becomes critical for class certification for investors in small-cap issuers, courts have required rigorous, though preliminary, standards of proof to the issue of an efficient market for small-cap securities rather than merely presume facts in favor of the investors' petition. [136]

In *Unger v. Amedisys Inc.*[137] the Fifth Circuit faced issuer securities traded on the Over the Counter Bulletin Board ("OTCBB"), an electronic service offered by the National Association of Securities Dealers for real-time quotes for securities not listed or traded on any other national exchange, including the NASDAQ. The issuer, a company providing home health care and nursing services, allegedly manipulated the

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132. *Id.* at 701.

133. *See* 17 C.F.R. § 240.10b-5; *see also* Stephenson v. Paine Webber Jackson & Curtis, Inc., 839 F.2d 1095, 1098 (5th Cir. 1988) (the investor for the implied fraud action under Rule 10b-5 must prove (1) a material misrepresentation or omission by the perpetrator, (2) scienter on the part of the perpetrator, (3) reliance by the investor, and (4) due diligence by the investor in pursuing the investor's interest with care and good faith).

134. Basic, Inc. v. Levinson, 485 U.S. 224, 241-42 (1988) (quoting Peil v. Speiser, 806 F.2d 1154, 1160-61 (3d Cir. 1986)).

135. *See id.* at 248-49.

136. *See* Gariety v. Grant Thornton, LLP, 368 F.3d 356, 368-70 (4th Cir. 2004); Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 167-69 (3d Cir. 2001); Binder v. Gillespie, 184 F.3d 1059, 1064-65 (9th Cir. 1999). The Supreme Court's disallowance of lower courts inquiring into the merits of a case to determine a class certification does not bar the fact inquiry into an efficient market. *See* Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 177-78 (1974).

137. 401 F.3d 316 (5th Cir. 2005) (Judge Edith Jones, from the Middle District of Louisiana). Judge Jones served on the Texas Law Review with the author.

federal Medicare Prospective Payment System to inflate estimated costs for certain health services, artificially increasing earnings, and thereby enhancing the issuer's stock price.[138] In imposing a standard for the efficient-market issue, the Fifth Circuit refused to adopt a per se inefficient rule for all over-the-counter securities and did not require expert testimony on the issue.[139] The Fifth Circuit, however, did compile an inexhaustive list of eight factors used in varying degrees by prior court decisions on the issue.[140] The Fifth Circuit's advice lay in requiring that use of the factors required an analytical weighting, not merely a counting, since each of the factors represented a facet of market efficiency.[141] In certifying that the class had failed in requiring the investors to conduct this analytical weighting, the district court used the factors merely as a checklist.[142] The district court considered only three factors: (1) the stock's trading volume percentage, (2) market makers trading the stock, and (3) a causal relationship between issuer events and price movement. A finding of a trading volume of 3.9% based on internet printouts was insufficient since some exchanges report exaggerated volume by double-counting both sales and purchases, and the district court failed to verify the figure. A finding of twenty-two market makers based on a single internet printout and affidavits admitted without an opportunity for cross-examination was inadequate since there was no link between that number and trading volume. A finding of a causal relation between security price and issuer press releases based on three time-points, a price rise following a positive press release on two different days, and one price decline following a negative press release, was also error since three points are not enough to establish the causal relationship.[143] Also, the evidence ignored by the district court pointed to an inefficient market. There were no market analysts for the issuer to digest the public information for the investors. The issuer was unable to use the SEC's short form registration.[144]

In *Bell v. Ascendant Solutions, Inc.*[145] the Fifth Circuit confronted issuer securities traded on the NASDAQ, the automatic quote system of the NASD for the more actively traded over-the-counter market. The issuer, a company that provided electronic order management and customer-service solutions to e-commerce and direct marketing firms allegedly made false and misleading statements with respect to its initial public

138. *Id.* at 319.
139. *Id.* at 323.
140. *Id.*
141. *See id.* at 325.
142. The eight factors were (1) the average weekly trading volume as a percentage of total outstanding shares, (2) the number of security analysts following and reporting on the issuer, (3) the extent to which market makers and arbitrageurs trade in the security, (4) the company's eligibility to file short form registrations with the SEC on Form S-3, (5) empirical evidence of a causal relation between the issuer's significant press releases and immediate price response of its securities, (6) the issuer's market capitalization, (7) the bid-ask spread for its securities, and (8) the securities' float excluding insider securities. *Id.* at 323.
143. *Id.* at 324-25.
144. *Id.* at 325.
145. 422 F.3d 307 (5th Cir. 2005) (from the Northern District of Texas).

offering.[146] The Fifth Circuit refused to limit its new *Unger* decision to the OTCBB securities. Even though NASDAQ securities are more heavily traded, small-cap issuers on NASDAQ must also satisfy the *Unger* burden to show market efficiency since many securities of relatively unknown issuers trade them merely because they met the eligibility requirements.[147] The district court correctly refused to certify the class since the investors made the same mistakes that the *Unger* investors did—failing to conduct the necessary analytical analysis with respect to the relevant factors. The investors presented only three of the factors: (1) trading volume, (2) the number of market makers and analysts, and (3) a causal relationship between issuer events and price movement. The court held that high trading volume fails to indicate an efficient market without converting the number to the percentage of outstanding shares. Further, seventeen market makers is inadequate without data relating to the volume of shares they are committed to trade and actually traded with the prices. Finally, analyst coverage absent during a third of the purported class period does not reveal an efficient market. Evidence contained in the excluded expert's report also revealed an absence of a difference between stock-price movement on information days and stock-price movement on non-information days. Consequently, there was no error in the district court's refusal to certify the class.[148]

146. *Id.* at 309-10.
147. *Id.* at 312-13.
148. *Id.* at 315-16.