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Securities Regulation

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SECURITIES REGULATION

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Securities regulation deals primarily with the laws preventing and providing remedies for fraud in the sale of stocks and bonds. Texas has two major statutes to combat securities fraud: The Texas Securities Act (TSA) and the Texas Stock Fraud Act (TSFA).[1] Since the legislature modeled the fraud provisions of the TSA on the federal statutes,[2] Texas courts use federal decisions under the federal statutes to interpret the TSA's similar language.[3] This article, therefore, includes the Fifth Circuit cases involving state law and securities fraud under federal law. The

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1. *See* TEX. REV. CIV. STAT. ANN. art. 581-1 (West 2015); TEX. BUS. & COM. CODE ANN. § 27.01 (West 2015).

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

3. *See, e.g.*, Highland Capital Mgmt., L.P. v. Ryder Scott Co., 402 S.W.3d 719, 741 (Tex. App.—Houston [1st Dist.] 2012, no pet.); Anglo-Dutch Petroleum Int'l, Inc. v. Haskell, 193 S.W.3d 87, 102 n.13 (Tex. App.—Houston [1st Dist.] 2006, pet. denied); *see also* George Lee Flint, Jr., *Securities Regulation*, 66 SMU L. REV. 1129, 1130 n.3 (2013) [hereinafter Flint, *Securities Regulation 2013*] (discussing *Highland Capital Management, L.P.*); George Lee Flint, Jr., *Securities Regulation*, 60 SMU L. REV. 1293, 1299–1302 (2007) (discussing *Haskell*).

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, 2015, to November 30, 2016.[4]

I. COVERAGE OF THE TEXAS SECURITIES ACTS

The definitions, especially those relating to what constitutes a security or a stock and the persons liable, as well as federal preclusion of state securities fraud actions, determine the fraudulent transactions subject to the state's securities acts.[5] One Texas court dealt with an insurance agency peddler of interests in a diversified pool of life settlements who made several omissions of material fact, was not registered with the Texas State Securities Board (TSSB), and claimed the life settlements were not securities.[6] Another Texas court dealt with aiding and abetting liability for an investment company's failure to disclose in the sales materials that the investment company would have a high concentration of low tranche securities, the degree to which they would be subordinated, and the extent to which the assets were leveraged.[7]

A. Clarification of Entrepreneurial or Management Efforts of others for Life Settlements

Peddlers of life settlements in Texas continue their best efforts to transfer what little wealth they have remaining to their lawyers by challenging the finding of the Texas Supreme Court, and numerous other courts and state securities boards, that life settlements are investment contracts and therefore securities under the TSA.[8] A life settlement is a transaction under which an owner of a life insurance policy sells the policy at a discount (reflecting a future rate of return and premium costs over the owner's expected life) in order to obtain current monies to spend. A financial intermediary locates the policy sellers, negotiates the discount, locates investors to provide the purchase price of fractional interests in the life insurance policies, takes title to the policies as agents of the investors, and maintains a trust fund to pay the premiums. If the insured outlives the life expectancy used to discount the sales price of the policy, a bonding company purchases the policy, providing a lower but guaranteed return. These financial intermediaries are notorious for underestimating

4. Flint, *Securities Regulation 2013*, *supra* note 3, at 1130.

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

6. Matlock v. Hill, No. 07–15–00048–CV, 2016 WL 3659988, at *3–5 (Tex. App.—Amarillo June 30, 2016, no pet.) (mem. op.).

7. Morgan Keegan & Co. v. Purdue Ave. Inv'rs LP, No. 05–15–00369–CV, 2016 WL 2941266, at *5 (Tex. App.—Dallas May 18, 2016, pet. denied) (mem. op.).

8. *See* Life Partners, Inc. v. Arnold, 464 S.W.3d 660, 662 (Tex.), *reh'g denied*, 2015 Tex. LEXIS 849 (Sept. 11, 2015); *see also* George Lee Flint, Jr., *Securities Regulation*, 2 SMU Ann. Tex. Surv. 437, 439–45 & n.57 (2016) [hereinafter Flint, *Securities Regulation 2016*] (discussing *Life Partners* and similar conclusions on the other states).

the life expectancies used in calculating the discounts,[9] which information they conceal from the investors prior to their purchases. These miscalculations have the effect of reducing the expected rates of return and increasing the premium costs, potentially leading to losses on the investment. These peddlers conceal those errors by providing the investors with only the total acquisition cost, with no breakdown of the amounts paid to the policy owners, the escrow amount, the peddlers' fees, and the expenses such as physician fees, escrow fees, consultant fees, and broker fees.

In *Matlock v. Hill*, the Amarillo Court of Appeals dealt with an insurance agency that had sold interests in life settlements on behalf of A & O Life Fund, L.P. to a couple for $100,000.[10] The fund went bankrupt, causing a loss of 90% of the couple's funds.[11] The couple sued the broker for fraud under the TSA as an aider and abettor.[12] The trial court's findings included that persons selling securities in Texas need to be registered, the life settlements marketed in a diversified pool constituted securities, A & O Life Fund had told the insurance agency the life settlements were securities in January 2007 when they removed him from selling the life settlements, and the insurance agency failed to disclose that it was not registered and was prohibited from selling the life settlements, failed to disclose that the bond company backing the life settlements was not registered in Texas, and failed to disclose that the bond company was barred subject to a cease and desist order until such registration occurred.[13] The trial court awarded damages for the $100,000 less that recovered from other sources plus attorney's fees.[14] The court of appeals affirmed.[15]

The main issue was whether the life settlements were securities.[16] The insurance agency presented several weak arguments. First, it relied on a 2004 opinion of the Waco Court of Appeals, which has since been de-

9. *See* Nathan Vardi, *Early Death*, FORBES.COM (Sept. 17, 2009, 1:22 PM), http://www.forbes.com/2009/09/17/life-insurance-settlements-a-and-o-business-insurance.html (discussing the practices of A & O Life Fund and its bankruptcy causing tens of millions of dollars in losses); *see also* Mark Maremont & Leslie Scism, *Odds Skew Against Investors In Bets on Strangers' Lives*, WALL ST. J. (Dec. 21, 2010), at A1 (For investments made in 2002 through 2005, 83% of the insureds lived past their life expectancies as calculated by Life Partners, Inc.). A & O Life Fund was the financial intermediary for the transactions involved in *Matlock*, 2016 WL 3659988, at *1.

10. *Matlock*, 2016 WL 3659988, at *1. As to the type of business entity for A & O Life Funds, see SEC v. W Financial Group, LLC, No. 3–08–CV–0499–N, 2009 WL 636540, at *2 (N.D. Tex. Mar. 9, 2009). *See also* Brown v. Entrust Admin. Servs., No. H–10–5220, 2011 WL 1230275, at *1 n.2 (S.D. Tex. Mar. 30, 2011).

11. *Matlock*, 2016 WL 3659988, at *1.

12. *Id.* at *1, *5.

13. *Id.* at *5 n.5.

14. *Id.* at *1.

15. *Id.*

16. *Id.* The insurance agency also complained of the retroactive application of the determination that life settlements were securities, but the Texas Supreme Court had dispensed with that argument since courts had treated life settlements as securities for decades. *Id.* at *4; *see* Life Partners, Inc. v. Arnold, 464 S.W.3d 660, 685 (Tex. 2015).

bunked by the Texas Supreme Court.[17] Second, it claimed the exemption from the definition of security for insurance companies under TSA section 4A applied; however, it supplied no evidence that A & O Life Fund, L.P. was subject to the supervision of the Texas Department of Insurance or had filed a form of the policy as required by the exemption.[18] Third, it claimed that, of the four factors required by the supreme court to establish an investment contract as a security, one was missing, namely the entrepreneurial or managerial efforts of others.[19] The court of appeals noted that although the supreme court had not explained what it meant by entrepreneurial or managerial efforts, it did provide examples for life settlements, namely:

> 1) the identification of the insureds, 2) the negotiation of the discounts for the policy, 3) the evaluation of the policy terms and conditions, 4) the evaluation of the insured's health, 5) the acquisition of the policies, 6) the acquisition of others to buy interests in the life settlement, 7) the evaluation of the insured's life expectancy, and 8) the selection of a purchase price to yield sufficient profit.[20]

The court of appeals then noted that the trial court had evidence, including that of an expert witness, of A & O Life Fund's selection of the right policies, evaluation of the insureds' life expectancies, controlling risk through pooling for diversification, payment of future premiums, monitoring of the insured's health, and reinvestment of revenues from death benefits.[21] Consequently, the court of appeals found this element of an investment contract satisfied.[22]

The court of appeals faced two lesser issues. The first concerned the non-existent findings with respect to aiding and abetting.[23] The court of appeals did not find these dispositive since it was clear from the evidence and findings that the insurance agency was not registered as required under TSA section 12 and that the insurance agency had made numerous omissions of material facts when selling the life settlement.[24] Both of these provided for liability in the amount of the awarded damages under TSA sections 33A(1) for failure to register and 33A(2) for selling through

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17. *Matlock*, 2016 WL 3659988, at *2; *compare Arnold*, 464 S.W.3d at 666–84, 678–80 (life settlements are securities, discussing the error of *Griffitts*), *with* Griffitts v. Life Partners, Inc., No. 10-01-00271-CV, 2004 WL 1178418, at *2 (Tex. App.—Waco May 26, 2004, no pet.) (mem. op.) (life settlements not securities since the only significant post-sale factor is death of insured, not efforts of others).

18. *Matlock*, 2016 WL 3659988, at *2; *see* TEX. REV. CIV. STAT. ANN. art. 581-4(A) ("this definition [of security] shall not apply to any insurance policy, endowment policy, annuity contract, optional annuity contract, or any contract or agreement in relation to and in consequence of any such policy or contract, issued by an insurance company subject to the supervision or control of the Texas Department of Insurance when the form of such policy or contract has been duly filed with the Department").

19. *Matlock*, 2016 WL 3659988, at *3–4.

20. *Id.* at *3 (citing *Arnold*, 464 S.W.3d at 683); *see Arnold*, 464 S.W.3d at 682–84 (describing the post-purchase efforts).

21. *Matlock*, 2016 WL 3659988, at *3.

22. *Id.* at *4.

23. *Id.* at *5.

24. *Id.*; *see* TEX. REV. CIV. STAT. ANN. art. 581-12.

an omission of a material fact.[25] The second involved the award of attorney's fees.[26] The court of appeals noted that the TSA allows recovery of attorney fees if they are equitable under the circumstances.[27] The court of appeals upheld the trial court's equitable findings that the insurance agency sold the involved life settlements after being told it could no longer sell them for A & O Life Fund since it was not registered, and that in 2001 the TSSB had issued a cease and desist order against the insurance agency for selling different securities while not being registered.[28]

B. Aider and Abettor Liability for Underwriters and Investment Advisors

The ease of becoming judgment proof in Texas with liberal exemptions from execution of judgment makes secondary liability very important. The Texas statutes provide for several vicarious liability theories, including aiding and abetting liability and control person liability. Since federal securities law does not allow a private investor to recover against aiders and abettors,[29] aiding and abetting has become a significant aspect of state securities law. One Texas appellate court opinion dealt with aider and abettor liability of an underwriter of, and an investment advisor to, an investment company, whose directors were employees of the underwriter and investment advisor, for failing to disclose in the sales materials, while being aware, that the investment company's manager, an employee of the investment advisor, intended to invest in deeply subordinated tranches of structured, asset-based securities such as mortgage-backed securities, collateralized mortgage obligations, and collateralized debt obligations exposing the investors to a high degree of risk through a lack of diversification and implicit leverage.[30]

The Dallas Court of Appeals confronted several disingenuous arguments in *Morgan Keegan & Co., Inc. v. Purdue Avenue Investors LP*.[31] The case involved a notorious fraud committed by a once prominent investment company manager under which investors lost over a billion dollars.[32] The Securities and Exchange Commission (SEC) charged the

25. *Matlock*, 2016 WL 3659988, at *5; *see* Tex. Rev. Civ. Stat. Ann. arts. 581-33A(1)–(2).
26. *Matlock*, 2016 WL 3659988, at *6.
27. *Id.*; *see* Tex. Rev. Civ. Stat. Ann. art. 581-33D(7).
28. *Matlock*, 2016 WL 3659988, at *6–7.
29. *See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 175–78 (1994).
30. Morgan Keegan & Co., Inc. v. Purdue Ave. Inv'rs LP, No. 05–15–00369–CV, 2016 WL 2941266 (Tex. App.—Dallas May 18, 2016, pet. denied) (mem. op.).
31. *Id.*
32. *See SEC Charges Morgan Keegan and Two Employees With Fraud Related to Subprime Mortgages*, SEC (Apr. 7, 2010), https://www.sec.gov/new/press/2010/2010-53.htm [https://perma.cc/NQ7Q-BPDU]; *see also* Joe Bel Bruno, *Morgan Keegan and Its Onetime Star Kelsoe Charged by SEC*, Wall St. J. (Apr. 7, 2010), www.wsj.com/articles/SB10001424052702303720604575169950288562186 (Funds managed by James Kelsoe led "the mutual fund pack" until the housing downturn caused the funds' value to drop by 60%, the worst of any U.S. fund that year.).

investment company manager with inflating the value of thinly-traded subprime securities by urging outside brokers not to offer price information unless the number exceeded a certain value and convincing the accounting staff to accept upward "price adjustments," both practices done to hide the declining value of the investment companies' investments.[33] The SEC also charged the underwriter marketing the investment companies' shares with failing to employ reasonable procedures to insure accurate net asset values and for selling shares on the basis of the inflated prices.[34] The Financial Industry Regulatory Authority (FINRA) charged the underwriter with marketing and selling investment company shares to investors using inaccurate and misleading sales materials.[35] The investment companies were heavily invested in risky subordinated tranches of mortgage- and asset-backed securities, but the underwriter's misleading sales materials and deficient guidance for training its brokers on the risks caused the underwriter to make material misrepresentations to prospective investors, namely portraying the investment companies as safer than they actually were even though the underwriter was aware of the special risks and their unsuitability for certain investors.[36] The underwriter further failed to disclose to investors in 2007 that the investment companies were then seriously and adversely affected by the subprime mortgage crisis.[37] The SEC, state regulators, and FINRA obtained a settlement for the fraud from the underwriter and its affiliated investment advisor employing the investment company's investment manager, without an admission or denial of the SEC's findings, in the amount of $200 million to compensate the investors, and barred the investment manager from the securities industry.[38]

Morgan Keegan involved closed-end management investment companies established and operated by subsidiaries of Regions Financial Corporation, namely the underwriter and the investment advisor described above.[39] One involved fund sought a high current income level by "in-

33. Bruno, *supra* note 32.

34. Bruno, *supra* note 32; *SEC Charges Morgan Keegan*, *supra* note 32.

35. *FINRA Files Complaint Against Morgan Keegan & Company for Misleading Customers Regarding Risks of Bond Funds and Advertising, Other Violations*, FINRA (Apr. 7, 2010), www.finra.org/newsroom/2010/finra-files-complaint-against-morgan-keegan-company-misleading-customers-regarding [https://perma.cc/NK4T-DQFW].

36. *Id.*

37. *Id.*

38. *See* Morgan Asset Mgmt., Exchange Act Release No. 34-64720, 2011 WL 2482883, at *1 (June 22, 2011) (without admitting); *id.* at *15 (barring the investment manager); *id.* at *16 (civil penalty of $75 million); *Morgan Keegan to Pay $200 Million to Settle Fraud Charges Related to Subprime Mortgage-Backed Securities*, SEC (June 22, 2011), https://www.sec.gov/news/press/2011/2011-132.htm [https://perma.cc/928D-8XV8]; *see also Morgan Keegan to Pay $678,390 to Texas for Deceiving Investors in Bond Funds*, TEX. STATE SEC. BD. (Mar. 1, 2012), https://www.ssb.texas.gov/news-publications/morgan-keegan-pay-678390-texas-deceiving-investors-bond-funds [https://perma.cc/CT73-U69D] (Texas was awarded $678,390, part of an additional $10 million fine that Keegan agreed to pay the state).

39. The funds were the RMK Strategic Income Fund and the RMK Advantage Income Fund. Several of the directors and officers of the funds are also officers of Regions Financial Corporation or its subsidiaries, Morgan Keegan & Co., Inc. and Morgan Asset

vest[ing] a majority of its total assets in below investment grade debt securities . . . including corporate bonds, mortgage-backed and asset-backed securities and municipal and foreign government obligations," but also by investing in "investment grade securities, up to 15% of [the fund's] total assets in foreign debt and . . . equity," and as much as 25% in domestic equity.[40] And the fund could leverage approximately 33% of the fund's total assets, including the borrowed amount.[41] The other would invest similarly, but most of the fund's assets would be invested some of the time in investment grade securities and at other times in below grade securities, and it included securities of companies in the process of bankruptcy proceedings.[42] The investor had purchased $2 million in 2005 through his own broker and lost, bringing suit in 2009.[43] The crux of the matter, similar to the FINRA action, was the adequacy of the disclosure in the prospectus.[44] The prospectus described the proposed investments as diversified with 25% to 65% of assets invested in below investment grade debt securities and that leverage from borrowings up to 33 1/3% of assets could occur.[45] Not disclosed, however, was that two-thirds of the portfolio was invested in "subordinated tranches and securities . . . mostly

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Management, Inc., the defendants in the case. *See* RMK Strategic Income Fund, Inc., Annual Shareholder Report for Mar. 31, 2004 (Form N-CSR), at 20–24 (June 6, 2004), https://www.sec.gov/Archives/edgar/data/1275902/000089843204000518/form-ncsr.txt https://perma.cc/5D27-UBXV] [hereinafter RMK Form for Mar. 31, 2004] (listing J. Kenneth Alderman, fund director [Vice President of Regions Financial Corporation since 2000, C.E.O. of Morgan Asset since 2002], Allen B. Morgan, Jr., fund director [a director of Regions since 2001, Chairman of Morgan Keegan since 1969], Carter E. Anthony, fund President [President of Morgan Asset since 2002], Thomas R. Gamble, fund Vice-President [executive of Regions Financial since 1981], Joseph C. Weller, fund Treasurer [Executive Vice President of Morgan Keegan since 1969], Charles D. Maxwell, fund Secretary [Asst. Treasurer and Asst. Secretary of Morgan Keegan since 1994], J. Thompson Weller, Asst. Secretary [Controller of Morgan Keegan since 2001]). "Morgan Asset Management, Inc., is a wholly owned subsidiary of Regions Financial Corporation." *Id.* at 13. Morgan Keegan is also a wholly owned subsidiary of Regions Financial Corporation. RMK Strategic Income Fund, Inc., Annual Shareholder Report for Mar. 31, 2007 (Form N-CSR), at 86 (June 6, 2007), https://www.sec.gov/Archives/edgar/data/1275902/000119312507130986/dncsr.htm [https://perma.cc/B5M6-K3P5] [hereinafter RMK Form for Mar. 31, 2007].

40. RMK Form for Mar. 31, 2007, *supra* note 39, at 2 (objective and strategy of the RMK Advantage Income Fund, Inc.).

41. RMK Form for Mar. 31, 2007, *supra* note 39, at 2.

42. RMK Form for Mar. 31, 2007, *supra* note 39, at 56 (objective and strategy of the RMK Strategic Income Fund, Inc.).

43. Morgan Keegan & Co., Inc. v. Purdue Ave. Inv'rs LP, No. 05–15–00369–CV, 2016 WL 2941266, at *1 (Tex. App.—Dallas May 18, 2016, pet. denied) (mem. op.); *see* Brief for Appellees at 1–2, *Morgan Keegan*, 2016 WL 2941266 (No. DC-09-14448), 2015 WL 5312065 (for 2005 purchase).

44. *Morgan Keegan*, 2016 WL 2941266, at *3.

45. *See, e.g.*, RMK Strategic Income Fund, Inc., Registration Statement (Form N-2), at 1 (Mar. 17, 2004), http://www.sec.gov/Archives/edgar/data/1275902/000089843204000261/rmkstrategic-n2a.txt [https://perma.cc/38N5-H4RB] ("RMK Strategic Income Fund, Inc. . . . is a newly-organized, diversified, closed-end management investment company."); *id.* at 2 ("[T]he Fund . . . will invest up to 65%, but not less than 25%, of its total assets in below investment grade debt securities."); *id.* at 3 ("The Fund currently intends to use leverage through borrowings in an amount equal to approximately 33 1/3% of its total assets. . . .").

backed by housing and housing finance."[46] Also not disclosed was the heightened risk of investing in the bottom tranches and the effective leveraging from the subordination.[47] Expert testimony indicated that this investment was not a diversified investment and was risky, subject to being wiped out even if a small amount of the underlying loans went into default.[48] These risks were not disclosed until late 2007.[49] After a trial before the judge, the trial court entered a judgment against the brokerage firm underwriter and the investment advisor for $2.1 million, including prejudgment interest.[50] The court of appeals modified the judgment and affirmed.[51]

The main issue involved an alleged discrepancy in the trial court's judgment and its conclusions of law, which convinced the underwriter and investment manager to doubt whether they were properly found liable.[52] The trial court's conclusions of law indicated the underwriter and investment advisor were liable as aiders and abettors.[53] But the final judgment recited recovery under TSA section 33C(2), the provision for issuer liability for a material misstatement or omission in a prospectus for a regis-

46. *Morgan Keegan*, 2016 WL 2941266, at *7.

47. *Id.*

48. *Id.* The expert witness was the former Associate Chief Economist with the SEC and had testified in more than 50 trials and arbitrations that involved the RMK bond funds. *See* Brief for Appellees, *supra* note 43, at 3.

49. *Morgan Keegan*, 2016 WL 2941266, at *8; *compare* RMK Strategic Income Fund, Inc., Semi-Annual Shareholder Report for Sept. 30, 2007 (Form N-CSR), at 2 (Dec. 5, 2007), https://www.sec.gov/Archives/edgar/data/1275902/000119312507259684/dncsrs.htm [https://perma.cc/W33H-39XD] (The "Investment Risks" section of this report notes that mortgage-backed or asset-backed securities are subordinated and that this increases risks since the fund may not receive payments until the pool's other obligations have been met, and because below investment grade bonds are less liquid, particularly during times of economic uncertainty.), *with* RMK Form for Mar. 31, 2007, *supra* note 39, at 2 (This "Investment Risks" section mentions leverage as an opportunity).

50. *See* Final Judgment at ¶ 1, Purdue Ave. Inv'rs LP v. Morgan Keegan & Co., No. DC0914448, 2014 WL 10298830, at *1 (101st Dist. Ct., Dallas County, Tex. Dec. 2, 2014).

51. *Morgan Keegan*, 2016 WL 2941266, at *1.

52. *Id.* at *5.

53. *See id.* The conclusions of law recited a finding of the four elements for aider and abettor liability under the TSA from *Darocy v. Albildtrup*, 345 S.W.3d 129, 138–39 (Tex. App.—Dallas 2011, no pet.), namely (1) a primary violation of TSA; (2) the aider's "general awareness" of the role it played in the violation; (3) the aider's "substantial assistance" in the carrying out violation; and (4) the aider's acting with reckless disregard for the truth. *Id.*; *see also* Frank v. Bear, Stearns & Co., 11 S.W.3d 380, 384 (Tex. App.—Houston [14th Dist.] 2000, pet. denied); Flint, *Securities Regulation 2013*, *supra* note 3, at 1136–37 (discussing *Darocy*).

The conclusions of law also recited control person liability under TSA Section 33F(1), but lacked the findings of the two elements for control liability under the TSA from *Barnes v. SWS Fin. Servs., Inc.*, 97 S.W.3d 759, 764 (Tex. App.—Dallas 2003, no pet.). *See* George Lee Flint, Jr., *Securities Regulation*, 57 SMU L. Rev. 1207, 1212–13 (2004) (discussing *Barnes*); *Frank*, 11 S.W.3d at 384 (discussing (1) the controller's exercise of control over the operations in general; and (2) the controller's power over the specific activity of the primary violation). *See also Morgan Keegan*, 2016 WL 2941266, at *5 (Finding of Law 34). A perusal of the shareholder reports of the investment companies indicate the officers and several directors of the investment companies were officers of the underwriter and investment advisor. See *supra* note 39, suggesting that control person liability also should have been found.

tered offering.[54] Consequently, the underwriter and investment manager sought reversal since this cause of action against the issuers had not been pled or proved.[55] Note, however, that the statutory provision for aider and abettor liability under TSA section 33F specifically says the aider and abettor is liable under TSA section 33C.[56] But rather than point out the underwriter's and investment advisor's inability to read a Texas statute, the court of appeals proceeded to examine the petition and discovered three counts, one for issuer liability, one for aider and abettor liability, and one for control person liability, together providing sufficient notice to allege causes of action for primary and secondary liability under the TSA.[57] As to the proof of the primary violation, the material misstatements and omissions in the prospectus, the court of appeals examined the evidence provided by the two expert witnesses, one explaining the investment companies' losses stemmed from the failure to diversify and the other claiming the losses came from a systemic meltdown caused by the sub-prime mortgage crisis, and concluded that a reasonable fact-finder would reach the same verdict as did the trial court.[58] For proof of the secondary liability, the court of appeals examined the testimony of the investment advisor's employee chosen to design and manage the investment companies and the expert testimony and again concluded a reasonable fact-finder would reach the same verdict concerning aider and abettor liability.[59] The court of appeals then addressed the alleged discrepancy between the trial court's judgment and its conclusions of law, found that the evidence, arguments, and pleadings were directed to both the primary violation by the issuing investment companies and secondary liability of the underwriter and investment advisor so the court of appeals could, and did, modify the final judgment to clarify that their liability came under both TSA sections 33C and 33F.[60]

The other alleged issues of the underwriter and investment manager were no better thought out. First, they claimed the three-in-five-year statute of limitations should have begun to run at the first shareholder report.[61] That first report in 2005 indicated a large portion of assets in non-

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54. *See* Final Judgment, *supra* note 50 ("judgment for Plaintiffs . . . pursuant to TEX. REV. CIV. STAT. ANN. art. 581-33(c)(2)."); *see also* TEX. REV. CIV. STAT. ANN. art. 581-33C(2) ("If the prospectus required in connection with the registration contains, as of its effective date, an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, the issuer is liable to a person buying the registered security. . . .").

55. *Morgan Keegan*, 2016 WL 2941266, at *5.

56. *See* TEX. REV. CIV. STAT. ANN. art. 581-33F(2) ("A person who directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law materially aids a[n] . . . issuer of a security is liable under Section . . . 33C jointly and severally with the . . . issuer, and to the same extent as if he were the . . . issuer.").

57. *Morgan Keegan*, 2016 WL 2941266, at *5–6.

58. *Id.* at *7.

59. *Id.* at *8.

60. *Id.* at *8–9.

61. *Id.* at *2; *see* TEX. REV. CIV. STAT. ANN. art. 581-33H(2) ("No person may sue under Section . . . 33F so far as it relates to . . . 33C: (a) more than three years after

investment grade securities, but claimed a high degree of diversification with no indication of a high concentration of low tranche securities or a high degree of leverage.[62] Consequently, the court of appeals determined the statute of limitations did not begin to run until later, within the allowed limits.[63] Second, the fraudsters complained about a biased trial judge due to his familiarity with financial matters; however, the court of appeals found the record showed the trial judge remained impartial and reflected his impatience with both parties when they tried to explain financial concepts to him that he already knew.[64] Third, they complained of the admission as evidence of an SEC cease and desist order and a joint notice of intent to revoke registration by several state securities commissioners since these documents were settlement agreements.[65] The court of appeals, rather than enter the debate on whether SEC orders are admissible, found the trial court's judgment was not based on such evidence.[66] This should have been obvious to the underwriter and investment advisor since the SEC order related to the mis-valuations of the assets of the investment companies, rather than the misstatements and omissions in the prospectus.[67] Lastly, the fraudsters complained of the failure to offset against the damages recovered in the SEC and state securities commissioners' settlement actions.[68] The court of appeals quickly dismissed this complaint since they had neither pled nor offered evidence concerning investments in the investment companies made subsequent to the filing of the lawsuit and the administrative bodies' consent

discovery of the untruth or omission, or after discovery should have been made by the exercise of reasonable diligence; or (b) more than five years after the sale. . . .").

62. *See, e.g.*, RMK Strategic Income Fund, Inc., Annual Shareholder Report for Mar. 31, 2005 (Form N-CSR), at 37 (June 6, 2005), https://www.sec.gov/Archives/edgar/data/1275902/00089843205000476/form-ncsr.txt [https://perma.cc/A2MC-Q7X2] ("Our high income strategy emphasizes very broad diversification utilizing asset categories beyond the well recognized below investment grade corporate and convertible bonds."); *id.* at 39 (portfolio credit rating BB; leveraged assets 26%); *id.* at 45–46 (asset backed securities—investment grade 26.2%; asset backed securities—non-investment grade 61.1%).

63. *Morgan Keegan*, 2016 WL 2941266, at *2–4.

64. *Id.* at *9–11.

65. *Id.* at *11; *compare* TEX. R. EVID. 408(a)(2) (West 2016) ("Evidence of the following is not admissible either to prove or disprove the validity or amount of a disputed claim: . . . statements made during compromise negotiations about the claim."), *with* TEX. R. EVID. 803(8) ("The following are not excluded by the rule against hearsay: . . . (8) A record or statement of a public office.").

66. *Morgan Keegan*, 2016 WL 2941266, at *12; *compare* Option Res. Grp. v. Chambers Dev. Co., 967 F. Supp. 846, 851 (W.D. Pa. 1996) (SEC consent decree admissible), *with* Carpenters Health & Welfare Fund v. Coca-Cola Co., No. 1:00–CV–2838–WBH, 2008 WL 9358563, at *7 (N.D. Ga. Apr. 23, 2008) (SEC consent decree inadmissible).

67. *See* Morgan Asset Mgmt., *supra* note 38, at 4 (failure to follow valuation policies and procedures from Nov. 2004 through July 2008).

68. *Morgan Keegan*, 2016 WL 2941266, at *12–13. The investors had entered into an agreement to defer discovery on attorney's fees until after full discovery. The trial court, however, had determined that attorney's fees would not be equitable, and so denied the discovery on attorney's fees. *See id.* at *14. This decision was affirmed by the court of appeals since attorney's fees are at the discretion of the trial court. *See* TEX. REV. CIV. STAT. ANN. art. 581-33D(7) (West 2015) ("[A] buyer . . . may also recover reasonable attorney's fees if the court finds that the recovery would be equitable in the circumstances.").

decrees barred offsets against funds recovered under the consent decrees.[69]

The comedy of legal arguments continues to enrich the lawyers representing the underwriter and investment advisor. Their petition for review before the Texas Supreme Court asserts first that the court of appeals dramatically expanded secondary liability under the TSA by not tying it to the underlying primary violation and claiming the decision stands for the proposition that just status as an underwriter or investment advisor is sufficient.[70] This of course ignores the examination of the facts and conclusions of law made by the court of appeals in affirming both the primary liability of the investment company for material misstatements and omissions in the prospectus, and the secondary liability of the underwriter and investment manager as aiders and abettors.[71] That petition asserts second that the modification to the trial court's judgment made by the court of appeals added a cause of action denied by the trial court.[72] This of course is taking advantage of their own misreading of the TSA, which provides that aiders and abettors are liable under TSA section 33C. All the court of appeals did by adding liability also under TSA section 33F was to clarify that the underwriter's and investment advisor's liability was not primary liability as an issuer but secondary liability as an aider and abettor.

II. REGISTRATION AND ENFORCEMENT

The TSA created the TSSB to handle the registrations required by the TSA and to serve as an enforcement agency.[73] The basic rule of most securities laws is that securities must be registered with their corresponding regulatory agency unless they fall within an exemption.[74] 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.[75] Enforcement actions generally focus on issuers failing to register their securities, and simultaneously their selling agents, and making misleading statements to aid their sales.

The TSSB obtained an informal letter ruling from the Texas Attorney General that a communication between a staff attorney for the TSSB and the Director of Enforcement for the TSSB, "made for the purpose of facilitating . . . professional legal services to the board[,] . . . was intended

69. *Morgan Keegan*, 2016 WL 2941266, at *13; *see, e.g.*, Morgan Asset Mgmt., *supra* note 38, at *19 (barring offsets in investor actions).

70. *See* Petition for Review at *14, *Morgan Keegan*, 2016 WL 2941266 (No. 16-0514), 2016 WL 4628121.

71. *See Morgan Keegan*, 2016 WL 2941266, at *7–9.

72. *See id.* at *17–18. The trial court's final judgment contains the boiler-plate provision denying "any and all other remaining claims, if any. . . ."); *see also* Final Judgment, *supra* note 50, at ¶ 4.

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

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

75. *See id.* art. 581-12(A)–(B).

to be confidential and has remained confidential," and fits the attorney-client privilege exception to public disclosure under the Texas Government Code.[76]

A. Issuer Securities

The TSSB amended its rule permitting Regulation A offerings under the federal securities laws to register by a notice, payment of a fee, and where applicable, a consent to service to include Tier 2 offerings under the new Regulation A definition, since the federal statutes have preempted state registration for such offerings.[77] The TSSB also amended its oil and gas auction exemption to include associate auctioneer, an individual "employed by and under the direct supervision of a licensed auctioneer," that the legislature added to the Texas Occupations Code in 2015.[78] And the TSSB amended its conditional exemption for money market funds to conform to the recent federal definition of a money market fund eliminating valuations by credit rating.[79]

B. Market Operators

One common feature of state regulation of securities is the usual requirement to register as a seller of securities before selling securities in the state, and to register as an investment adviser before rendering investment advice.[80] Registration infractions generally surface when applying or reapplying for registration.

The TSSB simplified the registration process for dealers and investment advisers by authorizing communications by email and providing a

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76. Tex. Att'y. Gen. OR2015-27321, 2015 WL 9693239, at *2; *see* Tex. Gov't Code § 552.107(1) (West 2015) (not available for public disclosure if "information that the . . . attorney of a political subdivision is prohibited from disclosing because of a duty to the client under" evidentiary rules or professional conduct rules). The communication satisfied the four elements of (1) a communication; (2) rendered to facilitate a legal service; (3) occurred between only the attorney and the client; and (4) was intended to be confidential. Tex. Att'y. Gen. OR2015-27321, 2015 WL 9693239, at *2.

77. *See* 40 Tex. Reg. 6805 (2015), *adopted by* 41 Tex. Reg. 1223 (2016) (without comment) (codified at 7 Tex. Admin. Code § 113.1 (West 2016) (amending the rule for qualification of securities for Regulation A and B to include federal covered securities)); *see also* Flint, *Securities Regulation 2016*, *supra* note 8, at 456–57 (discussing the new federal exemption for small issues and the preemption of state registration for Tier 2 issues). Under the Texas rules, "federal covered securities" are "covered securities" under SA § 18(b). 7 Tex. Admin. Code § 107.2(15) (defining "federal covered securities"). *See also* 15 U.S.C. § 77r(b)(4)(C) (2012) (SA § 18(b) including sales to only accredited persons in definition of "covered securities" for which state law is preempted); 17 C.F.R. § 230.251 (2017) (defining Tier 2 issues to be Regulation A offerings between $50 million and $20 million).

78. *See* 40 Tex. Reg. 6814 (2015), *adopted by* 41 Tex. Reg. 1225 (2016) (without comment) (codified at 7 Tex. Admin. Code § 139.12); *see also* Tex. Occ. Code Ann. § 1802.001(2) (West 2015) (as amended by Tex. H.B. 2481, 84th Leg., R.S. (2015)) (effective Sept. 1, 2015).

79. *See* 41 Tex. Reg. 1195 (2016), *adopted by* 41 Tex. Reg. 4251 (2016) (without comment) (codified at 7 Tex. Admin. Code § 123.3); *see also* 17 C.F.R. § 270.2a-7 (2017) (the definition); Money Mkt. Fund Reform; Amendments to Form PF, Investment Company Act Release No. 33-9616, 79 Fed. Reg. 47735, 47736 (Aug. 14, 2014) (final rule) (explaining the removal of credit ratings to evaluate money market funds).

80. *See* Tex. Rev. Civ. Stat. Ann. art. 581-12(A)–(B).

standardized form by adopting a form for the certification of the balance sheet by the principal financial officer to be filed with the company's application for registration.[81] The TSSB also made some changes to its expedited registration procedures for military service members and veterans by revising the form for the request for special consideration of a registration and authorizing waivers and refunds of the initial registration fees.[82]

The TSSB has followed the legislative drive to incentivize new small business enterprises to raise capital by "tak[ing] advantage of the populace's penchant for gambling" through crowdfunding portals run by certain nonprofits and public entities.[83] So the TSSB adopted a new rule for crowdfunding portal registration for authorized small business development entities specified in the statute and for nonprofit community development financial institutions certified by the Community Development Financial Institutions Fund, a program of the U.S. Department of the Treasury, of which thirty-three are in Texas.[84] The TSSB also amended its crowdfunding portal registration "to permit a registered portal to handle

81. *See* 40 Tex. Reg. 3291 (2015), *adopted by* 40 Tex. Reg. 6888 (2015) (with one comment) (codified at 7 TEX. ADMIN. CODE § 104.4(c) (authorizing email communications for registration)); 40 Tex. Reg. 3294 (2015), *adopted by* 40 Tex. Reg. 6889 (2015) (with one comment) (codified at 7 TEX. ADMIN. CODE § 133.18 (providing the standardized form)); *see also* 40 Tex. Reg. 3292 (2015), *adopted by* 40 Tex. Reg. 6888 (2016) (without comment) (codified at 7 TEX. ADMIN. CODE § 115.2 (making reference to the new form for the application by dealers)); 40 Tex. Reg. 3293 (2015), *adopted by* 40 Tex. Reg. 6889 (2015) (without comment) (codified at 7 TEX. ADMIN. CODE § 116.2 (making reference to the new form for the application by investment advisers and investment adviser representatives)).

82. *See* 40 Tex. Reg. 6813 (2015), *adopted by* 41 Tex. Reg. 1225 (2016) (without comment) (codified at 7 TEX. ADMIN. CODE § 133.4 (providing the revised form for the request)); 40 Tex. Reg. 6814 (2015), *adopted by* 41 Tex. Reg. 1225 (2016) (without comment) (codified at 7 TEX. ADMIN. CODE § 133.19 (authorizing waivers or refunds to military applicants)); *see also* 40 Tex. Reg. 6813 (2015), *adopted by* 41 Tex. Reg. 1225 (without comment) (repealing the old application request form); 40 Tex. Reg. 6806 (2015), *adopted by* 41 Tex. Reg. 1223 (2016) (without comment) (codified at 7 TEX. ADMIN. CODE § 115.4 (amending the rule for renewal of dealer registration for military applicants)); 40 Tex. Reg. 6809 (2015), *adopted by* 41 Tex. Reg. 1224 (2016) (without comment) (codified at 7 TEX. ADMIN. CODE § 116.18 (amending the rule for renewal of investment adviser and investment adviser representative registration for military applicants)); Flint, *Securities Regulation 2016*, *supra* note 8, at 461 (discussing the expedited rules for military applicants under the 2013 legislation).

83. *See* Flint, *Securities Regulation 2016*, *supra* note 8, at 456–60 (discussing the efforts of the TSSB to permit crowdfunding as a method of raising capital, including the initial 8 portals); *see also* TEX. REV. CIV. STAT. ANN. art. 581-44(c)(1)–(6) (the public entities are municipal corporations, those created by municipalities under the government code, the Texas Veterans Commission, nonprofit community development financial institutions, and nonprofit organizations with federal government authorization to distribute block grants for housing and community development).

84. *See* 41 Tex. Reg. 1192 (2016), *adopted by* 41 Tex. Reg. 4251 (2016) (one comment) (codified at 7 TEX. ADMIN. CODE § 115.20); *see also* 41 Tex. Reg. 1195 (2016), *adopted by* 41 Tex. Reg. 4252 (2016) (without comment) (codified at 7 TEX. ADMIN. CODE § 133.20 (providing the form for the registration)); 41 Tex. Reg. 1196 (2016), *adopted by* 41 Tex. Reg. 4252 (2016) (without comment) (codified at 7 TEX. ADMIN. CODE § 139.25 (permitting certain small development entities registered in Texas as crowdfunding portals to have an interest in the issuer listed on their website)).

investor funds if [they] are held in a segregated account."[85]

C. 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 ten threats to investors: unregistered individuals because investors don't know about the information available from the registration requirement; stream-of-income investments because the income is redirectable; cybersecurity and digital currency risks because the currency is not subject to regulation; private placements because the investments are not transparent; use of social media, on which it is easier to lie than in print; high-yield notes since investors can't evaluate credit worthiness; life settlements because it is impossible to reliably forecast an individual's life expectancy; real estate because the hard asset masks other risks; affinity fraud because the scheme disperses rapidly among group members; and oil and gas deals since investors can't investigate the claim.[87] The TSSB's actions focus on these threats.

1. Unregistered Securities

The TSSB also took several enforcement actions against issuers for failure to register their non-exempt securities and selling agents. Since sales to only accredited persons are covered securities and not subject to state registration due to preemption,[88] all of these actions also involve failures to verify the accreditation of the investors. These serial fraudsters generally advertised on the internet and failed to disclose the risks of their investment schemes, the details of their investments, and their prior securities law disciplinary histories.

Several unregistered securities schemes involved practices included in the top ten threats to investors. With respect to unregistered interests in Texas oil and gas prospects marketed through social media touting 117% initial annual returns and using bitcoin payments without disclosing the risks, the TSSB modified its 2014 Emergency Cease and Desist order.[89]

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85. *See* 41 Tex. Reg. 4751 (2016), *adopted by* 41 Tex. Reg. 9196 (2016) (without comment) (codified at 7 Tex. Admin. Code § 115.19 (permitting crowdfunding portals to hold investor segregated investor funds)); *see also* 41 Tex. Reg. 4752 (2016), *adopted by* 41 Tex. Reg. 8195 (2016) (without comment) (codified at 7 Tex. Admin. Code § 139.25 (corresponding change for the intrastate crowdfunding exemption)).

86. *See* Tex. Rev. Civ. Stat. Ann. art. 581-23-2.

87. *See Texas Securities Regulator Identifies Top 10 Investor Threats*, Tex. State Sec. Bd. (Nov. 17, 2014), https://www.ssb.texas.gov/news-publications/investor-alert-texas-securities-regulator-identifies-top-10-investor-threats [https://perma.cc/NMT9-4TC2] (also listing real estate deals).

88. 15 U.S.C. § 77r(b)(4)(C) (2012) (the JOBS Act provision including sales to only accredited persons in definition of "covered securities" for which state law is preempted).

89. *See In re* Balanced Energy, LLC, No. ENF-16-CDO-1745, 2016 WL 4719125, at *9 (Tex. St. Sec. Bd. July 14, 2016) (ordered to stop selling unregistered securities); *see also In re* Balanced Energy, LLC, No. 312-14-3801, 2016 WL 2941389 (Tex. Office of Admin. Hearings May 10, 2016) (proposal for decision); *see also* Flint, *Securities Regulation 2016*,

Another scheme by a serial fraudster sold unregistered promissory notes and life settlements returning 9% through a website, advertisements on the radio, and dinner seminars in a real estate development company, an urgent care health provider company, a health care delivery company, a life settlement company, and an advertising company, using the funds for personal uses, including paying off a personal tax lien.[90] Another serial fraudster sold interest in a pension income stream program that earned returns from the payout of pension benefits the schemer acquired from federal government employees, members of the military, and certain corporations, without disclosing that federal law prohibits assignment of pension payments.[91]

2. *Errant Market Operators*

Besides those dealers involved with unregistered securities, the TSSB prosecuted several enforcement actions against other dealers and selling agents. These dealers failed to supervise their agents by enforcing their policies, leading to administrative fines.[92] One dealer, in examining financial statements of agents, had a policy of requiring an explanation for all deposits that are not dealer commissions and exceed $1,000, but failed to follow that policy in discovering deposits of $1 million and so failed to discover the deposits were loans from a client to the agent.[93] That same dealer also failed to supervise agents who had sold non-traded Real Estate Investment Trusts (REIT) in excess of the amounts specified in the respective REIT's prospectus, state concentration limits, or the dealer's own investment guidelines.[94] Tipped by a client, the TSSB reprimanded another dealer whose agent recommended that clients invest 95% in low-priced equities, the majority 100% invested in the energy sector, and the majority 100% in a single company at certain times, yet failed to investigate the alerts regarding the concentrated account positions, falling value

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supra note 8, at 465 (discussing the 2014 emergency cease and desist order against Balanced Energy).

90. *See In re* Tex. First Fin., LLC, No. ENF-16-CDO-1746, 2016 WL 4432579 (Tex. St. Sec. Bd. Aug. 15, 2016) (emergency cease and desist order to stop selling unregistered securities, offering securities through unregistered dealers, and engaging in fraud in connection with the sales of securities; the principal failed to disclose an SEC action against his prior selling of life settlements in Georgia).

91. *See In re* Sobell Corp., No. ENF-16-SDO-1741, 2016 WL 463331 (Tex. St. Sec. Bd. Feb. 1, 2016) (emergency cease and desist order to stop selling unregistered securities, engaging in fraud in connection with the sales of securities and offering securities through materially misleading offers; the principals failed to disclose Arkansas, New Mexico, and California cease and desist orders, and a bar from sales in Pennsylvania); *see also*, *e.g.*, 29 U.S.C. § 1056(d)(1) (2012) (ERISA's anti-alienation provision: "Each pension plan shall provide that benefits provided under the plan may not be assigned or alienated.").

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

93. *See In re* Dealer Registration of LPL Fin. LLC, No. IC16-CAF-02, 2016 WL 770971 (Tex. St. Sec. Bd. Feb. 18, 2016) (reprimand with $95,000 fine).

94. *See In re* Dealer Registration of LPL Fin. LLC, No. IC15-CDO-04, 2015 WL 8000829 (Tex. St. Sec. Bd. Dec. 1, 2015) (ordered to remediate losses of Texas investors from sales in excess of the limits).

of the accounts, client complaint letters, and amended client customer profile forms by including "speculative" as one of its investment objectives.[95] Another dealer failed to require contemporaneous notifications to clients of third-party wire transfers used for customers who receive advisory services provided by independent investment advisors, thereby violating a rule.[96] And another dealer, although it had a system to determine if any of its agents with client powers of attorney were accepting compensation for providing investment advice, failed to follow up on determining whether the agents were registered, and if not, removing them.[97]

The TSSB had several enforcement actions against investment advisers and investment adviser representatives. These involved providing investment advice for a fee without registering;[98] making unsuitable recommendations in penny stocks, non-traded REITs, and life settlements;[99] failing to disclose fees, costs, and bankruptcy;[100] failing to keep adequate

95. *See In re* Dealer Registration of the Inv. Ctr., Inc., No. IC16-CAF-13, 2016 WL 4166596 (Tex. St. Sec. Bd. Aug. 2, 2016) (reprimanded with a fine of $50,000).

96. *See In re* Dealer Registration of Scottrade, Inc., No. IC16-CAF-04, 2016 WL 952027 (Tex. St. Sec. Bd. Mar. 7, 2016) (reprimanded with a fine of $50,000); *see also*, *e.g.*, FIN. IND. REG. AUTH., Rule 2232, Customer Confirmations (2011), finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9788 [https://perma.cc/US64-HLAW] (confirmation sent to customer at or before completion of any transaction).

97. *See In re* Dealer Registration of Charles Schwab & Co., No. IC-CAF-16, 2016 WL 5643543 (Tex. St. Sec. Bd. Sept. 22, 2016) (fined $95,000 plus agreed to contribute $30,000 for Texas investor education programs in Texas through the Investor Protection Trust).

98. *See In re* Catlin, No. IC16-CAF-10, 2016 WL 3131452 (Tex. St. Sec. Bd. May 31, 2016) (solicited ten clients for $75,000; ordered to cease and desist operating as an investment adviser in violation of TSA and fined $6,000); *In re* Lillard, No. IC16-CAF-11, 2016 WL 3131453 (Tex. St. Sec. Bd. May 31, 2016) (solicited seven new clients for $29,100; ordered to cease and desist operating as an investment adviser in violation of TSA and fined $3,000); *In re* Inv. Adviser Registration of Fuller Capital Mgmt., No. IC16-CAF-08, 2016 WL 2957868 (Tex. St. Sec. Bd. May 11, 2016) (used two unregistered solicitors compensated with 35% of the annual fee assessed by the registered investment adviser; reprimanded and fined $5,000).

99. *See In re* Inv. Adviser Registration of Rubicon Inv. Mgmt. & Analytics, LLC, No. IC16-CAF-15, 2016 WL 5349038 (Tex. St. Sec. Bd. Sept. 20, 2016) (failed to maintain records to determine investment objectives, suitability information, and required client information; failed to establish supervisory oversight of investment adviser representatives; and failed to establish procedures to review and resolve client complaints [one dealing with the alleged unsuitability of penny stocks in a 93-year-old client's account]; reprimand with undertaking and fine of $5,000); *In re* Inv. Adviser Representative Registration and the Agent Registration of M F Long II, No. REG16-SUS-03, 2016 WL 5888781 (Tex. St. Sec. Bd. Oct. 4, 2016) (recommended exploratory drilling programs and non-listed REITs contrary to employing investment adviser's policies to 70-year old client in amounts exceeding client's risk tolerance form; registration suspended for 45 days with undertaking); *In re* Inv. Adviser Registration of Harrison, No. IC16-SUS-01, 2016 WL 695711 (Tex. St. Sec. Bd. Feb. 16, 2016) (advised 63-year old retiree to invest her primary source of income in completely illiquid life settlements without any suitability basis; registration suspended for 90 days with undertaking and cease and desist being unregistered).

100. *See In re* Inv. Adviser Registration of Jim Poe & Assocs., No. IC16-REV-05, 2016 WL 1179748 (Tex. St. Sec. Bd. Mar. 18, 2016) (failed to disclose his 6% of managed investment fees were above the industry norm as required by TSA rule, and the costs of purchasing life settlements; reprimanded with undertaking, registration revoked, ordered to cease and desist violating TSA); *In re* Inv. Adviser Registration of Mowery Capital Mgmt., LLC, No. IC16-CAF-06, 2016 WL 1179747 (Tex. St. Sec. Bd. Mar. 18, 2016) (failed to disclose to clients receipt of a portion of trading commissions under a brokerage service contract and

records;[101] failing to update TSSB filings;[102] and charging excessive fees and withdrawing them from client funds.[103]

D. Criminal Enforcement

TSA section 29 provides criminal penalties for various acts.[104] One appellate court considered a criminal case involving the rendering of services as an investment advisor failing to disclose information and without registering under the TSA.[105] *Ex parte Paxton* involved a July 2015 three-count indictment against the individual serving as the Texas Attorney General for securities law violations committed in 2012 and 2011.[106] Paxton was charged with securities fraud in offering to sell two people (one a state representative) over $100,000 in shares of a technology company in July 2011 without disclosing that the company was paying him for the sales and without divulging that he had no shares in the company (other than the shares received as compensation).[107] The SEC has charged the

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a bankruptcy, and committed plagiarism by inserting name at end of another's investment letter on website as a letter to clients; ordered to cease and desist in the fraudulent practices, principal fined $40,000, investment adviser fined $50,000 plus $2,930 in transcription costs); *see also* 7 Tex. Admin. Code § 116.13(a) (West 2016) (Tex. St. Sec. Bd., Advisory Fee Requirements) (to charge more than 3% of funds under management as advisory fee requires disclosure).

101. *See In re* Inv. Adviser Registration of Valor Capital Asset Mgmt., LLC, No. IC16-CAF-14, 2016 WL 4268922 (Tex. St. Sec. Bd. Aug. 8, 2016) (failed to keep records of pre-allocations for block trades with clients and agents and did not pre-allocate consistently; reprimanded and fined $48,000); *In re* Inv. Adviser Registration of Post Oak Inv. Mgmt., Inc., No. IC16-CAF-09, 2016 WL 3035160 (Tex. St. Sec. Bd. May 23, 2016) (failed to send quarterly statements or have annual independent audits when in custody of client funds as required by TSA; reprimanded with undertaking and fined $1,000); *see also* 7 Tex. Admin. Code § 116.17 (b)(3), (c)(4) (Tex. St. Sec. Bd., Custody of Funds or Securities of Clients by Registered Investment Advisers) (quarterly statements to clients; exception for audit).

102. *See In re* Inv. Adviser Representative Registration of Kuhn, No. REG16-SUS-01, 2016 WL 3035161 (Tex. St. Sec. Bd. May 23, 2016) (failed to update Form U4 when notified of unsatisfied judgments against him; suspended 30 days, fined $5,000).

103. *See In re* Inv. Adviser Registration of J. Pinkernell Global Wealth, LLC., No. IC16-SUS-17, 2016 WL 6216113 (Tex. St. Sec. Bd. Oct. 14, 2016) (overcharged two clients for fees and withdrew substantially more than that from the clients' accounts; suspended five years, cease and desist in fraudulent business practices with undertaking); *In re* Inv. Adviser Representative Registration of Hancock, No. IC16-REV-07, 2016 WL 1179746 (Tex. St. Sec. Bd. Mar. 23, 2016) (withdrawing fees of $1.6 million when fee was $45,000; registration revoked, ordered to cease and desist with undertaking).

104. *See* Tex. Rev. Civ. Stat. Ann. arts. 581-29C(3), (4)(c) (West 2015) ("Any person who shall: . . . in connection with the rendering of services as an investment adviser or an investment adviser representative . . . knowingly . . . omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading . . . [is] guilty of a felony of the first degree, if the amount involved is $100,000 or more."); art. 581-29I ("Any person who shall . . . [r]ender services as an investment adviser or an investment adviser representative without being registered as required by this Act shall be deemed guilty of a felony of the third degree.").

105. *Ex parte* Paxton, 493 S.W.3d 292 (Tex. App.—Dallas 2016, pet. ref'd).

106. *Id.* at 296–97.

107. *See* Patrick Svitek, *Paxton Surrenders in Securities Fraud Indictment*, Tex. Trib. (Aug. 3, 2015 10:17 AM), https://www.texastribune.org/2015/08/03/paxton-set-surrender-securities-fraud-indictment [https://perma.cc/8RV8-MR5D] (including a copy of the indictment with first count for lack of registration on 18 July 2012 to James and Freddie Henry,

technology company with securities fraud.[108] Paxton was also charged with acting as an investment advisor representative to two clients for his business partner in July 2012 without registering with the TSSB as an investment advisor representative and for which he was paid 30% of the commission.[109] The TSSB had reprimanded and fined Paxton $1,000 after he admitted in 2014 he had solicited investment clients for a business partner and friend without being registered with the TSSB.[110] That action spurred leftist political groups to pressure the Travis County District Attorney to bring a criminal action against Paxton; that district attorney, however, referred the action to Collin County where the alleged lawbreaking occurred.[111] The Collin County District Attorney, a business associate of Paxton, requested to withdraw and for the district judge to appoint two special prosecutors.[112] The two prosecutors obtained the indictment. If convicted under any one of the charges, Paxton would be ineligible to serve in a public elective office in Texas.[113]

In *Ex parte Paxton*, the Dallas Court of Appeals faced several arguments under a pretrial writ of habeas corpus, primarily directed at the failure to register as an investment advisor representative.[114] The court of appeals would uphold any cognizable argument.[115] To be cognizable, the

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and second and third counts for failure to disclose on 26 July 2011 to Byron Cook and Joel Hochberg).

108. *See* SEC: Company Misled Investors About Energy-Efficient Technology, SEC Press Release No. 2016-65, 2016 WL 1403523 (Apr. 11, 2016) (Servergy sold $26 million of shares through private offerings by representing the company's server was particularly energy-efficient without disclosure that their server's processor was becoming obsolete in the industry and that the large technology companies were developing high-performance servers with more powerful processors); *see also* SEC v. Mapp, NO. 4:16-CV-246, 2016 WL 5870576, at *2 (E.D. Tex. Oct. 7, 2016) (adding to Paxton as parties the technology company, Servergy, Inc., its founder and C.E.O., William E. Mapp III, and Caleb J. White, another promoter). For a discussion of *Mapp*, see *infra* notes 126–40 and accompanying text.

109. *See* Svitek, *supra* note 107; *see also* Brandon Formby, *Paxton Will Plead Not Guilty, Ask for Jury Trial*, DALLAS NEWS (Aug. 3, 2015), http://www.dallasnews.com/news/politics/2015/08/03/dems-plan-to-rally-against-paxton-at-collin-county-courthouse-monday [https://perma.cc/T3FX-QJ48] (same two offenses and dates).

110. *See In re* Inv. Adviser Representative Registration of Paxton, No. IC14-CAF-03, 2014 WL 1875790, at *2 (Tex. St. Sec. Bd. May 2, 2014) (reprimand and administrative fine of $1,000).

111. *See* Patrick Svitek & Terri Langford, *2 Attorneys Appointed to Replace Collin County DA in Paxton Probe*, KERA (Apr. 22, 2015), http://keranews.org/post/2-attorneys-appointed-replace-collin-county-da-paxton-probe [https://perma.cc/YL5V-PUKR].

112. *Id.*

113. *See* TEX. ELEC. CODE ANN. § 141.001(a)(4) (West 2015) ("To be eligible to be a candidate for, or elected or appointed to, a public elective office in this state, a person must . . . have not been finally convicted of a felony from which the person has not been pardoned."); *see also* TEX. REV. CIV. STAT. ANN. art. 581-29C(3) (West 2015) (a felony for an investment advisor representative to fail to disclose a material fact); art. 581-29I (a felony for an investment advisor representative not to be registered).

114. *Ex parte* Paxton, 493 S.W.3d 292, 296–97 (Tex. App.—Dallas 2016, pet. ref'd). One additional issue challenged the grand jury as improperly constituted since the selection method chose from only those jurors willing to serve. The court of appeals ruled it not cognizable on a pretrial writ of habeas corpus since it was not a complaint that would render the jury void. *Id.* at 297–301.

115. *Id.* at 297.

pretrial writ of habeas corpus argument must involve "the protection of the applicant's substantive rights or the conservation of judicial resources."[116] First, Paxton argued that he was not required under the TSA to register.[117] The TSA provides several exemptions from the filing requirement, and for Paxton that was as a representative of a federally registered investment advisor, which representative is not required to register, but only provide notice.[118] Paxton's federally registered investment advisor, Mowery Capital Management, LLC, did not terminate its SEC registration until after the offending solicitations although its Texas registration began before the offending solicitations; both registrations were concurrently permitted under the then-SEC rules due to changes in the size of the funds under management made by the Dodd-Frank Act.[119] The court of appeals found the issue not cognizable under a pretrial writ of habeas corpus since it would require construing TSA section 29I, resolving disputed facts,[120] and applying the statute to Paxton's particular circumstances rather than involving Paxton's substantive rights or dealing with conservation of judicial resources.[121] Paxton's second argument was that the federal definition of "investment adviser representative" applies and it either preempts the state definition in TSA section 4P or renders TSA section 29I unconstitutionally vague because it provides competing federal and state definitions.[122] Again, the court of appeals found this not

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116. *See Ex parte* Perry, 483 S.W.3d 884, 895 (Tex. Crim. App. 2016).

117. *Ex parte Paxton*, 493 S.W.3d at 302–03.

118. *See* TEX. REV. CIV. STAT. ANN. art. 581-12-1(B) ("The Board by rule shall authorize . . . a representative of a federal covered investment adviser to engage in rendering services as an investment adviser in this state on submission to and receipt by the Commissioner of: (1) a notice filing . . . and (2) a fee. . . .").

119. *See* SEC Inv. Adviser Firm Summary for Mowery Capital Mgmt., LLC, https://www.adviserinfo.sec.gov/IAPD/IAPDFirmSummary.aspx?ORG_PK=130761(federal registration terminated effective 10/11/2012; Texas registration approved 6/25/2012); *see also* Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. 42950-01, 42952, 43011 (July 19, 2011), (codified at 17 C.F.R. § 275.203A-2) (2017) (SEC Rule 275.203A(c)(1) in effect in 2011, providing for mid-sized investment advisers withdrawing from SEC registration due to the Dodd-Frank Act to withdraw before June 28, 2012, and while the investment adviser is registered with both the SEC and a state securities authority, the Investment Adviser Act and the applicable State law will be applied to the investment adviser's advisory activities). Mowery Capital Management, LLC was a mid-sized investment adviser removed from federal registration by the Dodd-Frank Act's raising the limit from $25 million under management to $100 million.

120. *Compare In re* Inv. Adviser Representative Registration of Paxton, IC14-CAF-03, 2014 WL 1875790, at ¶ 3 (Tex. St. Sec. Bd. May 2, 2014) (third finding of fact says Mowery Capital Management made the transition back to state registration on June 25, 2012), *with* SEC Inv. Adviser Firm Summary, *supra* note 119 (federal registration terminated effective 10/11/2012).

121. *Ex parte Paxton*, 493 S.W.3d at 303.

122. *Id. Compare* 17 C.F.R. § 275.203A-3(a)(1) ("'Investment adviser representative' of an investment adviser means a supervised person of the investment adviser: (i) Who has more than five clients who are natural persons . . . and (ii) More than ten percent of whose clients are natural persons. . . ."), *with* TEX. REV. CIV. STAT. ANN. art. 581-4P ("'Investment adviser representative' . . . includes each person or company who, for compensation, is employed, appointed, or authorized by an investment adviser to solicit clients for the investment adviser or who, on behalf of an investment adviser, provides investment advice, directly or through subagents, . . . to the investment adviser's clients.").

cognizable since it would involve far-reaching research into federal and state statutes and regulations to determine which definition applied.[123] And third, Paxton argued that TSA section 29I was overbroad in that it regulated commercial speech and vague in that TSA section 4P's use of "solicit" does not give fair notice of the proscribed conduct, and TSA section 29I fails to provide a degree of scienter.[124] The court of appeals rejected the overbreadth concept since it is inapplicable to commercial speech and the vagueness idea since the definition of "solicit" appears in numerous dictionaries and since the Texas Penal Code provides the appropriate scienter of knowingly rendering investment adviser services without having registered, regardless of whether the investment adviser representative knew he needed to be registered.[125]

With respect to securities fraud claims against Paxton, the SEC filed *SEC v. Mapp* in the U.S. District Court for the Eastern District of Texas for similar fraudulent acts under the Securities Act (SA) § 17 and the Exchange Act (EA) §§ 10 and 15, but with such poorly thought-out causes of action that a political motivation seems likely.[126] Paxton met with the founder of the technology company in Paxton's office, agreed to a 10% commission for soliciting investors, solicited at least seven investors at a meeting at the company's offices, and solicited five other investors, generally his business associates, friends, and fellow members of an investment club.[127] Paxton solicited investors who invested $840,000, for which he got 100,000 shares in the company, receiving an IRS Form 1099 for $100,000.[128] Paxton was charged with making false statements, failing to disclose he was being compensated for soliciting the investors, and for failing to conduct due diligence to confirm the company's false claims.[129]

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123. *Ex parte Paxton*, 493 S.W.3d at 304. The Texas Court of Criminal Appeals has determined that the pretrial writ of habeas corpus is inappropriate to construe the meaning of a statute that defines the alleged offense. *See Ex parte* Perry, 483 S.W.3d 884, 895 (Tex. Crim. App. 2016).

124. *Ex parte Paxton*, 493 S.W.3d at 304–07.

125. *Id.*; *see* Vill. of Hoffman Estates v. Flipside, Hoffman Estates, Inc., 455 U.S. 489, 497 (1982) ("overbreadth doctrine does not apply to commercial speech"); Watson v. State, 369 S.W.3d 865, 870 (Tex. Crim. App. 2012) (words are not vague if they are defined in dictionaries); *see also* TEX. PENAL CODE ANN. § 1.03(b) (West 2015) ("The provisions of Titles . . . 2 [§§ 6.01 et seq.] apply to offenses defined by other laws, unless the statute defining the offense provides otherwise. . . ."); *id.* § 6.02(b) ("If the definition of an offense does not prescribe a culpable mental state, a culpable mental state is nevertheless required unless the definition plainly dispenses with any mental element."); *id.* § 6.02(c) ("If the definition of an offense does not prescribe a culpable mental state, but one is nevertheless required under Subsection (b), intent, knowledge, or recklessness suffices to establish criminal responsibility."); Tovar v. State, 978 S.W.2d 584, 587 (Tex. Crim. App. 1998) (convicted of violating the Open Meetings Act upon a showing he knowingly called the closed meeting even without proof he knew of the prohibition against closed meetings).

126. *See* SEC v. Mapp, No. 4:16-CV-246, 2016 WL 5870576, at *2 (E.D. Tex. Oct. 7, 2016) (adding as parties the technology company, Servergy, Inc., its founder and C.E.O., William E. Mapp III, and Caleb J. White, another promoter); *see also* 15 U.S.C. §§ 77q, 78j, 78o (2012) (SA § 17 & EA §§ 10 & 15, respectively).

127. *Mapp*, 2016 WL 5870576, at *1.

128. *Id.* at *2.

129. *Id.*

Paxton moved for dismissal of the claims against him.[130] The liability under EA § 10 was based on misstatements or omissions.[131] With respect to the false statements that the company was a "great investment," the district court found the claims to be mere puffery and not material.[132] With respect to the other false statements (that he had met with management and that the investment would double), the district court found that the SEC failed to allege the statements were false or misleading.[133] With respect to the omission of the compensation, the district court found that the SEC failed to allege a duty to speak or any statements regarding his compensation that might be rendered a misleading half-truth.[134] The liability under SA § 17 was based on his circulation of sales materials describing the securities while failing to disclose his compensation.[135] The SEC alleged only two communications.[136] With respect to the email, the district court found no duty to disclose since the prospective investor did not invest, hence there was no compensation received.[137] With respect to the phone call, the district court found it was not a communication since, under the *ejusdem generis* interpretative doctrine, it must be tangible, and no recording was made of the phone call.[138] The liability under EA § 15 was based on Paxton's failure to register as a broker.[139] The district court found that Paxton was not performing brokerage services of exercising control over investor accounts, but was merely a facilitator.[140] Consequently, the district court conditionally dismissed the SEC's action but granted leave to amend the petition.[141] The SEC did file an amended petition in October 2016.[142]

The U.S. District Court for the Eastern District of Texas delivered its second opinion[143] after the review period of this article. The SEC failed to improve its position. With respect to the "great company" statement, this time the SEC cited cases that found liability for factual assertions when the spokesman knew they were false, but for Paxton, the SEC failed to allege with the requisite particularity that Paxton knew the state-

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130. *Id.*
131. *Id.* at *4.
132. *Id.* at *4–5.
133. *Id.* at *5.
134. *Id.* at *5–8. The district court recognized the circuit courts were split on whether a fiduciary relationship would create that duty, but was inclined to allow it; however, the SEC failed to allege facts to support a fiduciary relationship with the investment club. *Id.* at *6.
135. *Id.* at *8; *see* 15 U.S.C. § 77q(b) (2012) (unlawful by means of a communication to offer to sell a security for consideration without disclosing the receipt of such consideration).
136. *Mapp*, 2016 WL 5870576, at *9–10.
137. *Id.* at *9.
138. *Id.* at *10–12.
139. *Id.* at *12.
140. *Id.* at *12–13.
141. *Id.* at *14.
142. *See* David Lee, *Texas AG Paxton Faces New SEC Fraud Suit*, COURTHOUSE NEWS (Oct. 24, 2016), http://www.courthousenews.com/2016/10/24/texas-ag-paxton-faces-new-sec-fraud-suit.htm [https://perma.cc/35WN-Q9CS].
143. SEC v. Mapp, No. 4:16-CV-246, 2017 WL 823559 (E.D. Tex. Mar. 2, 2017).

ment was false.[144] With respect to the other misstatements (that Paxton had met with management and that the investment would double), the SEC again failed to allege how the statements were false or misleading.[145] With respect to the omission of compensation, the SEC this time claimed a duty to speak from Paxton's trust-like relationship with the investment group, which had a policy of disclosing compensation.[146] The SEC, however, failed to allege that Paxton controlled or dominated the investment club members as required to establish a duty to disclose.[147] The SEC then attempted to assert the state law definition of fiduciary duty and Paxton's status as an attorney for one investor as providing the duty to speak.[148] But the district court found state law irrelevant in order to maintain uniformity of federal law[149] and Paxton's services as a lawyer did not involve the investment.[150] With respect to the half-truth claim, the SEC alleged that all the puffing statements required full disclosure of Paxton's compensation.[151] The district court dismissed this assertion since the circuit courts require the omitted half-truth to relate to the spoken half-truth—not the case with Paxton.[152] With respect to the communications charge with the promotional email, the SEC alleged Paxton failed to conduct due diligence before sending the promotional email, but the SEC failed to allege any duty to do so.[153] With respect to the communications charge with the telephone call, the SEC argued for a broad interpretation of communications to include oral communications, but the district court used *ejusdem generis* to determine the communication must resemble the others listed in the statute, which are all recorded forms.[154] As to the failure to register as a broker allegation, the SEC failed to allege that Paxton effected transactions in securities for the account of others as required by the statutory definition of broker.[155]

III. SECURITIES FRAUD DECISIONS UNDER THE FEDERAL ACTS

The fraud provisions of the TSA are modeled on the federal statutes. Therefore, Texas courts look to federal decisions under the federal stat-

144. *Id.* at *6. In the Fifth Circuit, puffery does not support a securities fraud action. *See* Southland Sec. Corp. v. INSpire Ins. Sols., Inc., 365 F.3d 353, 372 (5th Cir. 2004).
145. *Mapp*, 2017 WL 823559, at *7.
146. *Id.* at *8.
147. *Id.*; *see* United States v. Skelly, 442 F.3d 94, 99 (2d Cir. 2006).
148. *Mapp*, 2017 WL 823559, at *9.
149. *Id.*; *see* Steginsky v. Xcelera Inc., 741 F.3d 365, 371 (2d Cir. 2014).
150. *Mapp*, 2017 WL 823559, at *10.
151. *Id.*
152. *See* Meyer v. Jinkosolar Holdings Co., 761 F.3d 245, 250 (2d Cir. 2014); FindWhat Inv'r Grp. v. FindWhat.com, 658 F.3d 1282, 1305 (11th Cir. 2011); *In re* K-Tel Int'l, Inc. Sec. Litig., 300 F.3d 881, 898 (8th Cir. 2002).
153. *Mapp*, 2017 WL 823559, at *14; *see* SEC v. Tambone, 597 F.3d 436, 458 (1st Cir. 2010).
154. *Mapp*, 2017 WL 823559, at *15.
155. *Id.* at *16–17.

utes to interpret the TSA provisions with similar language.[156] As a result, there is an interest in Fifth Circuit securities law fraud opinions. Fraud actions under the federal statutes generally possess six elements: "(1) a material misrepresentation (or omission); (2) scienter . . . ; (3) a connection with the purchase or sale of a security; (4) reliance . . . ; (5) economic loss; and (6) 'loss causation,' i.e., a causal connection between the material misrepresentation and the loss."[157] The last element comes from the Private Securities Litigation Reform Act (PSLRA).[158] The PSLRA also requires the investor's petition to recite facts giving a strong inference of scienter.[159] In the Fifth Circuit, scienter requires an intent to defraud or either severe recklessness with knowledge of the danger to investors, or action despite danger so obvious the officer must have been aware of the danger.[160] Moreover, the Fifth Circuit has rejected the group pleading doctrine, so the scienter must be of a specific issuer officer; it may not be implied from press releases, prospectuses, and registration statements.[161]

In *Local 731 I.B. of T. Excavators and Pavers Pension Trust Fund v. Diodes, Inc.*, the Fifth Circuit dealt with a putative class action for securities fraud under a petition alleging omissions, rather than misstatements, evidencing the required scienter.[162] The case dealt with an issuer headquartered in Texas but with most of its employees in China.[163] The issuer's February press release for fiscal year 2010 results indicated that Chinese labor shortages would impact future first quarter results with revenues flat or down 5% and gross profit at a certain amount.[164] The chief executive officer's conference call with analysts attributed the labor shortage to the Chinese policy aimed at driving economic growth inland and to the Chinese New Year holiday, but predicted that by the second quarter the issues would be corrected.[165] The issuer's May press release for first quarter results revealed that the gross profit prediction was accurate; however, a large number of employees had not returned so the issuer was hiring new workers.[166] The chief executive officer's conference call predicted gross profit margins for the second quarter would be the same as in the first quarter and the labor problem would be solved during the second quarter.[167]

156. *See supra* note 3 and accompanying text.
157. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005) (discussing commission rule 10b-5, 17 C.F.R. § 240.10b-5 (2004)) (emphasis omitted) (citations omitted).
158. *See* 15 U.S.C. § 78u-4(b)(4) (2012).
159. *See id.* § 78u-4(b)(2) ("[T]he complaint shall . . . state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.").
160. *See* Southland Secs. Corp. v. INSpire Ins. Sols., Inc., 365 F.3d 353, 366 (5th Cir. 2004); *see also* George Lee Flint, Jr., *Securities Regulation*, 58 SMU L. Rev. 1135, 1155–56 (2005) (discussing *Southland*).
161. *See Southland*, 365 F.3d at 363–64, 366.
162. Local 731 I.B. of T. Excavators and Pavers Pension Trust Fund v. Diodes, Inc., 810 F.3d 951, 954 (5th Cir. 2016).
163. *Id.* at 954–55.
164. *Id.* at 955.
165. *Id.*
166. *Id.*
167. *Id.*

At a conference, the chief financial officer indicated that it would take two months to train the new workers and they would not be fully efficient for half a year. Consequently, the issuer's stock price fell.[168] The issuer's June press release for the second quarter results revealed management's gross profit margin prediction for the second quarter had been accurate.[169] Within two years the pension fund filed a securities fraud claim on behalf of the class against the issuer, the chief executive officer, and the chief financial officer.[170] On the scienter issue the class urged three facts from which to infer scienter.[171] First, the class claimed that omitting mention of harsh factory policies requiring doubling of employees' hours and cutting down on holiday leaves, which frustrated workers and prompted them to quit, revealed an intent to conceal the magnitude of the labor shortage problem.[172] Second, the pension fund claimed that shipping customer orders early implied efforts to hide the gravity of the labor shortage.[173] And third, the sale of stock by insiders implied an attempt to profit.[174] The district court dismissed the action for failure to state a claim.[175] The Fifth Circuit affirmed.[176]

With respect to the first claim of harsh factory policies, the petition did not allege any facts that the chief executive officer and chief financial officer in Texas knew about the harsh factory policies in China, that the workers were disgruntled over the policies, or that they were quitting as a result.[177] The fact that, as officers, they must have known generally does not suffice in the Fifth Circuit.[178] Nor do any of the Fifth Circuit's special circumstance exceptions to this rule for small companies, critical transaction, ready apparency, or internal inconsistency apply.[179] Companies with widely dispersed headquarters and factories with 4,000 employees aren't small companies; there were no allegations that the labor shortage was critical to the company; the proximity of the labor shortage to the announcement of the Chinese labor policy prevented ready apparency; and

168. *Id.*
169. *Id.*
170. *Id.*
171. *Id.* at 956.
172. *Id.* at 956–58
173. *Id.* at 956.
174. *Id.*
175. *Id.*
176. *Id.* at 961.
177. *Id.* at 958.

178. *See* Ind. Elec. Workers' Pension Tr. Fund IBEW v. Shaw Grp., Inc., 537 F.3d 527, 535 (5th Cir. 2008) (scienter can't be inferred from position in company); Abrams v. Baker Hughes Inc., 292 F.3d 424, 432 (5th Cir. 2002) (same); *see also* George Lee Flint, Jr., *Securities Regulation*, 56 SMU L. Rev. 1995, 2021–22 (2003) (discussing *Abrams*).

179. *See* Dorsey v. Portfolio Equities, Inc., 540 F.3d 333, 342 (5th Cir. 2008) (critical transaction, small company, readily apparent); Plotkin v. IP Axess Inc., 407 F.3d 690, 700 (5th Cir. 2005) (critical transaction, internally inconsistent statements); Nathenson v. Zonagen Inc., 267 F.3d 400, 425 (5th Cir. 2001) (critical transaction, readily apparent, small company, internally inconsistent statements); *see also* George Lee Flint, Jr., *Securities Regulation*, 62 SMU L. Rev. 1435, 1449–50 (2009) (discussing *Dorsey*); George Lee Flint, Jr., *Securities Regulation*, 59 SMU L. Rev. 1541, 1560–61 (2006) (discussing *Plotkin*).

the company's statements were "both consistent and accurate . . . ."[180] With respect to the second claim, the early shipments did not provide a basis on which to infer scienter.[181] The early shipments were legal, they did not conceal the labor shortage since that was disclosed, and they would have worked to exacerbate the problem rather than conceal it since they would create an inventory shortage making it harder to stay on pace with orders causing a decreased gross profit margin.[182] With respect to the third claim, insider trading by itself does not establish an inference of scienter, but can enhance such an inference if done at times or in amounts that are suspect, meaning out of line with past practices.[183] Suspiciousness for the case at hand cannot be determined since there are no allegations concerning past practices.[184] Moreover, the amounts sold were small, not large, being only 12.1% of total holdings by the chief executive officer and only 1.7% for the chief financial officer.[185]

The reason the class focused on omissions, rather than misstatements, was to avoid the safe harbor for forward-looking statements provided in the PSLRA.[186] In other words, the case involved an attempt to circumvent the protections provided for certain statements under the securities laws. With respect to the alleged omissions, the Fifth Circuit specifically noted that investors would rather have the forward-looking information rather than all the omitted reasons behind the forward-looking statements.[187] So although this class lost since its petition was woefully pled, future companies in the Fifth Circuit facing unfavorable quarterly results may take some solace in their accurate assessments of those unfavorable results coupled with the Fifth Circuit's refusal to water down its position on finding knowledge from executive position and statements concerning innocent reasons for certain actions, including stock sales.[188] Other attempts to circumvent the protections afforded by the PSLRA are unlikely to succeed.

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180. *Local 731*, 810 F.3d at 959.
181. *Id.* at 959–60.
182. *Id.*
183. *See* Cent. Laborers' Pension Fund v. Integrated Elec. Servs. Inc., 497 F.3d 546, 552–53 (5th Cir. 2007); *see also* George Lee Flint, Jr., *Securities Regulation*, 61 SMU L. REV. 1107, 1124–25 (2008) (discussing *Central Laborers*).
184. *Local 731*, 810 F.3d at 961.
185. *Id.*
186. *See* 15 U.S.C. § 78u-5 (2012).
187. *Local 731*, 810 F.3d at 958 ("Most reasonable investors would rather receive an accurate 'bottom line' assessment of a disclosed company problem than all of its assumptions and nuances.").
188. *See id.* at 960 ("[E]arly shipping is a legal practice that may be supported by 'any number of legitimate reasons,' and usually 'does not support a strong inference of scienter.'") (quoting Greebel v. FTP Software, Inc., 194 F.3d 185, 203 (1st Cir. 1999); *id.* at 961 ("The sales represented a small portion of his investment in the company, and there are many innocent reasons why an individual would sell stock at a given time.").

IV. CONCLUSION

Several courts addressed the scope issues of the TSA. A Texas court of appeals reiterated that interests in life settlements sold by an insurance agency on behalf of the life settlement packager are securities where the only differences from earlier forms were a pooling of the life settlements and a supporting bond for late death of the insured. Another Texas court of appeals found an underwriter and investment advisor liable for aiding and abetting securities fraud committed by their affiliated investment company for omissions and misstatements in the original prospectus of which they were aware for an investor buying through his own broker.

The TSSB obtained an attorney general's opinion that their staff attorney's communication to the Director of Enforcement was protected from public disclosure by the attorney-client privilege. The TSSB also amended several exemption rules to reflect federal changes to Regulation A and money market funds and Texas changes to the Occupation Code concerning auction associates; simplified its procedures by allowing email communications with registrants, specifying balance sheet forms for registrants, and expediting registration for military personnel; and created a new rule for the registration of crowdfunding portals for public and nonprofit entities recently authorized by the legislature. The TSSB's enforcement efforts for unregistered securities focused on fraudsters marketing oil and gas interests, high return promissory notes and life settlements, and streams of pension income. The enforcement efforts against dealers dealt with failure to supervise underlings by enforcing firm policies with respect to unsuitable investments (illiquid, risky, or non-diversified programs for elders), agent registrations, and failure to require contemporary notices to clients for wire transfers. The enforcement efforts against investment advisors concerned failing to register, recommending unsuitable investments, failing to disclose fees, failing to keep adequate records and updating TSSB filings, and charging excessive fees. One Texas court of appeals dealt with the early stages of a criminal action against an investment advisor with political rank for failure to disclose certain information and register with the TSSB. The SEC similarly seeks civil penalties against this same investment advisor and the involved issuer for fraud in the failure to disclose.

For the federal fraud action, the Fifth Circuit dealt with establishing a strong inference of scienter. The investors tried to avoid the federal safe harbor rule for forward-looking statements by alleging omissions of material information. The Fifth Circuit determined that the distance between the issuer's headquarters and the affected factory did not provide the substantial inference that the officers had scienter with respect to the alleged omissions, especially since they did disclose a problem and their disclosed estimates of its impact turned out to be correct. Moreover, the officers' small percentage of issuer sales (10% or less) during the period in the absence of a trading pattern similarly did not provide the requisite inference of scienter.