

MEMORANDUM

To: SBOT Legislative Policy Committee
From: John Fahy, Chair of the Securities Law Committee, SBOT Business Law Section
Re: Proposed amendment to Texas Securities Act to correct errors in the 2019 recodification
Date: May 29, 2020

The SBOT Business Law Section asks that the SBOT Legislative Policy Committee consider and approve the draft bill attached as Exhibit A (the “Proposed Bill”) as part of the State Bar of Texas legislative package for the 2021 Texas Legislature. The Proposed Bill has been approved by the Council of the Business Law Section and is believed to be non-controversial. It would amend Section 4008.051(a)(1) of the newly recodified Texas Securities Act (“TSA”) to eliminate the cross-references in the list of non-fraud private causes of action that incorrectly reference several TSA provisions that impose no duties on private actors and thus cannot be violated by private actors.

Texas Legislative Council drafted the TSA recodification, which passed last session as HB 4171 and was signed into law by Governor Abbott. HB 4171’s effective date is January 1, 2022. The delayed effective date was intended to allow time for study of the recodification provisions in order to identify problems or errors that need to be corrected before the provisions become effective law.

Although the TSA recodification was purportedly a non-substantive recodification, the Legislative Council erroneously created six new purported non-fraud private civil causes of action by cross-referencing six provisions of the TSA that impose no duties on private actors whatsoever. The Business Law Section views the erroneous cross-references to statutory provisions with concern. At best, with no imposition of duties on private actors, there’s a strong likelihood for confusion among judges and litigators, or, at worst, there’s a source for creating new phantom causes of action that the legislature did not intend.

How did this happen last session? The pre-recodification TSA has 64 sections. The recodified TSA has 248 sections - almost 400% more. In the pre-recodification TSA, a cross-reference to another section would include the reason for the cross-reference thus allowing the reader to focus on the relevant language in the section and to ignore other language in the section that may not be relevant for the purpose of the reference. Over the past seven decades, Texas attorneys and judges have exercised sound discretion when faced with a statutory cross-reference under the TSA’s private causes of action to focus on those provisions that impose duties on private actors and to ignore those provisions that did not. But, when the Legislative Council recodified the TSA, it inserted erroneous cross-references into Section 4008.051(a)(1) for new subsections of the recodified TSA that were derived from the previously cross-referenced statutory section, regardless of what those provisions actually said and (only for its own purposes) deemed such recodification as non-substantive. However, these drafting errors create considerable risk of introducing erroneous substantive changes via the TSA recodification if courts apply traditional statutory canons of construction.¹ “The cardinal principle of statutory construction is to save and not to destroy. . . It is our duty to give effect, if possible, to every clause and word of a statute”²

¹ See *In re Winton Lumber Co.*, 63 P.2d 664, Ida. 1936); *Chicago & N. W. R. Co. v. Railroad Com. of Wisconsin*, 155 N.W. 941 (Wis. 1916); *U.S. v. Menasche*, 348 U.S. 528, 538-539, 75 S.Ct. 513, 520 (1955) (citations omitted); and *Lorenzo v. SEC*, US. Supreme Court Matter No. 17-1077, decided March 27, 2019, Thomas dissenting, quoting *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. 639, 645 (2012) (quoting *D. Ginsberg & Sons, Inc. v. Popkin*, 285 U.S. 204, 208 (1932))

² *U.S. v. Menasche*, 348 U.S. at 538-539.

Accordingly, the Business Law Section requests that the State Bar of Texas Legislative Policy Committee approve the Proposed Bill as part of the State Bar of Texas legislative package for the 2021 Texas Legislature. The Proposed Bill would correct the TSA recodification by repealing these erroneous cross references in Section 4008.051(a)(1).

The following table highlights the problematic cross references in recodified TSA Section 4008.051(a)(1) relating to private causes of action, as discussed herein.

Summary of Problematic Statutory Cross-References in HB 4171, Section 4008.051(a)(1)

| Recodified TSA Provisions Cross-Referenced | Corresponding Provisions of Current TSA | Description | Comment |
|--|--|---|-------------------------------------|
| 4003.001(a) | Section 7.A(1) | General provision requiring the registration of securities | OK |
| 4003.002 | Section 7.A(1) | Permit Application to Qualify Securities for Sale | Imposes no duties on private actors |
| 4003.003 | Section 7.A(1)(f)(1) | Statement of Financial Condition and Income Statement | Imposes no duties on private actors |
| 4003.004 | Section 7.A(1)(f)(2) | Exceptions to Certification Requirements for Financial Statements | Imposes no duties on private actors |
| Subchapter B, Chapter 4003 other than Section 4003.054(b)(1) | Section 7.B | Registration by Notification with a carve-out on the directive to the Commissioner to examine the documents | Imposes no duties on private actors |
| Subchapter C, Chapter 4003 other than Section 4003.103(b) | Section 7.C | Registration by Coordination with a carve-out on the directive to the Commissioner to examine the documents | Imposes no duties on private actors |
| 4004.001 | Section 12.C | Rules for Exemption from Registration Requirements | Imposes no duties on private actors |
| 4004.051 | Section 12 | Registration of Dealers Required | OK |
| 4004.052 | Section 12 | Registration of Investment Advisers Required | OK |
| 4004.101(a) | Section 12 | Registration of Agents Required | OK |
| 4004.102(a) | Section 12 | Registration of Investment Adviser Representatives Required | OK |
| 4007.103 | Section 23.C | Cease Publication Order | OK |
| 4004.051 | Section 12 | Registration of Dealers Required | OK |

State Bar Information Requirements

Identification of, reference to, or copies of similar legislation, if any, being considered in the same legislative or administrative body.

The Business Law Section is not aware of any similar legislation being considered for the 2021 Legislative Session. We are aware that Legislative Council is working on a separate clean-up bill to address certain other TSA recodification vagaries and errors that Legislative Council has deemed non-substantive. Legislative Council has indicated that the amendment in the Proposed Bill cannot be included in its to-be-proposed TSA recodification clean-up bill.

A statement indicating whether the proposed legislation has been introduced in either the House or the Senate during prior legislative sessions, as well as a statement of any amendments to the proposed legislation during the prior legislative sessions and the status of the proposed legislation.

The TSA was recodified and placed in the Texas Government Code under HB 4171 in the 2019 Legislative Session (effective date January 1, 2022). It is an entirely new and restated TSA. Consequently, there has been no relevant proposed legislation introduced in either the House or Senate during prior legislative sessions (other than 2019 TSA full recodification in HB 4171).

A statement of the known position on the legislative proposal taken by any section or committee of the State Bar that has considered the same proposal, including the principal reasons for support of our opposition to the proposal.

The Business Law Section is not aware of any other State Bar section or committee taking a position in favor of or opposed to the Proposed Bill.

Provision of proposed legislation to all SBOT sections and committees.

On May 29, 2020, the Business Law Section the provided a copy of this Memorandum to the SBOT staff for distribution to all SBOT sections and committees.

Detailed Explanation of Reasons for Proposed Bill

Securities Registration Causes of Action

The TSA provides for three methods to register an offering of securities in Texas: Qualification, Notification and Coordination. Section 7.A(1) of the current, pre-recodification TSA requires that securities transactions in Texas be registered with the Securities Commissioner by qualification unless the securities are registered by notification or coordination or exempt. Current TSA Section 7.B and 7.C say that a securities issuer “may” register securities by notification or coordination in lieu of registering by qualification.

Registration by Qualification involves submitting a prospectus and supporting exhibits to the Texas State Securities Board staff, and the offering terms must meet certain substantive structural and offering thresholds. Registration by Notification involves a securities issuer that has been in operation for at least three years and has met certain operational performance standards and that files a registration statement

with the Securities Commissioner that must contain designated information and be in the form prescribed. Registration by Coordination involves contemporaneous filings of registration statements with the U.S. Securities and Exchange Commission and the Texas State Securities Board, to generally become effective at the moment the coordinated registration statement becomes effective with the Securities and Exchange Commission unless the Securities Commissioner has issued an order denying or suspending the effectiveness of registration by Coordination – called a “stop order.”

Currently Section 33.A(1) of the TSA says:

“a person who offers or sells a security in violation of Section 7 . . . is liable to the person buying the security from him, who may sue either at law or equity for rescission or for damages if the buyer no longer owns the security.”

The only way a private party could violate Section 7 is through non-compliance of mandatory requirements of the registration provision. But, the recodified TSA includes a private cause of action for failure to comply with a general securities registration requirement plus three separate causes of action for failure to register the securities offering by qualification, notification and coordination. This leads to a result that an issuer that registers its securities with the Texas State Securities Board by qualification could conceivably still face civil liability for a securities registration violation for not separately also registering the securities offering by notification and coordination. We can’t imagine this result would be intended from the Texas Legislature.

Thus, the Proposed Bill retains the private cause of action relating to violating the TSA’s securities registration provisions by keeping the cross-reference in Section 4008.051(a)(1) to Section 4003.001(a). But, the Proposed Bill deletes the erroneous cross-references in Section 4008.051(a)(1) to Section 4003.002; Subchapter B, Chapter 4003 other than Section 4003.054(b)(1); and Subchapter C, Chapter 4003 other than Section 4003.103(b), all of which impose no duties on private actors and all of which are quoted and explained further below. These are rows 2, 5 and 6 on the above table.

Recodified TSA Section 4003.001 states:

“(a) A dealer or agent may not sell or offer for sale any securities issued after September 6, 1955, unless the commissioner has issued a permit qualifying securities for sale for those securities to the issuer of the securities or a registered dealer.

(b) This section does not apply to:

- (1) securities that have been registered by notification under Subchapter B or by coordination under Subchapter C; or*
- (2) transactions or securities that are exempt under Chapter 4005.”*

This provision provides for liability for the sale of unregistered securities in Texas, subject to alternative registrations by notification or coordination and applicable securities registration exemptions. It is all that is needed to cover private causes of action for securities registration violations.

Recodified TSA Section 4003.002 begins by stating:

*“PERMIT APPLICATION TO QUALIFY SECURITIES FOR SALE. (a) **The commissioner may not issue a permit** qualifying securities for sale required by Section 4003.001 **until** the issuer of the securities or a registered dealer files with the commissioner an application for the permit in the form of a statement containing the following information: . . .”* (emphasis added)

This section continues by listing all the statutory requirements as to what an issuer needs to include in a registration statement before the Commissioner issues a registration permit. Note that this section only imposes duties on the Commissioner, not any private party – “The commissioner may not issue a permit qualifying securities for sale required by Section 4003.001 **until** . . .”

Recodified TSA Subchapter B, Chapter 4003 (other than Section 4003.054(b)(1), which is the directive to the Commissioner to examine the documents for sufficiency requirements), begins by stating:

*“Sec. 4003.051. ELIGIBILITY FOR REGISTRATION BY NOTIFICATION. Securities **may** be registered by notification under this subchapter if the securities are issued by an issuer that . . .”* (emphasis added).

This section continues by listing all the statutory requirements as to which issuers are eligible to use registration by notification and what is required in a registration statement by notification. Note the verb in use is “*may*.” No issuer or dealer has an obligation to register securities by notification. It is just one of two permissive forms of securities registration other than registration by qualification.

Recodified TSA Subchapter C, Chapter 4003 (other than Section 4003.103(b)(1), which is the directive to the Commissioner to examine the documents for sufficiency requirements) begins by stating:

*“Sec. 4003.101. ELIGIBILITY FOR REGISTRATION BY COORDINATION. A security **may** be registered by coordination if a registration statement has been filed under the Securities Act of 1933 (15 U.S.C. Section 77a et seq.) in connection with the same offering.”* (emphasis added).

This section continues by listing what is required in a registration statement by coordination. Note the verb in use is “*may*.” No issuer or dealer has an obligation to register securities by coordination. It is just one of two permissive forms of securities registration other than registration by qualification.

In each of these three instances, Section 4008.051(a)(1)’s cross-reference is superfluous, unnecessary, and otherwise confusing because 4008.051(a)(1) retains the cross reference to Section 4003.001(a), which requires the registration of securities by qualification unless registered by notification or coordination, or otherwise exempt. That is all that is needed for the private causes of action relating to the securities registration requirement.

Financial Statements Requirements and Private Causes of Action

The TSA requires that the Commissioner generally cannot issue a securities registration permit (for registrations via qualification) unless the securities offering includes audited financial statements. And as discussed above, registration via qualification is just one of several methods for an issuer to satisfy the statutory requirements relating to registration of securities. Moreover, securities that are issued under several statutory and regulatory securities registration exemptions do not require audited financial statements.

Securities registered by qualifications are generally required to have financial statements. Section 4003.003(b) starts:

*“(b) A statement of financial condition required in the application under this subchapter must:
...”*

This section then goes on to state what is required in the financial statements. Note that this section does not impose any separate duty on any person. It just states that financial statements “*required in the application under this subchapter*” (registration by qualification) must meet certain designated requirements. This section is a direction to the Securities Commissioner, not a private party. It refers back to the previous Section 4003.002 which states:

*“**The commissioner may not issue a permit** qualifying securities for sale required by Section 4003.001 **until** the issuer of the securities or a registered dealer files with the commissioner an application for the permit in the form of a statement containing the following information: . . .”*
(emphasis added)

Likewise Section 4003.004 provides an exemption to the requirement that the financial statements included in the registration statement for a securities registration by qualification be audited. Section 4003.004(a) starts:

“(a) Financial statements filed as required by this subchapter are not required to be certified by an independent certified public accountant or independent public accountant if:” . . .

This section then goes on to list the conditions under which certified financial statements are not required.

Section 4003.004(b) covers audited financial statements for small business issuers, as defined by rule, and exempts them from the audited financial statement requirement. It states:

“(b) Instead of being audited and certified, the financial statements described by Section 4003.003 of a small business issuer, as defined by board rule, that meets all other requirements the board by rule or order prescribes, conditionally or unconditionally, may be reviewed by an independent certified public accountant in accordance with the Statements on Standards for Accounting and Review Services promulgated by the American Institute of Certified Public Accountants.”

Like Section 4003.003, Section 4003.004 refers to the duty of the Securities Commissioner to not issue a registration statement until the specified financial statement requirements are met for a certain set of securities issuers. It imposes no duties on private actors. Curiously, in two other instances, the codification did appropriately make an exception to the cross-reference for similar type provisions, namely for Section 4003.054(b)(1) and Section 4003.103(b), which refer to the directive to the Securities Commissioner to examine the registration documents for sufficiency. The same logic should apply with Section 4003.003 and Section 4003.004.

The Proposed Bill would repeal Section 4008.051(a)(1)’s cross-references to the financial statement requirements in Sections 4003.003 and 4003.004 (rows 3 and 4 on the above table) that impose duties on the Commissioner not to issue a registration permit until these requirements are met, but impose no duties on private actors. Otherwise, would these erroneous cross-references raise an issue whether private

offerings might require audited financial statements, when, for the most part, there is no such requirement and no such violation of law? This is an example of the potential unintended consequences and confusion surrounding these additional unnecessary cross-references.

Statutory Designation of Rulemaking Authority relating to Broker-Dealers and Investment Advisers

Current TSA Section 12 has three sections. Section 12.A directs private actors to not sell securities without first being registered with the Securities Commissioner as agents or dealers. Section 12.B directs private actors not to act as investment adviser representatives or render services as an investment adviser without first being registered as an investment adviser representative or investment adviser with the Securities Commissioner. Both Section 12.A and 12.B impose duties on private actors and are suitable for inclusion in the private causes of action in the recodified TSA. But TSA Section 12.C imposes no duties on private actors. It is a grant of rulemaking authority to the Texas State Securities Board. When current TSA Section 33.A(1) refers to offering or selling a security in violation of Section 12, it is referring to Sections 12.A and 12.B, which impose duties on private actors, and not Section 12.C's grant of rulemaking authority to the Texas State Securities Board.

Current TSA Section 12.C states:

*“C. **The Board may adopt rules and regulations** exempting certain classes of persons from the dealer, agent, investment adviser, and investment adviser representative registration requirements, or providing conditional exemptions from registration, if the Board determines that such rules and regulations are consistent with the purposes of this Act.” (emphasis added).*

The corresponding recodified TSA Section 4004.001 states:

*“Sec. 4004.001. RULES FOR EXEMPTION FROM REGISTRATION REQUIREMENTS. **The board may adopt rules** that exempt certain classes of persons from the dealer, agent, investment adviser, and investment adviser representative registration requirements, or provide conditional exemptions from registration, if the board determines that the rules are consistent with the purposes of this title.” (V.A.C.S. Art. 581-12, Subsec. C.) (emphasis added).*

Clearly, neither of these provisions imposes any duties on private actors. But Section 4008.051(a) includes an erroneous cross-reference to Section 4004.001's grant of rulemaking authority to the Texas State Securities Board as a provision causing civil liability for private actors under the TSA. This makes no sense and could provide fodder for claims against private actors that violations of various Texas State Securities Board rules can be the basis for civil liability, even though there is no such cause of action under the current TSA.

Thus, the Proposed Bill would repeal Section 4008.051(a)'s cross reference to Section 4004.001 because Section 4004.001 merely refers to a legislative grant of rulemaking authority to a state agency and does not impose any duty on any private actors.

More Information:

| | |
|--|---|
| <p>For supplemental information about the proposed TSA amendment, contact:</p> <p>John R. Fahy Whitaker Chalk 301 Commerce St. Suite 3500 Fort Worth, TX 76109 Office: (817) 878-0547 Cell: (817) 800-3139 Email: jfahy@whitakerchalk.com</p> | <p>For background information generally on the Texas Securities Act recodification:</p> <p>Marlene Sparkman General Counsel Texas State Securities Board PO Box 13167 Austin, Texas 78711-3167 Office: (512) 305-8304 Email: msparkman@ssb.texas.gov</p> |
|--|---|