

EXEMPTIONS UPDATE

UNDER TEXAS LAW

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- I. **Introduction.** The Texas Securities Act (“Act”) and the Rules and Regulations of the State Securities Board (“Rules”) are available on the Texas State Securities Board web site (www.ssb.state.tx.us) or for purchase from the agency at:

Texas State Securities Board
P.O. Box 13167
Austin, Texas 78711-3167
512/305-8300 (voice)
512/305-8310 (facsimile)
www.ssb.state.tx.us

- II. **Overview of Exemptions and Exemptive Authority.** Six separate, but related, provisions of the Act and the rules adopted by the State Securities Board (“Board”) provide exemptions from securities registration for issuers engaged in limited offerings in Texas: Sections 5.I(a), 5.I(c) and 5.Q of the Act, and Rules 109.13(k), 109.13(l) and 109.14(c). Sections 5.I and 5.Q of the Act are also interpreted in Rules 109.13(a)-(j), and 109.14(a)-(b), respectively. Additionally, the National Securities Markets Improvement Act of 1996 (“NSMIA”), Public Law 104-290, enacted by the 104th Congress, created an exemption from state regulation for offerings of “covered securities.”

- A. **Private offerings.** Section 5.I(a) of the Act exempts sales by issuers made without public solicitation or advertisements so long as the total number of security holders does not exceed 35. Section 5.I(c) permits sales to 15 persons in a 12 month period, in addition to sales made pursuant to registered offerings or pursuant to other exemptions contained in the Act, other than Section 5.I(a) and (b), Rule 109.13(k) and (l), and, for oil and gas offerings, Section 5.Q, Rule 109.14(a)-(b) and Rule 109.14(c).

1. **History.** These exemptions have developed over the years through Board interpretation by rule, and, to a lesser extent, court cases. Initially, these exemptions were available to small entrepreneurs who raised capital from close personal friends, relatives, and business associates. Eventually, the concept of the “sophisticated investor” changed the character of the exemptions and dispensed with the need for the issuer to have a special relationship with the purchaser.
2. **Agency interpretation by rule.** Rules 109.13(a)-(e) and (h)-(j) define the terms and concepts used in Section 5.I(a) and (c). These provisions are described in more detail in Part III of this Outline.

B. Intrastate offerings. Rule 109.13(l), the Intrastate Limited Offering Exemption, was adopted pursuant to the authority vested in the Board by Section 5.T of the Act. The rule provides an exemption from the securities registration requirements of the Act for any offer or sale of any securities by the issuer itself or by a registered dealer acting on the issuer's behalf, provided all offers and sales are made pursuant to an offering made and completed solely within Texas. The rule is self-contained for ease of use by oil and gas operators who have no need to refer to federal law for their Texas-only offerings.

1. Additional requirements. Some of the significant conditions of the exemption follow.

a. Public solicitation prohibited. The use of public solicitation or advertisements is prohibited.

b. Who may purchase. Sales may be made to not more than 35 new security holders who are sophisticated and well-informed or who are well-informed and have a relationship with the issuer. Sales also may be made to other well-informed investors who are "accredited investors" as defined in Rule 109.13(l)(11). The definition of "accredited investor" in Rule 109.13(l)(11) differs from that set forth in Rule 501 of the Securities and Exchange Commission's ("SEC") Regulation D and incorporated in Rule 109.13(k), the Uniform Limited Offering Exemption; the Rule 109.13(l) definition is patterned after a predecessor version of SEC Rule 501. The retention of this self-contained definition better serves nonlawyers who avail themselves of the exemption.

c. Disqualifications. Neither the issuer nor the registered dealer (as those terms are defined in Rule 109.13(l)(4)) may:

1. currently be subject to any administrative order issued by state or federal authorities within five years of the expected offer and sale of securities in reliance on the exemption, if the order:

A. is based on a finding that such person engaged in fraudulent conduct; or

B. has the effect of enjoining such person from activities subject to federal or state statutes designed to protect investors or consumers against unlawful or deceptive practices involving securities, insurance, commodities or commodity futures, real estate,

franchises, business opportunities, consumer goods, or other goods and services;

2. have been convicted within five years prior to commencement of the offering of any felony or misdemeanor of which fraud is an essential element, or which is a violation of the securities laws or regulations of Texas or of any other state of the United States, or of the United States, or any foreign jurisdiction; or which is a crime involving moral turpitude; or which is a criminal violation of statutes designed to protect consumers against unlawful practices involving insurance, securities, commodities or commodity futures, real estate, franchises, business opportunities, consumer goods, or other goods and services; or

3. be subject to any order, judgment, or decree entered within five years prior to commencement of the offering by any court of competent jurisdiction which temporarily or permanently restrains or enjoins such person from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security or involving any false filing with any state; or which restrains or enjoins such person from activities subject to federal or state statutes designed to protect consumers against unlawful or deceptive practices involving insurance, commodities or commodity futures, real estate, franchises, business opportunities, consumer goods, or other goods and services.

d. Filing. A filing is required under Rule 109.13(l) only if sales are made, other than by and through a dealer registered in Texas, to investors in those classes of accredited investors which may include natural persons as opposed to only businesses. The filing must be made on Form 133.29. A filing fee of one-tenth of 1.0% of the aggregate amount of securities described as being offered for sale, but in no case more than \$500, must accompany the filing.

2. Effect of the rule. The rule permits sales to be made on an intrastate basis to an unlimited number of accredited investors who do not have to be “counted” in the 35 limitation on nonaccredited investors. The requirements of Rule 109.13(a)-(j) must be met. For a discussion of those provisions, see Part III.A of this Outline.

C. Interstate offerings. Rule 109.13(k), the Uniform Limited Offering Exemption (“ULOE”), was adopted by the Board in 1985. Formulated by the North

American Securities Administrators Association (“NASAA”) in conjunction with the SEC and the American Bar Association, ULOE represents a uniform approach to limited offerings. ULOE is, in essence, a state law addendum to SEC Regulation D that adds requirements not found in the federal exemption. The primary focus of ULOE was on Rule 505 offerings. Many states, however, have included Rule 506 offerings within their ULOE exemption as well. ULOE is static; it is tied to specific SEC releases, thereby giving the states an opportunity to accept or reject future changes to SEC Regulation D. ULOE is set out at Rule 109.13(k) of the Board’s rules and is discussed in more detail in Part III.C of this Outline.

- D. Oil and gas limited offerings. The sale of fractional interests in oil and gas leases has been, and continues to be, a large segment of exempt offerings in Texas. Section 5.Q of the Act exempts the sale of such interests if the total number of sales by any one owner of those interests does not exceed 35 within a period of 12 consecutive months and no use is made of advertisement or public solicitation.
1. Agency interpretation by rule. To a large extent, Section 5.Q is interpreted in a manner similar to Section 5.I. Indeed, Rule 109.14(a) states that Rule 109.13(a)-(c) and (j) apply to Section 5.Q transactions. Thus, the terms defined in Rule 109.13(a)-(c) and (j) have the same meanings for purposes of Section 5.Q as they do for Section 5.I. For a discussion of Rule 109.13(a)-(c) and (j), see Part III.A of this Outline.
 2. Who may sell. Rather than using the term “issuer” as does Section 5.I, Section 5.Q uses the term “owner.” Section 5.Q also provides that if sales are made by an agent for such owner or owners, such agent shall be licensed pursuant to the Act. Registration of such agents is necessary because they are acting on their own behalf, as paid sales personnel engaged in sales activity, rather than acting on behalf of the owner. By rule, however, the Board has clarified that certain employees of the owner are not required to be registered under the Act. An employee of an owner may, without being registered, assist the owner in selling interests in an oil, gas, or mineral lease, fee, or title if:
 - a. the employee was not hired for the purpose of offering or selling such securities;
 - b. the employee’s activity involving the offer and sale of such securities is strictly incidental to the employee’s bona fide primary nonsecurities related work duties; and
 - c. the employee’s compensation is based solely on the performance of nonsecurities related work duties; *i.e.*, the employee does not

receive any compensation for offering for sale, selling, or otherwise aiding in the sale of securities.

3. Rule 109.14(c). Rule 109.14(c), adopted by the Board pursuant to Section 5.T of the Act, serves as a bridge between Section 5.Q and Rule 109.13(k) and (l), giving Section 5.Q the same relationship to Rule 109.13(k) and (l) as has Section 5.I. Thus, as Rule 109.14(c) itself states, its purpose is “to provide a mechanism which will allow for sales of [oil and gas interests] to accredited investors” if the conditions of Rule 109.13(k) or (l) are met.
- E. Federal covered securities. The National Securities Markets Improvement Act of 1996 (“NSMIA”), Public Law 104-290, created a new category of classification for securities -- a covered security. Federal covered securities are discussed in greater detail in Part VIII of this Outline.

III. Texas Exemptions Compatible with SEC Regulation D.

- A. SEC Rule 504 and Section 5.I. As one commentator has stated, the SEC “defers to the states for regulation of offerings meeting the conditions of Rule 504. Both the [SEC] and NASAA have concluded that greater emphasis on state blue sky laws is appropriate for Rule 504 transactions in view of (1) the small amount of the offering and (2) the likelihood that Rule 504 sales will occur in a limited geographic area.” Hicks, *Limited Offering Exemptions: Regulation D* §1.03[4][b] (Clark Boardman Callaghan, 1998-99 ed.) (citations omitted). Accordingly, the Texas version of ULOE does not encompass SEC Rule 504 and issuers must look to other exemptions or register securities offered pursuant to the rule. Persons seeking to rely on SEC Rule 504 at the federal level in connection with interstate offerings are often able to rely on the private offering exemptions set forth in Section 5.I(a) and (c) of the Act. There is no filing requirement for use of these exemptions; they are self-executing. Significant aspects of Section 5.I(a) and (c) follow.

1. Manner of sale.

- a. Public solicitation prohibited. Unlike SEC Rule 504, Section 5.I(a) and (c) prohibit the use of public solicitation or advertisements. Indiscriminate offers to persons who do not fall within the classes of purchasers described in Rule 109.13(a) also will render the exemptions unavailable. This prohibition against indiscriminate offers encompasses the practices of mass mailings, cold calls, and other mass or random solicitations. Similarly, it is safe to assume that any pronouncement designed to reach the public generally, indicating that securities are for sale, will be regarded as advertising. Under Rule 109.13(b), controlled disseminations to

prospective investors of the type of material through which persons may become “well-informed” do not constitute advertisements.

- b. Who may sell. The exemption provided by Section 5.I is available to issuers. The staff takes the position that the exemption is available even if certain officers and/or directors engaged in the daily decision-making of the issuer make offers and sales without being registered, on the theory that the “issuer” can act only through individuals. These officers and/or directors may not receive any special remuneration for selling because they then cannot be said to be acting on behalf of the issuer, but rather on their own behalf as paid sales personnel engaged in sales activity. Other persons offering and selling the securities, regardless of the payment of commissions, will be “dealers” or “agents” who must be registered.

- c. Who may purchase. Only those persons described in Rule 109.13(a) may purchase securities offered as part of a transaction exempt under either Section 5.I(a) or (c). The purchaser must be either well-informed and sophisticated or well-informed and have a relationship with the issuer or its principals, executive officers, or directors, evincing trust between the parties. The following factors should be considered in determining who is sophisticated:
 - 1. the investor’s financial capacity -- the amount invested must not be material when compared with the investor’s total financial capacity. If the amount invested is not more than 20% of the investor’s net worth, the amount will be presumed not to be material;
 - 2. the investor’s knowledge of finance, securities, and investments generally; and
 - 3. the investor’s experience and skill in investments, based on actual participation.

- d. Well-informed purchasers. Purchasers must receive adequate disclosure to make a well-informed investment decision. The requirement that investors be well informed may be satisfied through full and factual disclosure of the following:
 - 1. the issuer’s plan of business;
 - 2. the issuer’s history;

3. financial statements of the issuer; and
 4. other material facts necessary to make the statements made, in light of the circumstances under which they are made, not misleading.
- e. Purchaser representatives. The factors specified in Part III.A.1.c.2 and c.3 of this Outline may be met by the purchaser's representative. The conditions placed on a purchaser representative under Rule 109.13(a)(2) are somewhat different from those of SEC Regulation D. Thus, for example, while Regulation D requires only disclosure of most material relationships between the purchaser representative and the issuer, the Texas rule relating to Section 5.I(a) and (c) requires that the purchaser representative:
1. have no business relationship with the issuer;
 2. represent only the investor and not the issuer; and
 3. be compensated only by the investor.
2. Number of "persons" or "security holders."
- a. Section 5.I(a). Section 5.I(a) exempts sales by issuers, so long as the total number of *security holders* does not exceed 35. It does not matter how or where persons become security holders; all security holders, regardless of where they are domiciled, must be included in the count to 35. Sales made pursuant to almost all other exemptions contained in the Act and Board rules count toward the total. However, a sale to an accredited investor who becomes a security holder under Rule 109.13(l) would not count toward the total number of security holders for purposes of Section 5.I(a).
 - b. Section 5.I(c). Section 5.I(c) permits sales to not more than 15 *persons* in any 12 month period. Excluded from the 15 person limitation are sales made pursuant to a registered offering and/or any other exemption contained in the Act and Board rules, other than Section 5.I(a) and Rule 109.13(k) and (l) (for oil and gas offerings, see Part II.D of this Outline). For example, Rule 139.7 exempts from the securities registration provisions of the Act, offers and sales made by an issuer and its selling agents to non-Texas residents not present in Texas when the offer is made. Consequently, sales to non-Texas residents made in compliance with Rule 139.7 need not be counted in determining the number of purchasers for purposes of Section 5.I(c). To calculate the

allowable number, the issuer must count the number of all sales made within one year before the date of the proposed sale in reliance on exemptions, listed above, which are exclusive by their own terms. Assuming the other conditions of the exemption are met, if the number is less than 15, the sale may be made in reliance on Section 5.I(c).

- c. **Counting.** Not all persons are counted as “security holders” or “persons” for purposes of Section 5.I(a) and (c). Rule 109.13(c) contains various guidelines for determining who is counted as one or more purchaser(s) or security holder(s). Thus, Rule 109.13(c) provides that two or more persons or entities count as only one security holder or person when, for example, the persons reside in the same home and are related to either the security holder or his or her spouse. Under Rule 109.13(h), a noncontributory employees’ stock ownership plan or employees’ stock ownership trust that holds securities of the employer company for the benefit of that company’s employees is counted as one security holder. Employee participants in such a plan or trust are not deemed security holders of the employer company for counting purposes solely because of their participation in the plan or trust. However, employee participants receiving distributions of securities from the plan or trust will be deemed security holders of the employer on receipt of securities of the employer from the plan or trust.
3. **Investment intent.** Purchasers under 5.I(a) and (c) must acquire securities as an investment for their own account and not for distribution. Accordingly, the issuer must exercise reasonable care to assure the purchasers’ investment intent. Rule 109.13(j) sets out certain actions indicative of such reasonable care. Thus, for example, the rule states that reasonable care should include, but not be limited to, the following:
- a. making reasonable inquiry to determine if the purchaser is acquiring the securities for his or her own account or on behalf of other persons;
 - b. placing a legend on the document evidencing the securities to the effect that the securities have not been registered and setting forth or referring to the restrictions on transferability and sale of the securities;
 - c. issuing stop transfer instructions to the issuer’s transfer agent, if any, with respect to the securities, or, if the issuer transfers its own securities, making a notation in the appropriate records of the issuer;

- d. obtaining from the purchaser a signed, written agreement to the effect that the securities will not be sold without registration under applicable securities laws or exemptions therefrom; and
 - e. disclosing in writing, prior to sale, that the purchaser must bear the economic risk of the investment for an indefinite period of time because the securities have not been registered and therefore cannot be sold unless they are subsequently registered or an exemption from registration is available and that the securities are subject to the limitations set forth in (b)-(d) above.
4. SEC proposal. In May 1998, the SEC published Release No. 33-7541, proposing to eliminate the freely tradable nature of securities issued under Rule 504. The SEC proposal was in response to reports indicating that the freely tradable nature of these securities may have facilitated fraudulent secondary transactions in the over-the-counter markets for securities of “microcap” companies. The full text of the release is available on the SEC’s web site at: www.sec.gov and the comment letter submitted by the Texas Securities Board is included in the Appendix to this paper. As of the submission date of this article, the comment period for the release had closed but no final action on the proposal had occurred.
- B. SEC Rule 504 and the securities registration alternative. The Board has recommended that Form U-7 be used in Texas for making small public offerings pursuant to Section 7.A of the Act. Form U-7, a uniform form for Small Company Offerings Registration (“SCOR”), devised by NASAA in collaboration with the American Bar Association, is a simplified, uniform disclosure document using a question and answer format. Staff of the Agency’s Securities Registration Division are available to assist issuers with questions pertaining to SCOR. Certain issuers who propose to use Form U-7 to register small business offerings may be permitted to submit reviewed, rather than audited, financial statements if the criteria set forth in Rule 113.5(b)-(e) are satisfied.
- C. SEC Rules 505 and 506 and ULOE. As of May 1997, more than 38 states had registration exemptions coordinated with Rule 505 of SEC Regulation D. Most, like Texas, have adopted ULOE as their method of coordination and have included Rule 506 in their coordinating exemption. As an initial matter, compliance with all of the conditions of SEC Rule 505 or Rule 506 is a condition for claiming ULOE. As of October 11, 1996, when Title I of NSMIA became effective, securities offered in a Rule 506 offering are “covered securities” and are not subject to registration in Texas; however, as detailed in Part III.C.2 of this Outline, a notice filing and fee are still required. Another effect of NSMIA was to make certain parts of Rule 109.13(k) inapplicable to Rule 506 offerings.

1. Rule 505 offerings. Under ULOE, the following further conditions and limitations, among others, must be observed.
 - a. “Bad Person” disqualifications. Rule 505 of SEC Regulation D contains certain bad person disqualifications. ULOE contains certain disqualification provisions applicable to offerings made in reliance on either federal exemption. The ULOE bad person exclusions are similar to those contained in SEC Regulation A (as incorporated in SEC Rule 505), but are adapted to state, rather than federal, actions. There are certain “escape hatches” from bad person disqualifications, as set forth in Rule 109.13(k)(3) and (4). The bad person disqualifications, set out in Rule 109.13(k)(2)(A)-(E), include:
 1. having filed a registration statement which is subject to a currently-effective stop order entered pursuant to any state’s securities law within five years prior to filing the notice required under ULOE;
 2. having been convicted, within five years prior to filing the required notice, of any felony or misdemeanor in connection with the offer, purchase, or sale of any security or of any felony involving fraud or deceit;
 3. currently being subject to any state’s administrative enforcement order or judgment entered by that state’s securities administrator within five years prior to the filing of the required notice, or being subject to any state’s administrative enforcement order or judgment, entered within five years prior to the filing of the required notice, in which fraud or deceit was found;
 4. being subject to any state’s administrative order or judgment prohibiting, denying, or revoking the use of any exemption from registration in connection with the offer, purchase, or sale of securities; or
 5. currently being subject to a court order, judgment, or decree, entered within five years prior to the filing of the required notice, which temporarily or permanently restrains or enjoins the party from engaging in or continuing any conduct or practice in connection with the purchase or sale of any security, or involving a false filing with the state.

- b. Filing requirements. Timely filing is a condition of Rule 109.13(k). Accordingly, the issuer should carefully note the following requirements.
 - 1. Form D filing. A completed Form D must be filed no later than 15 days after the receipt of consideration or the delivery of a subscription agreement by an investor in Texas, and at such other times and in the form required by SEC Regulation D.
 - 2. Undertaking. The initial notice must contain an undertaking by the issuer to furnish to the Securities Commissioner, on written request, the information furnished to offerees.
 - 3. Consent to service. The issuer must file a consent to service of process, unless one has already been filed with the Securities Commissioner by the same issuer.
 - 4. Filing fee. A filing fee must accompany the notice. The fee is one-tenth of 1.0% of the aggregate amount of securities described as being offered for sale, but in no case more than \$500. The fee is calculated on the basis of the entire offering, not just the portion to be offered in Texas.
 - 5. Staff review. The staff reviews Form D filings for completeness within five days of receipt. If the Form D is incomplete, the issuer will be notified by letter and will have 30 days to correct the deficiency.
- 2. Rule 506 offerings. NSMIA made certain parts of Rule 109.13(k) inapplicable in Rule 506 offerings coordinated with ULOE (most notably, the bad person disqualifiers). The Board adopted rules (particularly the addition of paragraph (16) to Rule 109.13(k) and new Rule 114.4(b)(1)) to address how Rule 506 offerings would be conducted in Texas. ULOE fee and certain filing requirements were not changed by NSMIA. Timely filings are required in this context, the same as they are with Rule 505 offerings coordinated with Rule 109.13(k). Accordingly, the issuer should carefully note the following requirements.
 - a. Form D filing. Rule 114.4(b) requires that a completed Form D be filed at the time the Form D is filed with the SEC, but no later than 15 days after the first sale of the issuer's securities in Texas.

- b. Consent to service. Generally, a non-Texas issuer must file a consent to service of process. Rule 114.3 details when a consent to service must be filed in an offering of federal covered securities.
 - c. Filing fee. A filing fee must accompany the notice. The fee is computed in the same manner as for Rule 505 offerings, detailed in Part III.C.1.b.4 of this Outline.
- 3. Suitability and sophistication. SEC Rule 505 does not require that nonaccredited investors be sophisticated. SEC Rule 506, on the other hand, does contain such a requirement. Under SEC Rule 506, an issuer can satisfy the sophistication requirement if the nonaccredited investor is, in fact, sophisticated, or if, immediately before the sale, the issuer reasonably believes that the investor was sophisticated. In an offering made under SEC Rule 505, ULOE requires either suitability or sophistication. Thus, under Rule 109.13(k)(6), if the issuer sells to nonaccredited investors in Texas in an SEC Rule 505 offering, the issuer, and any person acting on its behalf, must have reasonable grounds to believe, and after making reasonable inquiry, shall believe, that (a) the investment is suitable for the purchaser based on what the purchaser reveals about his or her financial situation and needs, or (b) the purchaser or the purchaser's representative has enough knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the investment. It is presumed that the investment is suitable if the amount invested does not exceed 10% of the investor's net worth.
- 4. Timely filing. In Texas, late filings sometimes occur when issuers, who had intended to proceed under Section 5.I, exceed the permissible number of security holders. Issuers are cautioned that ULOE does not serve as a safe haven for those who have underestimated the extent of sales. Thus, the time limit for filing the required notice will not be extended after the fact, when the issuer realizes that it has failed to satisfy the conditions of other exemptions. In addition, ULOE cannot be stacked with other exemptions in the Act to increase the number of investors permitted under those other exemptions.
- 5. Commissions. Commissions may be paid only to persons who are registered in Texas. The issuer has a "reasonable belief" defense -- that it did not know, and in the exercise of reasonable care could not have known, that the person who received the commission was not appropriately registered in Texas.

IV. SEC Regulation A Offerings in Texas. Because there is no specific exemption for offerings under SEC Regulation A, such offerings must either be registered in Texas or

be structured to fit within one of the numerous existing exemptions in the Act or Board rules. Two aspects of Texas law in this context warrant discussion.

- A. No filing by coordination. As stated in Rule 113.1, Regulation A filings with the SEC cannot be the basis for a filing by coordination under Section 7.C of the Act. As a consequence, such filings must meet all requirements set out in Section 7.A of the Act, including the requirement that audited financial statements be provided. However, Rule 113.5 does allow a “small business issuer” to submit reviewed financial statements, if those statements are submitted in connection with a “small business offering” not exceeding \$500,000.
- B. No testing-the-waters. The “test-the-waters” provisions of SEC Regulation A do not mesh with the requirements of the Act. Thus, in Texas, issuers are not permitted to offer securities using the solicitation of interest documents described in Rule 254 of SEC Regulation A. In like fashion, if the SEC rule proposal allowing issuers contemplating initial public offerings to “test-the-waters” before filing a federal registration statement is adopted (Rel. No. 33-7188, July 10, 1995), the current requirements of the Texas Securities Act would not permit an issuer to engage in such solicitations of interest before filing an application in Texas. Issuers should note, however, that once an application for registration has been filed, and while it is pending, Section 22 of the Act permits an issuer to engage in certain specified informational advertising. Both the Board’s Individual Accredited Investor exemption and the Board’s recently adopted Accredited Investor Exemption, promulgated by NASAA and based on the Board’s exemption, permit certain kinds of advertisements. Both are described in more detail in Parts VI.A and VI.A, respectively, of this Outline.

V. Texas Exemptions Compatible with SEC Rule 701.

- A. In general. To a large extent, Section 5.I(b) of the Act coordinates with SEC Rule 701, which exempts offers and sales of securities pursuant to certain employee benefit plans. Section 5.I(b) exempts the sale or distribution by an employer or its participating subsidiary, if any, of a security under a thrift, savings, stock purchase, retirement, pension, profit-sharing, option, bonus, appreciation right, incentive, or similar employee benefit plan for employees or directors of the employer or its subsidiary. Unlike SEC Rule 701, Section 5.I(b) limits neither the types of issuers which can avail themselves of the exemption nor the aggregate offering price of the securities.
- B. Conditions of the exemption.
 - 1. Public solicitation prohibited. The sale or distribution of securities exempt under Section 5.I(b) must be made without any public solicitation or advertisements. In addition to those rules regarding public solicitation and

advertisements discussed above, Rule 109.13(f) specifically addresses certain employee plan “advertising.” Rule 109.13(f) provides that no public solicitation or advertisement occurs by the distribution to eligible employees, officers, or directors of the employer or its subsidiaries, parents or subsidiaries of such parents, of a prospectus filed under the Securities Act of 1933 (“1933 Act”) with the SEC for the plan or any other material required or permitted to be distributed by the 1933 Act in connection with such plans when the securities under the plan are sold or distributed in a transaction otherwise meeting the requirements of Section 5.I(b).

2. Employer and participating subsidiary. Section 5.I(b) is available to an “employer” or its “participating” subsidiary. The staff takes the position that the term “participating” subsidiary means a subsidiary whose employees or directors are participating in a plan covered by the exemption. As set out in Rule 109.13(g), only the employer and its participating subsidiaries, parents, or subsidiaries of such parents, if any, may offer or sell securities in connection with the employee plan without registration as dealers. An employee of the employer or participating subsidiary who aids in offering or selling such securities in connection with an employee plan is not required to be registered as an agent provided the employee meets all of the following conditions:
 - a. the employee was not hired for the purpose of offering or selling such securities;
 - b. the employee’s activity involving the offer and sale of such securities is strictly incidental to the employee’s bona fide primary nonsecurities related work duties; and
 - c. the employee’s compensation is based solely on the performance of such other duties; *i.e.*, the employee does not receive any compensation for offering for sale, selling, or otherwise aiding the sale of securities.
3. Eligible participants. Eligible participants include employees or directors of the employer or its subsidiaries.
 - a. Thus, unlike SEC Rule 701, Section 5.I(b) does not extend to general partners, trustees, consultants or advisers of the issuer, its parents or majority owned subsidiaries.
 - b. In appropriate cases, no-action recommendations have been made with respect to the sale or distribution of securities to consultants, nonemployee insurance agents, and the like.

4. Types of plans. The exemption covers thrift, savings, stock purchase, retirement, pension, profit-sharing, option, bonus, appreciation right, incentive, and similar employee plans. The concept of employee plans is construed broadly to include, among other things, employee stock option plans, employee stock purchase plans, and unfunded deferred compensation plans. The plan must, however, be bona fide. Thus, even if sales are limited to employees, if the offering of securities is only coincidentally being made to employees, Section 5.I(b) is not available.
5. SEC proposal. In March 1998, the SEC published Release No. 33-7511, proposing to amend Rule 701 to permit companies greater access to the exemption. Among other things, the release proposes to modify the \$5 million ceiling on securities offered; require the issuer to disclose certain risk factors associated with investment in securities pursuant to the plan; require the issuer to deliver financial statements to each person purchasing securities; and permit securities to be sold to former employees. The release also solicited comments on whether the rule should cover sales to former directors, consultants, and advisors and whether offer and sales to consultants and advisors should be restricted. The full text of the release is available on the SEC's web site at: www.sec.gov. As of the submission date of this article, the comment period for the release had closed but no final action on the proposal had occurred.

VI. Small Business Initiatives.

- A. Individual accredited investor exemption. Rule 139.16, adopted in 1995, exempts from the securities registration requirements of the Act, the sale of securities, by the issuer itself or by a registered dealer, to individual accredited investors. The rule, which bears certain similarities to a number of exemptions recently adopted in other states, was adopted by the Board as part of its continuing effort to facilitate small business capital raising. The salient features of the rule are provisions concerning who may sell, who may purchase, when and how a seller may advertise, and when and how a seller may use other exemptions after using the rule. Although the rule is designed to stand alone, it coordinates with a variety of exemptions on the federal level. It will likely be used most often in conjunction with SEC Rule 504. (There is a certain degree of overlap between this exemption and the new uniform accredited investor exemption discussed in Part VI.B of this Outline.)
 1. Who may sell. The issuer itself or a registered dealer may offer and sell securities pursuant to Rule 139.16. For purposes of the rule, an issuer does not have to register as a dealer to make sales. The term "issuer" includes directors, officers, or employees of an issuer provided all the following conditions are satisfied:

- a. the director, officer, or employee was not hired for the purpose of offering or selling such securities;
 - b. the director's, officer's, or employee's activity involving the offer and sale of such securities is strictly incidental to his or her bona fide primary nonsecurities related work duties; and
 - c. the director's, officer's, or employee's compensation is based solely on the performance of other such duties; *i.e.*, the director, officer, or employee does not receive any compensation for offering for sale, selling, or otherwise aiding in the sale of securities.
2. Disqualifications. Certain "bad person" issuers and registered dealers are disqualified from using the exemption. The "bad person" disqualification provisions are similar to, but narrower than, those contained in ULOE. Under the rule, no exemption is available for the securities of any issuer if the issuer or registered dealer:
- a. within the last five years, has filed a registration statement which is the subject of a currently effective registration stop order entered by the SEC or any state securities administrator;
 - b. within the last five years, has been convicted of any felony in connection with the offer, purchase, or sale of any security or any felony involving fraud or deceit;
 - c. is currently subject to any state or federal administrative enforcement order, entered within the last five years, finding fraud or deceit in connection with the purchase and sale of any security; or
 - d. is currently subject to any order, judgment, or decree of any court of competent jurisdiction, entered within the last five years, permanently restraining or enjoining such party from engaging in or continuing to engage in any conduct or practice involving fraud or deceit in connection with the purchase and sale of any security.
3. Exceptions from disqualification. The disqualifications are rendered inoperative if:
- a. the party subject to the disqualification is duly licensed or registered to conduct securities related business in the state in which the order, judgment, or decree creating the disqualification was entered against such party; or

- b. before the first offer under the rule, the Securities Commissioner, or the court or regulatory authority that entered the order, judgment, or decree, waives the disqualification on a showing of good cause.
- 4. Provision of information furnished to offerees and record-keeping. On the Securities Commissioner's written request, an issuer relying on the exemption is required to furnish to the Securities Commissioner the information furnished to offerees. In addition, the rule requires that issuers must retain, for a period of at least three years, evidence of the basis for the belief that all purchasers were accredited investors at the time of purchase.
- 5. Who may purchase. For purposes of the rule, the term "individual accredited investor" means any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his or her purchase exceeds \$1 million, or any natural person who had an individual income in excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year. Thus, the definition of "individual accredited investor" is patterned after Rule 501(a)(5) and (6) of SEC Regulation D as currently written. The term also embraces self-directed employee benefit plans with investment decisions made solely by persons that are "individual accredited investors" as defined above, and the individual retirement accounts of any such individual accredited investors.
 - a. Issuer's reasonable belief. Sales under the rule may be made only to purchasers who are actually individual accredited investors or to purchasers who the issuer has reasonable grounds to believe, and after making reasonable inquiry shall believe, to be individual accredited investors.
 - b. Sophistication. The rule contains no sophistication requirement, nor does it specify that the investment must be a suitable one. Issuers and registered dealers should keep in mind, however, that the antifraud provisions of the Act would be applicable to transactions falling within the rule and that certain provisions, such as those set out in Section 14 of the Act, may operate to require that persons engaged in selling securities determine that the investment is suitable for the purchaser based on the information the purchaser reveals about his or her financial situation and needs.
- 6. Limited use advertisements. One of the most salient features of the rule permits the use of "limited use advertisements," as specified, in connection with offerings under the rule. Thus, although the rule generally prohibits

the use of advertising, should an issuer desire to reach a broad group of appropriate investors, it need only comply with the restrictions set out in subsection (e) of the rule.

- a. **Dissemination.** After careful consideration, the Board determined to permit an issuer to disseminate a limited use advertisement by any means, direct or indirect. Since the rule states that a limited use advertisement that results in an offer to a person who is not an individual accredited investor will not alone result in loss of the exemption, an issuer may advertise through a wide variety of media.
- b. **Filing requirement.** Limited use advertisements must be filed with the Securities Commissioner ten days prior to use in Texas. The filing of the advertisement does not mean that it or the securities to which it refers have been approved by the Securities Commissioner.
- c. **Required content.** Limited use advertisements *must* contain:
 1. a brief description of the securities to be offered;
 2. the name, address, and telephone number of the person to contact for additional information;
 3. the address where offering material may be obtained; and
 4. the following statement: “The securities have not been registered with or approved by the Texas Securities Commissioner and are being offered and sold pursuant to the exemption provided by §139.16 of the Rules and Regulations of the State Securities Board. This advertisement was filed with the Texas Securities Commissioner on or about (fill in date). The securities are being offered to, and may be purchased by, only those natural persons whose individual net worth, or joint net worth with that person’s spouse, at the time of purchase of the securities, exceeds \$1 million or natural persons who have an individual income in excess of \$200,000 in each of the two most recent years, or joint income with that person’s spouse in excess of \$300,000 in each of those years, and who have a reasonable expectation of reaching that same income level in the current year.”
- d. **Permitted content.** A limited use advertisement *may* also include:
 1. the name and address of the issuer;

2. a brief description of the issuer's business; and
 3. the name and address of the registered dealer(s) acting on the issuer's behalf in connection with the offering.
- e. **Safe harbor.** Because the rule permits dissemination of limited use advertisements, the use of such advertisements in connection with an offering made in reliance on the rule could result in the unavailability of other exemptions (such as those discussed in Parts II, III, and V of this Outline) which prohibit public solicitation and advertisements. The rule attempts to address this issue in two ways. First, it cautions issuers or registered dealers who use the exemption to take all necessary steps to document that any sales to persons who are not individual accredited investors were not made in response to a limited use advertisement. In the same vein, it urges users of the section to consult with experienced securities counsel, especially if the user anticipates selling securities, within six months of the last sale made under the rule, to persons who are not individual accredited investors. Second, the rule provides a six-month safe harbor. The rule specifies that the use of a limited use advertisement in compliance with the rule and in connection with sales under the rule will not render exemptions that prohibit public solicitation or advertisements unavailable for other sales that are made more than six months after the use of the limited use advertisement.
- f. **Combining exemptions.** The rule specifies that transactions exempt under the rule may be combined with offers and sales exempt under the Act, Section 5.H and Rule 109.3(c), which exempt sales to certain institutional investors.
- g. **Deviations from terms and conditions of rule.** Should an offer and sale of securities fail, for any reason, to comply with all the terms and conditions for use of the exemption, the rule specifies that the issuer may claim the availability of any other applicable exemption.
- B. **Accredited Investor Exemption.** Rule 139.19, effective December 2, 1997, is a uniform exemption developed by NASAA, and is loosely based on the existing Texas exemption for sales to individual accredited investors, Rule 139.16 (discussed in Part VI.A of this Outline). The rule provides an exemption from the securities registration requirements of the Act for the sale of securities by an issuer to accredited investors.
1. **Who may sell.** The issuer itself may offer and sell securities pursuant to Rule 139.19. For purposes of the rule, an issuer does not have to register

as a dealer to make sales. The exemption is not available to an issuer that is in the development stage that either has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person. As with Rule 139.16, the term “issuer” includes directors, officers, or employees of an issuer satisfying certain conditions, namely:

- a. the director, officer, or employee was not hired for the purpose of offering or selling such securities;
 - b. the director’s, officer’s, or employee’s activity involving the offer and sale of such securities is strictly incidental to his or her bona fide primary nonsecurities-related work duties; and
 - c. the director’s, officer’s, or employee’s compensation is based solely on the performance of other such duties; *i.e.*, the director, officer, or employee does not receive any compensation for offering for sale, selling, or otherwise aiding in the sale of securities.
2. Disqualifications. Certain issuers that are “bad persons” or that are affiliated with certain “bad persons” are disqualified from using the exemption. No exemption is available for the securities of an issuer if the issuer, the issuer’s predecessors, any affiliated issuer, any of the issuer’s directors, officers, general partners, beneficial owners of 10% or more of any class of its equity securities, any of the issuer’s promoters presently connected with the issuer in any capacity, any underwriter of the securities to be offered, or any partner, director, or officer of such underwriter:
- a. within the last five years, has filed a registration statement which is the subject of a currently effective registration stop order entered by any state securities administrator or the SEC;
 - b. within the last five years, has been convicted of any criminal offense in connection with the offer, purchase, or sale of any security or involving fraud or deceit;
 - c. is currently subject to any state or federal administrative enforcement order or judgment, entered within the last five years, finding fraud or deceit in connection with the purchase or sale of any security; or
 - d. is currently subject to any order, judgment, or decree of any court of competent jurisdiction, entered within the last five years, temporarily, preliminarily, or permanently restraining or enjoining such party from engaging in or continuing to engage in any conduct

or practice involving fraud or deceit in connection with the purchase or sale of any security.

3. Exceptions from disqualification. The disqualifications are rendered inoperative if:
 - a. the party subject to the disqualification is licensed or registered to conduct securities related business in the state in which the order, judgment, or decree creating the disqualification was entered against such party; or
 - b. before the first offer under the rule, the state securities administrator, or the court or regulatory authority that entered the order, judgment, or decree, waives the disqualification; or
 - c. the issuer establishes that it did not know and in the exercise of reasonable care, based on a factual inquiry, could not have known that the disqualification existed.

4. Who may purchase. Sales of securities shall be made only to persons who are “accredited investors.” Accredited investor has the same definition as that contained in SEC Regulation D, set forth at 17 Code of Federal Regulations §230.501(a).
 - a. Issuer’s reasonable belief. Sales under the rule may be made only to purchasers who are actually accredited investors or to purchasers who the issuer reasonably believes are accredited investors.
 - b. Sophistication. Like Rule 139.16, this rule contains no sophistication requirement, nor does it specify that the investment must be a suitable one. However, the antifraud provisions of the Act are applicable to transactions falling within the rule and certain provisions, such as those set out in Section 14 of the Act, may operate to require that persons engaged in selling securities determine that the investment is suitable for the purchaser based on the information the purchaser reveals about his or her financial situation and needs.
 - c. Investment intent. The issuer must reasonably believe that all purchasers are purchasing for investment and not with the view to or for sale in connection with distribution of the security. Any resale of a security sold in reliance on this exemption within 12 months of the sale is presumed to be with a view to distribution and not for investment. Excepted from this presumption is a resale pursuant to a registration statement effective under Section 7, or to

an accredited investor pursuant to an exemption available under the Act or Board rules.

5. General announcement. The rule permits the use of a published announcement in connection with offerings under the rule.
 - a. Dissemination. The general announcement of the proposed offering may be disseminated by any means. The rule states that dissemination of the general announcement to a person who is not an accredited investor does not disqualify the issuer from claiming the exemption.
 - b. Filing requirement. A notice of the transaction, a consent to service of process, and a copy of the general announcement must be filed with the Texas Securities Commissioner within 15 days after the first sale in Texas.
 - c. Required content. The general announcement *must* contain:
 1. the name, address, and telephone number of the issuer of the securities;
 2. the name, a brief description, and price (if known) of any security to be issued;
 3. a brief description of the business of the issuer, in 25 words or less;
 4. the type, number, and aggregate amount of securities being offered;
 5. the name, address, and telephone number of the person to contact for additional information; and
 6. a statement that:
 - A. sales will be made only to accredited investors;
 - B. no money or other consideration is being solicited or will be accepted by way of this general announcement; and
 - C. the securities have not been registered with or approved by any state securities agency or the SEC

and are being offered and sold pursuant to an exemption from registration.

6. Additional information. The issuer, in connection with an offer, may provide information in addition to the general announcement, if that information:
 - a. is delivered through an electronic database that is restricted to persons who have prequalified as accredited investors (such as a designated matching service, discussed in Part VI.C of this Outline); or
 - b. is delivered after the issuer reasonably believes that the prospective purchaser is an accredited investor.
7. Telephone solicitation. No telephone solicitation is permitted unless, prior to placing the call, the issuer reasonably believes that the prospective purchaser to be solicited is an accredited investor.

C. Designated matching services rule. Rule 109.15 and related Form 133.35, became effective in 1995. The rule carves out a narrow exception from the ban on public solicitation and advertisements in the context of exempt limited offerings by providing that the use of a designated matching service facility by an issuer member does not constitute public solicitation or advertisement within the meaning of certain specified exemptions. It also provides that a designated matching service is not deemed a dealer subject to registration within the meaning of the Act or Board rules. The rule is forward looking; it is one of the Board's attempts to anticipate future trends in the securities industry. The Board anticipates that the number of matching services, particularly on-line services, will continue to grow in the years to come and that the rule will provide a balanced framework for regulating those services.

1. Conditions for use. A person owning, operating, sponsoring, or conducting a computer system, seminar, or meeting limited to providing investor members with certain information regarding investment opportunities may apply to the Securities Commissioner for designation as a matching service.
 - a. In general. To be designated, the applicant must demonstrate that it limits its facility to providing investor members with the summary business plans and identities of issuer members.
 1. Investor member. The term "investor member" is defined as an investor who has been properly qualified by and uses a designated matching service. Any of the following investors, among others, may be properly qualified:

- A. any institutional investor described in the Act, Section 5.H or Rule 109.3(c);
 - B. any individual accredited investor as defined in Rule 139.16;
 - C. any sophisticated investor, as defined in Rule 109.13(a)(2); or
 - D. any person who is engaged in the same business, or in the practice of a profession or discipline directly related to that business, as is the issuer member whose identity and summary business plan is provided to that person.
2. Summary business plan. The term “summary business plan” is defined to mean a brief statement specifically describing the issuer, its management, its products or services, and the market for those products or services. Other information, including, specifically, financial projections, must not be included in a summary business plan.
3. Issuer member. The term “issuer member” is defined simply to be an issuer who uses a matching service facility. Thus, although the rule is designed primarily to benefit small business issuers, any issuer -- even large, well-established entities -- may use a designated matching service.
- b. Character of entity. The applicant must also demonstrate that it is a governmental entity, a quasi-governmental entity, an institution of higher education, or a domestic (Texas) nonprofit corporation that is associated with a governmental or quasi-governmental entity or an institution of higher education.
 - c. Other conditions. Other conditions for designation are intended to ensure, among other things, that the applicant will not be involved in any manner in the sale, offer for sale, solicitation of a sale or offer to buy a security other than as specifically allowed. Those conditions include:
 - 1. a prohibition on employing any person required to be registered under the Act as a dealer, investment adviser, salesman, or agent -- because of activities on or off their job with the facility -- and required disclosure of past securities-

related activities of any employees, officers, directors or control persons;

2. required disclosure of any officer's, director's, or control person's disqualification as set out in Rule 109.13(k)(2)(A)-(E) of the Board's rules. See Part III.C of this Outline for a discussion of Rule 109.13(k)(2)(A)-(E). Such disqualification might be a basis for the Securities Commissioner to deny the application or to impose additional conditions under Rule 109.15(c)(9) which permits the Securities Commissioner to require that the applicant meet conditions the Securities Commissioner considers appropriate for the protection of investors and consistent with the purposes fairly intended by the policy and provisions of the Act and Board rules;
3. a limitation on fees that can be charged for use of the facility; and
4. an agreement on the part of the applicant not to use any advertisement of its matching service facility that advertises any particular issuer or any particular securities or the quality of any securities or that is false or misleading or otherwise likely to deceive a reader thereof.

2. Safeguards. The rule has been narrowly crafted in an attempt to avoid abuses. By limiting the scope of the rule to those facilities operated by certain governmental or quasi-governmental entities, institutions of higher education, or associated Texas nonprofit corporations, the Board has attempted to forge a balanced approach toward easing regulation of matching service facilities. Designation is expressly not available to any matching service formed in a manner that constitutes part of a scheme to violate or evade the provisions of the Act or Board rules. The Securities Commissioner is vested with authority to withdraw a designation if the standards for designation are not maintained.

3. Three matching services designated. Since this rule was enacted, three matching services have been granted designations. These are the ACE-Net Angel Capital Electronic Network, developed by the Office of the Chief Counsel for Advocacy at the United States Small Business Administration; the American Electronics Association; and The Capital Network, Inc. (formerly, the Texas Capital Network).

D. Internet rule. Rule 139.17, made effective in 1996, was designed to provide a way for persons to use the Internet for securities offerings and avoid inadvertently

violating the Act. Persons who use the Internet to offer securities to Texas residents or to sell securities from Texas are held to the same standards and registration requirements as persons engaging in such activities in a more traditional manner. Rule 139.17 was patterned after a Pennsylvania order concerning Internet offers and more than half of the states have adopted a similar exemption.

1. Operation of the rule. Rule 139.17 exempts from the securities registration requirements of the Act -- and, under certain circumstances, the Act's dealer registration requirements -- offers of securities disseminated through the Internet if:
 - a. the offer indicates that the securities are not being offered for sale to any person in Texas;
 - b. an offer is not otherwise specifically directed to any person in Texas by, or on behalf of, the issuer; and
 - c. no sales of the issuer's securities are made to any person in Texas as a result of the offer.
2. Statement. The offer must contain a statement indicating that the securities are not being offered for sale to any person in Texas. The statement must be the same or substantially similar to one of the following:
 - a. "These securities are not being offered or sold in Texas."
 - b. "These securities are being offered or sold in (fill in names of states other than Texas)."
 - c. "This is neither a solicitation to buy nor an offer to sell to persons in Texas."
3. Enforcement. To date, the agency has issued several administrative orders against persons who failed to meet the criteria of this rule and neglected to register in this state. The majority of the violations encountered by the staff have been considered inadvertent and resolved by an informal agreement to cease publication over the Internet and rescind the offer.

VII. Rulemaking of Note.

- A. Chapter 105 - Contested Case Rules. Senate Bill 331, passed by the 75th Legislature in 1997, required the chief administrative law judge at the State Office of Administrative Hearings ("SOAH") to adopt rules that govern the

procedures, including discovery, that relate to a hearing conducted by SOAH. The bill provided that the procedural rules of a state agency would relate to the hearing only to the extent that the chief administrative law judge's rules adopt the agency's procedural rules by reference. In response to SOAH rulemaking, the Board acted to conform its rules of practice in contested cases to those SOAH rules. This resulted in a substantial rewrite of Chapter 105 which became effective in December 1998.

- B. Rule 109.3(e) - The Institutional Investor Exemption. Rule 109.3 and Section 5.H cover transactions with financial institutions and certain institutional investors. This addition was in the nature of an amendment, rather than an entirely new rule.
1. Applicable to Dealers and Investment Advisers. In 1998 the Board added subsection (e) to the existing rule to clarify that dealers and investment advisers dealing solely with such institutional customers are not required to register. The rule became effective April 5, 1998. The amendment formalizes a longstanding agency policy that provides an exemption from registration for dealers, salesmen, investment advisers, and agents when such persons are engaging in the offer or sale of securities and/or the rendering of investment advisory services to certain financial institutions or other institutional investors.
 2. Background. Previously, this position was reflected in a series of interpretative letters issued by the Agency's General Counsel:
 - a. Letter from the General Counsel to Ms. Donna M. D'Orazio (October 13, 1997) (regarding CoreStates Securities Corp.);
 - b. Letter from the General Counsel to Mr. Joel A. Adler (August 1, 1995) (regarding Investment Advisers Whose Clients Are "Accredited Investors") (reprinted in part at CCH Blue Sky Reports ¶55,827J);
 - c. Letter from the General Counsel to Mr. Christopher S. Stachowiak (December 5, 1994) (regarding NISA Investment Advisors, L.L.C.) (reprinted in part at CCH Blue Sky Reports ¶55,826R);
 - d. Letter from the General Counsel to Mr. Fred O'Fiesh (May 13, 1993) (regarding T. Rowe Price Associates, Inc.) (reprinted in part at CCH Blue Sky Reports ¶55,820S);
 - e. Letter from the General Counsel to Mr. William R. Volk (December 16, 1992) (regarding TGF Management Corp.);

- f. Letter from the General Counsel to Mr. A.L. Sarroff (July 24, 1991) (regarding A.L. Sarroff);
 - g. Letter from the General Counsel to Ms. Priscilla Hughes (October 11, 1989) Regarding Reuters Information Services, Inc. Dealing 2000);
 - h. Letter from the General Counsel to Mr. John B. Lederer (March 9, 1988) (regarding Southwest Corporation Federal Credit Union);
 - i. Letter from the General Counsel to Mr. Terry G. Hannon (December 12, 1986) (regarding Laughlin Group Advisors, Inc.);
 - j. Letter from the General Counsel to Mr. Drew R. Fuller, Jr. (October 11, 1984) (regarding United Service Advisors, Inc.) (reprinted in part at CCH Blue Sky Reports ¶155,809B); and
 - k. Letter from the Staff Legal Officer to Ms. Christine Beck (April 8, 1983) (regarding Investment Adviser Registration).
- C. Rule 107.2 Definitions Affecting Investment Advisers. The Board changed the definition of “investment adviser” to remove banks and bank holding companies and, in effect, relieved banks and bank holding companies from the notice filing and fee provisions. At the same time, the definition of “rendering services as an investment adviser” was also amended to permit persons to engage in such activities via registration or by notice filing. The purposes of these amendments were: (i) to more closely align the Board’s definition of investment adviser with the definition utilized by the federal government and other states and, thereby, achieve greater uniformity with other securities regulators and (ii) to incorporate the concept of notice filings by investment advisers as an authorization for rendering services as an investment adviser. These amendments became effective August 24, 1998. Although “geologists” are not mentioned in the federal definition of investment adviser, the Board kept the exclusion for this profession in its revised definition.
- D. Chapter 113 and Coordinated Equity Review.
- 1. Board action. In order to foster use of Coordinated Equity Review (“CER”) by registrants in Texas, the Board authorized the Commissioner and staff to apply a variety of uniform securities registration criteria developed by NASAA when reviewing offerings of securities requesting CER. Subsequently, the Board formally adopted these guidelines through a series of revisions to Chapter 113 in order to make these guidelines applicable to all registered offerings of securities, not just those in which

applicants utilize the CER process. These changes became effective in December 1998.

2. The CER process.

- a. Purpose. NASAA and the states constantly strive to create processes that allow issuers to register securities of small businesses more easily without sacrificing investor protection. With this in mind, NASAA developed CER, a program designed to bring greater speed and uniformity to the registration process. The purpose of CER is twofold. First, it streamlines the registration process for issuers and, second, it promotes uniformity among participating states by applying set standards to equity offerings.
- b. Availability. CER is available only to offerings of common stock, preferred stock, warrants, rights, and units consisting of equity securities that are also registered, or seeking registration, with the SEC. Blank check and blind pool offerings do not qualify.
- c. State participation. Of the 43 states that require the review of nonexempt equity offerings, 38 states (including Texas) have officially joined the CER program.
- d. Who can benefit from CER? The CER program is targeted at equity offerings between \$5 million and \$20 million in size that typically are filed on SEC forms SB-1, SB-2, and S-1, and F-1. These companies usually trade on the NASDAQ Small Cap, the OTC Bulletin Board and/or other small exchanges. CER is designed to shift part of the burden of gaining clearance to sell securities in individual states from the issuer to the states.
- e. Requesting CER. To take advantage of this program, the issuer sends its registration materials to the states in which it intends to offer its stock, along with an Application for Coordinating State Review (CER-1), and the forms and documents required by each state. An identical package is submitted to the Pennsylvania Securities Commission, which is the current program administrator, even if the issuer does not intend to register its shares for sale in Pennsylvania. (No fee is sent to Pennsylvania unless the issuer intends to register its securities there.) There is no additional fee for coordinated review. Any application filed in a state subsequent to the initial filing is reviewed separately, rather than as part of the CER.

- f. **Timing.** The CER process takes a minimum of 30 days, so the CER-1 and application should be filed in the states as soon as possible after filing with the SEC.
 - g. **Standards.** All states agree to review CER offerings on the basis of compliance with NASAA Statements of Policy.
 - h. **How it works.** Within three business days after receiving the CER-1, Pennsylvania selects two lead states. Lead states are selected from among the states where the issuer has filed an application and that have agreed to participate in the coordinated equity review program. The non-lead states have 10 business days to comment on the application. Once the comments have been collected, the two lead states formulate one comment letter, with both disclosure and substantive comments, and then forward this single comment letter to the issuer. The lead states then resolve outstanding comments with issuer's counsel. Once the lead state clears the application, all participating states agree to clear it as well.
- E. **Dealer and Investment Adviser Use of the Internet to Disseminate Information on Products and Services.** Rule 139.18, effective December 2, 1997, was designed to clarify for broker/dealers and investment advisers their ability to use Internet communications for initial business communications. The rule sets out certain activities that one may engage in without being deemed to be a dealer and, thereby, without triggering state registration and licensing provisions.
- 1. **Internet communications.** Internet communications include the distribution of communications made on the Internet directed generally to anyone having access to the Internet, transmitted through postings on bulletin boards, displays on home pages, or similar methods.
 - 2. **Legend requirement.** Although no specific language for the legend is mandated, the Internet communication must contain a legend that includes the following information:
 - a. the dealer, investment adviser, salesman, or agent may transact business in the state only if registered in Texas, or if excluded or exempted from such registration requirements; and
 - b. follow-up or individualized responses that involve either effecting, or attempting to effect, transactions in securities or the rendering of personalized investment advice will not be made, absent compliance with Texas registration requirements, or an exclusion or exemption from such registration requirements.

3. Firewalls. The rule requires that the Internet communication contain a mechanism, firewall, or implemented policies and procedures designed to reasonably ensure that, prior to any subsequent direct communication with prospective customers or clients in Texas, the dealer, investment adviser, salesman, or agent is registered in Texas, or is excluded from such registration.
4. Content. The Internet communication must be limited to the dissemination of general information on products and services. It cannot involve either effecting, or attempting to effect, transactions in securities or the rendering of investment advice for compensation.
5. Special requirements involving agents and representatives. Additional requirements apply in the case of agents and representatives. These include:
 - a. the Internet communication must prominently disclose the agent's or representative's affiliation with the dealer or investment adviser;
 - b. the associated dealer or investment adviser retains the responsibility for reviewing or approving the content of the Internet communication used by its agent or representative;
 - c. the associated dealer or investment adviser must authorize the distribution of the information on particular products and services through the Internet communication; and
 - d. the agent or representative must act within the scope of authority granted by the dealer or investment adviser.
6. Applicability. The rule is limited to dealer, investment adviser, dealer agent, or investment adviser representative registration only. It does not excuse compliance with applicable securities registration, antifraud, or related provisions. Nothing in the rule, however, affects activities not subject to the jurisdiction of the Texas Securities Commissioner as a result of NSMIA.

VIII. Board's Responses to the National Securities Markets Improvement Act of 1996.

A. Securities registration exemptions.

1. General. The National Securities Markets Improvement Act of 1996 ("NSMIA"), amended Section 18 of the 1933 Act by preempting states' authority to register most securities offerings. With respect to four classes

of “covered securities,” states are prohibited from requiring registration or qualification of the securities. States are also precluded from imposing any conditions on the use of any offering document prepared by or on behalf of the issuer of the covered securities.

2. Classes of covered securities. Four classes of securities are identified in NSMIA as covered securities.
 - a. Federally-registered investment company (mutual fund) shares.
 - b. National exchange-listed securities. NSMIA provides for exclusive federal registration of securities listed, or authorized for listing, on the New York Stock Exchange or the American Stock Exchange, or listed on the National Market System of the Nasdaq Stock Market. It also gave the SEC authority to expand the provision by designating additional national exchanges having substantially similar listing standards to those markets. In SEC Release 33-7494, effective January 21, 1998, the SEC added Tier I of the Pacific Exchange, Incorporated, Tier I of the Philadelphia Stock Exchange, Incorporated, and the Chicago Board Options Exchange, Incorporated.
 - c. Securities offered or sold to “qualified purchasers.” At the time this outline was prepared, the SEC had not proposed rules to define “qualified purchasers” in this context. NSMIA permits the SEC to define the term “qualified purchaser” differently with respect to different categories of securities, consistent with the public interest and the protection of investors.
 - d. Exempt securities based on certain transactional exemptions under the 1933 Act. These exempt offerings, detailed in Section 18(a)(4) of the 1933 Act, include securities of companies exempt under certain parts of Sections 3(a) and 4 of that Act. Included in this category are securities offered pursuant to SEC Regulation D, Rule 506, discussed previously in Part III.C.2 of this Outline.
3. Notice filings and fees preserved. NSMIA preserves the authority of the states to require notice filings and fees with respect to covered securities (except for national exchange-listed securities) and to suspend the offer and sale of such securities within a state as a result of the failure to submit a required filing or fee. States can require the registration of securities by any issuer that refuses to pay any required fee. Accordingly, if a corresponding exemption does not exist under the Texas Act or Board rules, the issuer or offeror of the federal covered securities must make a notice and consent to service filing and pay the fee that would have been due in the

case of a registration. When dealing in those grey areas in which a corresponding Texas exemption is not clearly applicable for the transaction in question, a no-action recommendation should be obtained from the staff before the issuer/offeror proceeds without making the appropriate filings and fee payment. A failure to do so could cause loss of the preemption and may cause the assessment of penalty fees for excess sales. Similarly, dealing in covered securities does not in and of itself provide an exemption from the dealer or agent registration requirements of the Act.

4. Board response. The Board adopted rules providing parallel exemptions for covered securities under its regulations and providing guidance on how Board rules mesh with the new federal requirements.
 - a. Definitions added. A definition of “federal covered securities” was added in Rule 107.2 to mirror the federal definition of “covered securities.”
 - b. Amendment to Rule 109.13(k). Paragraph (16) was added to the subsection to remove requirements inconsistent with SEC Rule 506.
 - c. Amendments to Chapter 113, Registration of Securities. Changes were made throughout the chapter to address the applicability of registration standards to federal covered securities and to remove merit review standards inconsistent with NSMIA.
 - d. New Chapter 114. A new Chapter 114 was created to specifically address treatment of various kinds of federal covered securities, set forth fee and notice filing requirements, as well as registration requirements for issuers who refuse to comply.
 1. The filing and fee provisions of the chapter are made inapplicable to federal covered securities that are eligible to claim a corresponding state exemption from securities registration. In other words, an exemption from securities registration also operates as an exemption from the notice filing, consent to service, and fee provisions for federal covered securities.
 2. As a general rule, the following items are required for most offerings of federal covered securities:
 - A. a consent to service is required from foreign (non-Texas) issuers of federal covered securities;
 - B. a notice filing, made on:

- i. Form U-1, Uniform Application to Register Securities (only items 1-6 on page 1 are required), or a document providing substantially the same information; or
 - ii. Form NF, Uniform Investment Company Notice Filing; and
 - C. a fee of \$10, plus 1/10 of 1.0% of the aggregate amount of federal covered securities proposed to be sold to persons in Texas.
- 3. In certain situations, these requirements vary. These “special circumstances” are addressed in Rule 114.4(b), and include the following:
 - A. SEC Regulation D, Rule 506 offerings. The filings and fees required when offering this type of federal covered security are detailed in Part III.C.2 of this Outline.
 - B. Listed securities. No filing, consent to service, or fee is associated with offerings of securities listed on certain exchanges, detailed in Part VIII.A.2.b of this Outline.
 - C. Money market status approved by the Securities Commissioner. If an investment company has met the requirements in Rule 123.3 and had its application for money market status approved by the Securities Commissioner, it may utilize the reduced fee schedule from that rule to determine its filing fees. Only the fee is affected by approval of money market status. The consent to service and notice filing requirements generally applicable to federal covered securities remain the same.
 - D. Secondary trading. A registered dealer or issuer of federal covered securities may claim the Section 5.O exemption by making the notice filing on Form U-1 (with items 1-6 on page 1 completed), filing a consent to service of process signed by the dealer, payment of the \$500 fee provided for in Section 35.I of the Act, and submitting a written statement confirming that the issuer is in compliance with the

reporting requirements of the 1934 Act, Sections 13 or 15(d).

E. Industrial development bonds (“IDBs”). IDBs, within the parameters of Chapter 135 of the Rules, are not exempt from securities registration under Section 5.M of the Act. Accordingly, the notice filing, consent to service, and fee recited in Part VIII.A.4.d.2 of this Outline are applicable to this type of covered security. In accordance with Section 18(a)(4)(C) of the 1933 Act, an IDB issued by a municipality located in Texas is ineligible for status as a covered security and must be registered in Texas, unless a corresponding Texas exemption from registration is found.

e. Repeals of existing rules. Most of the Board’s rules for registration of mutual funds, Chapter 123, Administrative Guidelines for Registration of Open-End Investment Companies, were repealed. The remaining provisions of Chapter 123 were amended to accommodate the reclassification of investment company securities as federal covered securities. Corresponding amendments were also made to Form 133.26, Request for Determination of Money Market Fund Status, and Form 133.27, Year End Report of Sales by a Money Market Fund. Chapter 124, Guidelines for Periodic Payment Plans, was also eliminated in light of NSMIA.

B. Exemptions from registration for agents of Texas dealers.

1. General. NSMIA added Section 15(h)(2) to the 1934 Act, providing a limited exemption from registration, essentially a grace period in which to register, in certain limited instances. It was designed to cover situations where an agent wants to continue to service an existing customer while the customer is traveling in or has recently relocated to a jurisdiction where the agent is not registered. To come within the parameters of this NSMIA provision, the agent must file an application for registration with the Securities Commissioner within 10 business days after the date the agent effects the transaction for the existing client. Section 15 provides that, after the application for agent registration has been filed, the agent may continue to effect transactions for the existing client for 60 days after the date the application was filed, as long as the agent has not been notified that the application has been denied or stayed for cause.
2. Board response. The Board added subsection (j) to Rule 115.1 to provide a corresponding carve-out for the salesman/agent exemptions of NSMIA.

In order to be exempt from registration for a given transaction, the agent must meet all of the following requirements:

- a. Not be ineligible to register in Texas. A person is considered ineligible for registration if that person has been convicted of either a securities-related felony or a theft-related felony.
- b. Be registered with a “registered securities association,” *i.e.*, the National Association of Securities Dealers, and in at least one other state.
- c. Be associated with a dealer that is registered in Texas.

C. Investment adviser and agent exemptions.

1. General. NSMIA preempts from state registration investment advisers with more than \$25 million in client assets under management. These large investment advisers became regulated exclusively by the SEC on July 8, 1997, the effective date of Title III of NSMIA, relating to investment advisers. NSMIA gave the SEC authority to raise the \$25 million threshold. Investment adviser firms with between \$25 million and \$30 million in client assets under management may elect to be registered with the state, rather than the SEC. Also, the SEC has adopted a rule allowing investment advisory firms that are subject to registration in at least 30 states to opt for SEC registration instead, regardless of the amount of assets under management.
2. Related exemptions. NSMIA preempts state registration in three additional areas relative to investment advisers’ activities, while preserving notice filings and fee payments to the states for the following:
 - a. persons who are supervised by SEC-registered advisers, except for those who have a place of business located in the state;
 - b. persons excepted from the definition of an investment adviser under section 202(a)(11) of the Investment Advisers Act of 1940; and
 - c. investment advisers who do not have a place of business in the state and have had fewer than six clients in the state within the preceding 12-month period.
3. Board response. The Board added subsection (l) to Rule 115.1, creating investment adviser exemptions that mirror the federal provisions, except where to do so would cause a loss of revenue to the state. Provisions for

the preservation of filing and fee requirements for exempt investment advisers and their agents also were adopted.

- D. Continued fraud authority of the states. NSMIA clearly continues the states' ability to investigate and bring enforcement actions for fraud, deceit, or unlawful conduct by an issuer, dealer, investment adviser, salesman or agent in connection with securities activities, regardless of the availability of registration exemptions. In order to emphasize that it is the intent of the Board to continue bringing enforcement actions for such illegal activities in Texas, each of the rule adoptions, setting forth registration exemptions under the Act in response to NSMIA, is followed by an affirmative statement acknowledging this authority.
- E. SEC "Aircraft Carrier" Release. SEC Release No. 33-7606A, also known as the "Aircraft Carrier" release, proposes a fundamental restructuring of the regulatory framework for offering securities under the Securities Act of 1933. Many of the proposals contained in this release were issued under the broad exemptive authority granted to the SEC in NSMIA. An extended (120 day) comment period is being utilized for this proposal, so comments must be received by April 5, 1999. The full text of the release is available from the SEC web site at: www.sec.gov. As these proposals develop and are finalized, we anticipate that they will necessitate changes at the state level to facilitate coordination of the federal and state regulatory schemes. Five major topics are addressed in the release.
 - 1. Registration system reform. Three basic registration forms would be used.
 - a. Form A. This form would be used by smaller issuers and larger unseasoned issuers. It is designed to replace Form S-1 as the basic registration form.
 - b. Form B. This form would be used for larger seasoned issuers and offerings to relatively sophisticated or informed investors. The SEC estimates that roughly twenty-five percent of all public companies would be eligible for Form B registration. Issuers, and their underwriters, utilizing this form would be able to designate the effective dates and have complete control over when they offer and sell the registered offerings. SEC staff would not review these registration statements before effectiveness.
 - c. Form C. This form would be used for registrations involving exchange offers and business combinations.
 - 2. Communications around the time of the offering. The proposals are designed to give issuers of all sizes and their underwriters greater freedom to communicate with investors in writing during the offering process.

Issuers in Form B offerings would be permitted to use “free writing” communications, not just the traditional prospectus. “Free writing” communications could also be used by other issuers, but only after they have filed a registration statement.

3. Prospectus delivery requirements. The proposals would refocus the requirements for the benefit of investors and require delivery of a term sheet before investors make their investment decisions, rather than at the time the sale is confirmed.
4. Integration of private and public offerings. The proposals seek to provide greater flexibility for issuers that face difficulties in assessing the extent of market interest in a planned offering. The issuer would be able to change an unregistered private offering into a registered public offering, or vice versa, after it has commenced the offering. Small companies that begin a registered public offering would have the option to make an unregistered, exempt offering to qualified buyers even though they broadly solicited potential investors. Some clarification would be needed at the state level to address how this flexibility would coordinate with state exemptions, particularly those addressing limited or private offerings, and offering restrictions.
5. Periodic reporting under the Securities Exchange Act of 1934. The proposals seek to expedite and expand some of the disclosure required in periodic reports and to assure that investors have more timely access to companies’ disclosure.