

RECENT CHANGES IN FEDERAL AND STATE LEGISLATION AND RULES

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I. Introduction.

This paper and the accompanying talk will provide a brief overview of recent changes in securities laws and regulations affecting small business capital raising. The Texas Securities Act ("Act") and the Rules and Regulations of the State Securities Board ("Rules") are available on the Texas 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. Texas Legislative Changes.

A. 1997 Legislation.

1. **H.B. 1507.** This bill limits the liability of certain professionals in civil actions brought under Section 33 of the Act. This provision appears in Section 33.N of the Act.

a. Background.

The bill was designed to address the problem faced by small issuers who were unable to get assistance from professionals. The bill analysis, prepared by the Senate Research Center, noted that a large number of attorneys, accountants, and other professionals were declining services in connection with the issuance of small securities offerings, due to the risk of jury findings of liability and the potential

for large damage awards. Many professionals have indicated that it would substantially increase the probability of professional involvement in small securities offerings if the amount of potential liability could be limited to a multiple of the fees earned by the professional in connection with the transaction.

b. **"Small business issuer."** A special definition of "small business issuer" was provided for application of this section. It includes an issuer of securities that, at the time of an offer to which this Section 33.N applies:

- i. has annual gross revenues in an amount that does not exceed \$25 million; and
- ii. does not have a class of equity securities registered, or required to be registered, with the Securities and Exchange Commission under Section 12 of the Securities Exchange Act of 1934, as amended (15 U.S.C. Section 78I).

c. **Limitation on liability.**

The maximum amount that may be recovered against a person to which Section 33.N applies, in any action or series of actions brought under civil liability provisions of Section 33, is an amount equal to three times the fee paid by the issuer or other seller to the person for the services related to the offer of securities. This limitation on liability does not apply if the trier of fact finds the person engaged in intentional wrongdoing in providing the services. The action must relate to an offer of securities to which Section 33.N applies.

d. **Application.** The limitation provided applies only to:

- i. an offer of securities made by a small business issuer or by the seller of securities of a small business issuer that is in an aggregate amount that does not exceed \$5 million; and
- ii. a person who has been engaged to provide services relating to an offer of securities described by Section 33.N(2)(a), including an attorney, an accountant, a consultant, or the firm of the attorney, accountant, or consultant.

e. **Furnishing disclosure materials.** A small business issuer making an offer of securities shall provide to the prospective buyer a written disclosure of the limitation of liability created by Section 33.N and shall receive a signed acknowledgment that the disclosure was provided.

f. **Effective date.**

The provisions of Section 33.N became effective September 1, 1997. They apply only to actions filed on or after September 1, 1997. Actions filed before that date are governed by the law in effect at the time the action was filed.

2. **H.B. 1971.**

This bill, also effective September 1, 1997, made no substantive changes to the Act. It simply updated citations to the statute used to set the interest rate for certain penalty fees contained in Sections 35-1 and 35-2 of the Act.

B. 1995 Legislation.

1. **H.B. 1295.**

This comprehensive legislation made a variety of changes to the Act, including several

that were aimed at encouraging capital formation and reducing burdens for small business by streamlining the registration application process for certain small business issuers. Most notably, Section 7.A of the Act was amended to relax the registration by qualification requirements to permit small business issuers, as defined by Board rule, to provide reviewed, rather than audited, financial statements.

- a. **Small business issuer.** Rule 113.5(c), which is loosely patterned after the conditions for use of Form U-7, (discussed in Part VI.B of this Outline) defines the term "small business issuer" to mean any corporation:
 - i. that has not previously sold securities by means of an offering involving public solicitation or advertising unless the offering was made in compliance with certain specified exemptions;
 - ii. that has not been previously required under federal or state securities law to provide audited financial statements in connection with the sale of securities;
 - iii. that is not an investment company;
 - iv. that does not engage or propose to engage in petroleum exploration or production or other extractive industries;
 - v. that is not subject to certain reporting requirements set forth in the Securities Exchange Act of 1934;
 - vi. that has its principal place of business in Texas and employs at least 50% of its full-time employees in Texas; and
 - vii. whose previous sales of securities (exclusive of debt financing with banks and similar commercial lenders) does not exceed \$500,000.
- b. **Parent corporations.** Under Rule 113.5(d), parent corporations of majority-owned "small business issuers" must also meet the criteria for a "small business issuer" if the subsidiary is to be permitted to submit reviewed financial statements.
- c. **Small business offering.** Under Rule 113.5(e), an offering will be considered a "small business offering" only if its amount does not exceed \$500,000.

XIII Federal Legislation - The National Securities Markets Improvement Act of 1996. The National Securities Markets Improvement Act of 1996 ("NSMIA"), Public Law 104-290, made substantial changes to state regulation of securities offerings and sales, dealers, investment advisers, and their agents.

A. Covered securities.

NSMIA amended Section 18 of the federal Securities Act of 1933 by preempting states' authority to register most securities offerings. With respect to four classes of "covered securities," concurrent registration at the state level is no longer required. 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.

1. Defined.

The four classes of securities identified by NSMIA as covered securities are: federally-registered mutual fund shares; national exchange-listed securities; exempt securities based on offers and sales to qualified purchasers; and exempt securities based on certain transactional exemptions under the Securities Act of 1933.

2. Preserved authority.

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. 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 in covered securities.

B. Board response.

The Board has adopted rules providing a parallel exemption for covered securities under its regulations. A definition of "federal covered securities" was added in Rule 107.2 to mirror the federal definition of "covered securities." A new Chapter 114 was created to specifically address treatment of various kinds of federal covered securities, and set forth fee and notice filing requirements, as well as registration requirements for issuers who refuse to comply.

C. Impact on small businesses.

The major change in NSMIA impacting securities issuances by small businesses is the change made to coordinate offerings made at the federal level pursuant to Securities and Exchange Commission ("SEC") Regulation D, Rule 506 and those made at the state level under the Uniform Limited Offering Exemption ("ULOE").

1. SEC Rule 506 and ULOE.

As of May 1995, more than 35 states had registration exemptions coordinated with Rules 505 and 506 of SEC Regulation D. Most, like Texas, have adopted ULOE as their method of coordination. 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, a notice filing and fee are still required.

2. Rule 109.13(k) and Rule 506 offerings. NSMIA made certain parts of Rule 109.13(k) (Texas' version of ULOE) 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. Please note that the ULOE fee and certain filing requirements remain intact.

a. 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.]

b. Filing requirements. The issuer should carefully note the following requirements.

i. Form D filing.

The rules require 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.

ii. Consent to service. If required by Rule 114.3, the issuer must file a consent to service of process.

iii. **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.

iv. **Timely filing.**

In Texas, late filings sometimes occur when issuers, who had intended to proceed under another private offering exemption (like Section 5.1), 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.

- c. **Suitability and sophistication.** SEC Rule 506 requires that nonaccredited investors be sophisticated. 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. Thus, if the issuer sells to nonaccredited investors in Texas, the issuer, and any person acting on its behalf, must have reasonable grounds to believe, and after making reasonable inquiry shall believe, that 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.

XXII Texas Rulemaking.

A. **Internet rule.**

Rule 139.17, effective March 27, 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 approximately 30 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.

The agency has issued several administrative orders against persons that 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.

B. Dealer and investment adviser use of the Internet to disseminate information on products and services.

Rule 139.18, expected to become effective in December 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 may occur 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. The Internet communication must contain a legend stating that:

- 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.
- 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 their 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.

- C. 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 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.

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.

7. **Limited use advertisements.** One of the most salient features of the rule permits the use of "limited use advertisements" 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 10 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:

- i. a brief description of the securities to be offered;
- ii. the name, address, and telephone number of the person to contact for additional information;
- iii. the address where offering material may be obtained; and
- iv. 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* include:

- i. the name and address of the issuer;
- ii. a brief description of the issuer's business; and
- iii. the name and address of the registered dealer(s) acting on the issuer's behalf in connection with the offering.

7. 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 that 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 to sales that are made more than six months after the use of the limited use advertisement.

8. 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.

9. 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.

D. Designated matching services rule. Rule 109.15 and related Form 133.35, became effective in April 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.

i. 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:

- I. any institutional investor described in the Act, Section 5.H or Rule 109.3(c);

- II. any individual accredited investor as defined in Rule 139.16;
 - III. any sophisticated investor, as defined in Rule 109.13(a)(2); or
 - IV. 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.
- ii. **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.
 - iii. **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:
- i. a prohibition on employing any person required to be registered under the Act as a dealer, investment adviser, salesman, or agent -- by dint of actions taken on or off the job with the facility -- and required disclosure of past securities-related activities of any employees, officers, directors or control persons;
 - ii. 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. 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;
 - iii. a limitation on fees that can be charged for use of the facility; and
 - iv. 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 met.

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

G. **Accredited investor exemption.** Rule 139.19, expected to become effective in December 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 IV.C 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. These disqualification provisions are similar to those contained in Rule 139.16. Under Rule 139.19, no exemption is available for the securities of any 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 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, 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 used for SEC Regulation D, contained 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 Rules.

5. General announcement.

As with Rule 139.16, this 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:

- i. the name, address, and telephone number of the issuer of the securities;
- ii. the name, a brief description, and price (if known) of any security to be issued;
- iii. a brief description of the business of the issuer, in 25 words or less;
- iv. the type, number, and aggregate amount of securities being offered;
- v. the name, address, and telephone number of the person to contact for additional information; and
- vi. iv. a statement that:
 - I. sales will be made only to accredited investors;
 - II. no money or other consideration is being solicited or will be accepted by way of this general announcement; and
 - III. 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 IV.D 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.

LIICoordinated Equity Review ("CER").

A. NASAA.

The North American Securities Administrators Association, Inc. ("NASAA") is a non-profit organization composed of securities administrators from the 50 states, the District of Columbia, Canada, Mexico, and Puerto Rico. It is the oldest international organization devoted to investor protection through efficient and fair securities registration. NASAA serves as the forum where its members work to protect investors at the grass roots level and to promote fair and open capital markets.

B. Purpose.

NASAA and the states are constantly striving to create processes that allow issuers to register securities of small businesses more easily without sacrificing investor protection. With this in mind, NASAA developed a coordinated equity review program. Coordinated Equity Review ("CER") is 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, secondly, it promotes uniformity among the states that participate by applying set standards to equity offerings.

C. 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 for coordinated review.

D. State participation.

Of the 43 states that require the review of nonexempt equity offerings, 37 states (including Texas) have officially joined the CER program. To date six offerings in Texas have been reviewed under this procedure.

E. 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.

F. 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 Arizona Securities Division, which has agreed to act as the initial program administrator, even if the issuer does not intend to register its shares for sale in Arizona (no fee is sent to Arizona 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 will be reviewed separately, rather than as part of the CER.

G. Timing.

The CER process will take 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.

H. Standards.

All states agree to review CER offerings on the basis of compliance with NASAA Statements of Policy.

I. How it works.

Within three business days after receiving the CER-1, Arizona selects two lead states. Lead states will be 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.

LVI. Small Company Offering Registration ("SCOR"). The SCOR program provides a coordinated approach among state securities regulators for the regulation of prospectus disclosure and registration of small issues, most notably those under the SEC's Regulation D, Rule 504. SCOR represents a balanced approach to the capital raising process by providing a registration form that a small business can easily use in multiple states, at a reduced cost, while at the same time maintaining the critical investor protection of the securities laws.

A. Regional review.

One of the most recent innovations relating to the review of smaller offerings is the establishment of the regional review project. Regional review is available for any offering on Form U-7. Under the regional review protocol, a group of states in close geographical proximity to one another agree to permit one securities agency in the region to take the lead in reviewing the Form U-7 and in communicating comments and concerns to the issuer. As a result, the review process is greatly consolidated and simplified for the issuer. Currently, there exists three regions representing almost half of the states requiring registration of these offerings. Due to the enormity of the capital market in Texas and the volume of offerings being made here, our state is, effectively, a region unto itself. In jurisdictions where regional review of an offering is not available, cooperation between the states on an informal basis is common.

1. Western region.

The Western Regional Review consists of the states of Alaska, Arizona, California (for Regulation A offerings only), Colorado, Idaho, Oregon, Utah, and Washington. Also, the State of Nevada recently amended its rules so that it can participate in the Western Regional Review Program.

2. New England region.

The states of Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, and Vermont comprise states in the New England Regional Review.

3. Midwest region.

The states of Illinois, Indiana, Iowa, Kansas, Michigan, Missouri, and Wisconsin comprise the Midwest Regional Review. Prior to implementation of the Midwest Regional Review, the participating states met to discuss review standards to assure a uniform review for issuers.

B. Form U-7.

The Board has adopted the Form U-7 as a recommended disclosure guide when 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 is 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. Essential features of SCOR.

While SCOR is just one of many securities offering vehicles available for use by small businesses, it provides the following distinct advantages in the area of small business finance:

1. **Simplified disclosure.**
The simplified question and answer disclosure format allows small companies to prepare a substantial amount of the disclosure themselves, without seeking out securities specialists. By minimizing the use of securities specialists, most small businesses can achieve significant cost savings.
2. **Form operates as the offering circular.** The SCOR registration form is designed to function as a disclosure document.
3. **Tailored for small business.** The SCOR questions are specifically written to deal with small emerging companies and start-up and developmental stage companies. Certain questions force the company to review its business plan in order to answer the questions. By requiring disclosures that are designed for small business and asking tough questions about the company, the SCOR disclosure format protects not only the investor but also the company.
4. **Public solicitation and unrestricted securities.** Registration, either with or without SCOR, permits a small business to conduct an offering using public solicitation. It also allows a company to sell securities that are not "restricted" to certain types of investors. Even if an issuer does not wish to conduct a public offering or publicly solicit shares, or an issuer prefers to have restricted stock, a SCOR registration frees the issuer of the necessity of following the strictures of private placement rules and protects the issuer in the event that it fails to follow them. This is important because, under a private placement, an inadvertent public solicitation or failure to restrict a security may disqualify the entire offering from exemption.
5. **Coordinates with SEC Rule 504.** SCOR is designed specifically to be used with the federal exemption provided by Rule 504.
6. **Facilitates interstate offerings.** Use of SCOR with Rule 504 allows a small business to conduct an interstate offering without the expense of federal registration.
7. **SCOR offers assistance to small business.** Both the SCOR form and the registration review assist the small business that cannot otherwise hire securities specialists to prepare and register its offering. Registration also puts the small business issuer in direct contact with the state securities regulator. Many states, like Texas, offer pre-filing conferences to small business issuers seeking assistance. Use of exemptions from registration by small issuers sometimes results in inadvertent violations of the securities laws simply because there is no double-check or oversight of the disclosure document or of compliance with other securities rules.

D. **Basic requirements for SCOR.**

SCOR is not available to all issuers. The following is a list of the basic eligibility criteria:

1. **Issuer transactions.**
In order to mirror SEC Rule 504, SCOR is available only to the issuer of securities. Thus, offerings by selling shareholders are not permitted under SCOR.
2. **U.S. corporations.**
The issuer must be a corporation or limited liability company organized under the laws of a state or possession of the United States.

3. **Certain issuers disqualified.** The issuer must engage in a business other than mining, petroleum exploration or production, or other extractive industries. SCOR is not available to investment companies subject to the Investment Company Act of 1940, or to companies subject to the reporting requirements of Section 13 or Section 15(d) of the Securities Exchange Act of 1934. A SCOR offering may not be a "blind pool" or other offering in which the issuer cannot describe the specific business to be engaged in or property to be acquired.
4. **Offerings up to \$1 million.** Generally, the aggregate offering price of the securities to be offered in a SCOR offering may not exceed \$1 million when a federal-state coordination is made. Although Texas places no limitation on the maximum offering size of issues that use the Form U-7 offering document in intra-state offerings, federal regulations or the laws of other states may impose offering size limits.
5. **Debt or equity securities.**
SCOR is available for the registration of either debt or equity securities offerings.
6. **No "bad persons" allowed.** Generally, if the issuer or the principals have been convicted of any crime involving securities or fraud or they are subject to any state cease and desist order or injunction, SCOR may not be available.
7. **No "penny stocks."**
The form provides that it may not be used in offerings of shares of stock which have an offering price of less than \$1 per share, or for convertible securities or options, warrants, or rights whose conversion or exercise price is less than \$1 per share.
8. **Federal filing.**
The issuer must file Form D with the SEC if claiming an exemption under Regulation D, Rule 504, or make a filing with the SEC under Regulation A.
9. **Licensed dealers.**
All offers and sales of registered securities in Texas must be made through a registered broker-dealer. The company may, however, register as an "issuer-dealer."

E. Structuring a SCOR offering.

Some states, including Texas, apply substantive standards to public offerings in order to assure that the terms and structure of the offering are fair to investors. An issuer seeking to register securities for sale in Texas must generally structure its offering to comply with the requirements of the Rules, as well as any other requirements contained in the Act. Chapter 113 of the Rules contains the general fairness standards imposed by this State. These standards relate to such issues as promoters investment, cheap stock, voting rights, conflicts of interest, excessive options and warrants, and offering expenses. This information is available on the Internet at www.ssb.state.tx.us. In addition, NASAA has made available on the Internet, at www.nasaa.org, an Issuer's Manual for companies using the Small Company Offering Registration Form. This Manual should be reviewed thoroughly when completing an offering of this type.

VII. Work in Progress.

The staff of the Texas Securities Board is presently developing a small business guide to securities offerings in response to the Board's directive to provide more assistance to start-up and growing businesses in navigating the ocean of investment resources. This guide will be a "plain English" approach to alternatives in securities offering structures, covering both public and private offerings, as well as a source reference for contacts in the legal and banking communities and governmental and quasi-governmental organizations facilitating capital production. For additional information about the Texas Securities Board, visit our web site at www.ssb.state.tx.us