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## EXEMPT SECURITY OFFERINGS AVAILABLE IN TEXAS

MONTE F. JAMES†

### I. INTRODUCTION

Recently due to the robust economy, the United States, including Texas, saw a significant increase in the number of initial public offerings (“IPOs”) in the securities markets. Nationally, \$1.16 trillion worth of new debt and equity IPOs were brought to market in 1993.<sup>1</sup> Yet, 1994 saw a decrease in new IPOs due mainly to rising interest rates. In 1994, there was only \$709.8 billion worth of IPOs brought to market in the U.S.<sup>2</sup>

The purpose of this article is to give direction to the business practitioner who unintentionally becomes involved in federal or state securities regulations. In Texas, a common involvement arises when a lawyer assists with the formation of a new business venture. A frequent misconception is if the deal is small enough, or if only a limited number of investors are involved, then federal and state securities laws are not invoked.

This article will address those securities not requiring the filing of a registration statement with the Securities and Exchange Commission (“SEC”) or the State Securities Board of the State of Texas (“State Securities Board”). The Securities Act of 1933<sup>3</sup> and the Securities Exchange Act of 1934<sup>4</sup> were enacted “to eliminate serious abuses in a largely unregulated securities market.”<sup>5</sup> To achieve this goal, Congress “painted with a broad brush” in defining which activities invoked federal securities laws.<sup>6</sup>

In reviewing any investment vehicle, regardless of title, in deciding whether it invokes federal security laws, the following three-step analysis should be performed: 1) Is it a security? 2) If so, is it an exempt security? and 3) If not, can it be sold in an exempt transaction? Each of these questions will be addressed individually in this article. One purpose in performing this three-step analysis is to avoid the expense

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1. Anita Raghaven, *Underwriters Endure a Bruising Year as Interest Rates Rise*, WALL ST. J., Jan. 3, 1995, at R38.

2. *Id.*

3. Securities Act of 1933, Ch. 38, tit. I § 1, 48 Stat. 74 (1933) (current version at 15 U.S.C. § 77 (1988)).

4. Securities Exchange Act of 1934, Ch. 404, tit. I § 1, 48 Stat. 881 (1934) (current version at 15 U.S.C. § 77b-78kk (1988)).

5. *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 849 (1975).

6. *Reves v. Ernst & Young*, 494 U.S. 56, 60 (1990).

and necessity of having to file a registration statement with the SEC or the State Securities Board, if one is not required. If an investment is not a security, a registration statement is not required. Furthermore, if a security is exempt, or can be sold in an exempt transaction, a registration statement is not required.<sup>7</sup>

Another equally important purpose of performing this three-step analysis is to avoid the strict liability provision of section 12(1) of the 1933 Act for failing to comply with an exemption.<sup>8</sup> Section 12(1) gives the purchaser a one year put on the given securities, if there was a failure to comply with an exemption, and no registration statement was filed.<sup>9</sup>

### A. *Is It a Security?*

The definition of a security is very broad and encompassing.<sup>10</sup> Section 77b of the Security Act dictates any note, stock, bond, debenture, certificate of deposit for a security, investment contract, or any interest or instrument commonly known as a security, is a security.<sup>11</sup> Therefore, practitioners should begin with the presumption that any investment is a security, and look to the available case law to determine if the investment is an exception.

*SEC v. W. J. Howey Co.*<sup>12</sup> is the seminal case interpreting what is or is not a security. *Howey* involved Florida citrus growers selling land coupled with a service contract. The United States Supreme Court held form was to be disregarded and instead the analysis should focus on “economic reality.”<sup>13</sup> *Howey* set forth a four-prong test to determine whether an investment contract is a security: 1) Is it an investment of money, or the purchase of something for value? 2) Is the activity a common enterprise between the participants, or is the promoter principally in control of the business operation? 3) Do the investors expect profits? and 4) Are the investors’ expectations derived solely through the efforts of others?<sup>14</sup>

In *Howey*, the Court held the investments met this test and, consequently, were securities that either had to meet an exception, or otherwise be registered as securities.<sup>15</sup> The Texas Supreme Court adopted the *Howey* test for the determination of whether an investment contract is a security pursuant to the Texas Securities Act.<sup>16</sup>

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7. 15 U.S.C. § 77c (1988).

8. *Id.* § 77l.

9. *Id.*

10. *Id.* § 77b.

11. *Id.*

12. 328 U.S. 293, 297-302 (1946).

13. *Id.*

14. *Id.* at 298-99.

15. *Id.* at 299-300.

16. TEX. REV. CIV. STAT. ANN. art. 581-1 et seq. (Vernon 1964 & Supp. 1995).

In *United Housing Foundation, Inc. v. Forman*,<sup>17</sup> the United States Supreme Court was presented with a state subsidized apartment complex where purchasers of stock were given the opportunity to lease apartments at a significantly reduced rate. The *Forman* Court held the shares purchased were not securities within the meaning of section 77b.<sup>18</sup> Thus, the Court held that a court must look to substance over form in determining whether an investment is a security and thereby subject to regulation under federal law.<sup>19</sup>

However, the determination of whether a note is a security does not follow the *Howey* test.<sup>20</sup> The United States Supreme Court in *Reves v. Ernst & Young*,<sup>21</sup> adopted a family resemblance test for analyzing whether a particular note is a security.<sup>22</sup> The test begins with the rebuttable presumption every note is a security due to the express language found in section 77b.<sup>23</sup> The *Reves* Court set forth four elements of the family resemblance test: 1) determine the motivations of the seller and buyer based on reasonableness; 2) examine the plan of distribution to determine if it is an instrument in which there is typical trading and speculation; 3) examine public expectation, which the reviewing court must give great weight; and 4) determine whether another regulatory scheme provides protection thereby negating the necessity of federal protection.<sup>24</sup>

Additionally, in *Landreth Timber Co. v. Landreth*,<sup>25</sup> the Court held that common or simple stock is a security, if it possesses the economic characteristics traditionally associated with stock.<sup>26</sup> Limited partnerships employ the *Howey* test with heavy emphasis on control in determining whether federal security laws are invoked. For instance, does the investor have significant control over the business affairs of the partnership; if so, most courts have held such an investment is a security.<sup>27</sup> Texas law specifically defines any limited partnership interest as a security.<sup>28</sup> In summary, practitioners should begin with the rebuttable presumption that any investment vehicle is a security, and then determine which test applies.

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17. 421 U.S. 837, 840-42 (1975).

18. *Id.* at 847.

19. *Id.* at 840-42.

20. *See Reves v. Ernst & Young*, 494 U.S. 56 (1990).

21. *Id.* at 64.

22. *Id.* at 64-65.

23. *Id.* at 65.

24. *Id.* at 66-67.

25. 471 U.S. 681, 682 (1985).

26. *Id.*

27. *See e.g., Sampson v. Invest Am., Inc.*, 754 F. Supp. 928, 932-34 (D. Mass. 1990); *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 650 F. Supp. 1378, 1383-84 (W.D. Va. 1986), *affirmed*, 840 F.2d 236 (4th Cir. 1988).

28. TEX. REV. CIV. STAT. ANN. art. 581-4A (Vernon 1964 & Supp. 1995).

*B. Exempt Securities*

Section 3 of the Securities Act of 1933<sup>29</sup> defines exempt securities. Such securities are exempt from the filing of a registration statement with the SEC as required under section 5.<sup>30</sup> Exempt securities, however, whether exempt under federal or state law, are not exempt from the anti-fraud provisions of federal and Texas law.<sup>31</sup>

Exemptions are strictly construed against the party relying on the exemption<sup>32</sup> and there is a substantial burden for those seeking shelter.<sup>33</sup> The major exempt securities are: 1) securities guaranteed by the United States government, any state, any political subdivision of a state, or any bank; 2) industrial development bonds as defined by 103(c)(2) of the Internal Revenue Code; 3) any note, draft, bill of exchange, or banker's acceptance that arises out of a current transaction, or the proceeds of which have been used for a current transaction *and* which has a maturity not exceeding nine months; 4) securities issued by religious, educational, charitable, fraternal, or benevolent organizations, or for reformatory purposes *and* are not for pecuniary gain *and* no part of the net earnings inure to the benefit of any person; 5) securities issued by a savings and loan association that state or federal authorities supervise; 6) insurance contracts or annuity contracts issued by corporations subject to supervision of the insurance commissioner; and 7) securities offered and sold only to a person resident in a particular state *and* where the issuer is a resident of that state.<sup>34</sup> In addition, variable annuity contracts are not exempt under section 5.<sup>35</sup> However, variable annuity contracts may be exempt in Texas. Under article 581-4 the term security does not include "any insurance policy, endowment policy, annuity contract, or optional annuity contract."<sup>36</sup>

Furthermore, the Texas Securities Act does not exempt industrial revenue bonds, as defined by 103(c)(2) of the Internal Revenue Code. Nor does it exempt any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction, or the proceeds of which have been used for a current transaction and which has a maturity date not exceeding nine months.<sup>37</sup> Moreover, the fact that a federal statute exempts these two types of securities does not pre-

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29. 15 U.S.C. § 77c (1988).

30. *Id.*

31. *See* Forman v. Community Servs., Inc., 421 U.S. 837 (1975); Russell v. French and Assocs., Inc., 709 S.W.2d 312 (Tex. App.—Texarkana 1986, writ ref'd n.r.e.); TEX. ADMIN. CODE tit. 7, § 109.13(k)(12) (1995).

32. Chapman v. Dunn, 414 F.2d 153, 159 (6th Cir. 1969).

33. McDaniel v. Compania Minera Mar de Cortes, Sociedad Anonimo, Inc., 719 F. Supp. 152, 160 (D. Ariz. 1981).

34. 15 U.S.C. § 77c (1988).

35. SEC v. United Benefit Life Ins. Co., 387 U.S. 202, 211-12 (1967).

36. TEX. REV. CIV. STAT. ANN. art. 581-4A (Vernon 1964 & Supp. 1995).

37. *Id.* art. 581-5.

empt Texas from requiring registration at the state level.<sup>38</sup> In Texas, unless these two types of securities can be sold in an exempt transaction, or otherwise meet the definition of some other exemption, they will require state registration. Most federally exempt securities listed under Section 3 are actually defined as exempt transactions in Texas under article 581-5.<sup>39</sup> Texas does have an exempt security section, article 581-6 of the Texas Securities Act, however, the legislature chose to define these securities as exempt transactions.<sup>40</sup> These securities are better defined as exempt securities because there are no limitations or guidelines placed on the actual selling transaction, which is common for the other transactional exemptions discussed below. Additionally, defining these securities as exempt under Texas law furthers the uniform regulation of securities between the state and federal governments. If it is determined an investment is a security, and does not fit the definition of an exempt security, the only remaining means of avoiding registration with the SEC or the State Securities Board is to determine if the security can be sold in an exempt transaction.

## II. EXEMPT TRANSACTIONS

Exempt transactions are sought when an issuer wishes to offer non-exempt securities. There are a number of potential alternative exempt transactions. Each issuer must examine its own specific needs to determine the best transactional exemption to employ. There are a number of factors to review in making this decision. For instance, the dollar amount of the offering, how the investors will be obtained (through general solicitations or private sales), whether the offerees and purchasers are located in a single state, the total number of potential offerees and ultimate purchasers, whether previous exempt transactions have been offered in preceding months, whether future exempt transactions will be offered in proceeding months, and the minimum amount of securities that can be purchased.

This article addresses the primary exempt transactions available under federal security laws and how Texas has restricted, or otherwise limited, exempt transactions through statutes enacted by the Texas legislature, and rules promulgated by the Texas Securities Board. An issuer must be cautious in fulfilling the requirements of both federal and state exemptions to avoid registration at both levels. The burden of proof is on the issuer of a security to prove exemption from registration under the Texas Securities Act.<sup>41</sup>

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38. 15 U.S.C. § 77r.

39. TEX. REV. CIV. STAT. ANN. art. 581-5 (Vernon 1964 & Supp. 1995).

40. *Id.* art. 581-6.

41. *See Jones v. Latham*, 671 S.W.2d 612 (Tex. App.—Eastland 1984, writ ref'd n.r.e.).

The three options available for the issuer seeking to offer exempt transactions are contained in Regulation D, or Reg D, as it is commonly called.<sup>42</sup> Rules 504, 505, and 506 are rules promulgated by the SEC providing safe harbors for offering securities under sections 3 or 4 of the Securities Act of 1933.<sup>43</sup>

#### A. Rule 504

Rule 504 is one of the simplest exemptions. It was amended in 1992 allowing for an offering of up to \$1,000,000 of securities without state registration, “less the aggregate offering price for all securities sold within the 12 months before the start of and during the offering of securities under this Rule 504, in reliance on any exemption under section 3(b), or violating section 5(a) of the Securities Act.”<sup>44</sup>

Prior to the 1992 amendment, Rule 504 allowed for an offering of up to \$1,000,000, but only with state registration.<sup>45</sup> The maximum offering without state registration was \$500,000.<sup>46</sup> The intent of the amendment was to provide an efficient, less costly manner of raising smaller sums of capital, and to defer to state law to protect investors.<sup>47</sup> Interstate sales are allowed under Rule 504. Rule 504 also allows for unrestricted solicitation and an unlimited number of subscribers. Furthermore, it permits free transferability of securities, and there are no restrictions on resales as with Rules 505 and 506.<sup>48</sup> As discussed below, Texas significantly restricts exemptions.

#### B. Texas Regulation of Rule 504 Offerings

Texas significantly limits the scope of Rule 504. Reg D does not relieve an issuer from complying with state regulations where an issuer markets its securities.<sup>49</sup> Statutorily, Texas limits the scope of Rule 504 by restricting exempt transaction sales made without any “public solicitation or advertisement” and limits the number of subscribers to 35.<sup>50</sup> The State Securities Board expounded upon article 581-5I(a) when it promulgated section 109.13 of the Texas Administrative Code.<sup>51</sup> The following are the regulations applicable to Rule 504 exemptions, if offered in the State of Texas.

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42. 17 C.F.R. § 230.504-506 (1994).

43. *Id.*

44. *Id.* § 230.504.

45. *Id.* § 230.504(b)(2)(i).

46. *Id.*

47. Release No. 6339, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,014 at 84,458 (Aug. 7, 1981).

48. 17 C.F.R. § 230.502; Freeport Resources, Inc., No-action letter from SEC (Dec. 9, 1982), N.6, at frame C9; Release No. 6455, Question (65), at 2637-14.

49. *Preliminary Note 2, Regulation D.*

50. TEX. REV. CIV. STAT. ANN. art. 581-5I(a) (Vernon 1964 & Supp. 1995).

51. TEX. ADMIN. CODE tit. 7, § 109.13(a)-(j) (1995).

1) There can be no public solicitation. There is no public solicitation if all the investors are well informed and sophisticated, and have a relationship with the issuer such as a close business relationship or family member. For an investor to be well informed requires a prospectus or offering memorandum to set forth the plan of business, the history of the issuer, the financial statements of the issuer, and any material facts necessary to assure that the prospectus or offering is not misleading. The prospectus or offering memorandum must be provided to an investor prior to the investor's purchase of the securities.<sup>52</sup> The following three factors must be considered in determining whether an investor is a sophisticated investor: a) whether the proposed investment exceeds 20% of the investor's net worth; b) whether the investor generally has knowledge of the securities markets and the investment; and c) whether the investor has any experience and skill in investments based on actual participation. An investor's purchaser's representative may meet this requirement if the purchaser's representative has no business relationship with the issuer, represents the investor and not the issuer, and is compensated only by the investor.<sup>53</sup>

2) No advertisements. The offering must be made without advertisements. A prospectus or offering memorandum is not considered an advertisement pursuant to this offering as long as several conditions are met: a) there is limited printing of the prospectus; b) distribution of the prospectus is limited only to sophisticated investors, or to persons who have a relationship with the issuer; c) there is control of the printing and distribution of the prospectus; and d) there are prohibitions printed on the front of the prospectus in large type stating the prospectus is for the investor's confidential use only and may not be reproduced and a further warning that any action to the contrary of these restrictions could place the investor in violation of the Texas Securities Act.<sup>54</sup>

3) Number of investors. Section 109.13(C) sets forth the manner in which the number of investors is to be calculated.<sup>55</sup> This section allows for certain closely related individuals to be counted as one investor.<sup>56</sup> In *Nicholas v. Crocker*, the Tyler Court of Appeals held the sale of working interests in oil and gas leases were exempt from registration where the total number of sales for each well was less than 35, even though there were more than 35 separate sales of working interests in wells located in the same oil and gas field.<sup>57</sup>

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52. *Id.* § 109.13(a)(1).

53. *Id.* § 109.13(a)(2)(A)-(C).

54. *Id.* § 109.13(b).

55. *Id.* § 109.13(c).

56. *Id.*

57. *Nicholas v. Crocker*, 687 S.W.2d 365, 369 (Tex. App.—Tyler 1984, writ ref'd n.r.e.).



4) Limitation on resale. The issuer, and any person acting on the issuer's behalf, has an affirmative duty to exercise reasonable care to assure the purchasers are purchasing the securities for their personal investment and not for resale. Reasonable care is determined by reviewing the following five criteria which are not exclusive: a) whether reasonable inquiry was made to assure the purchaser is acquiring these securities for his personal investment; b) whether a legend was placed on the certificates acknowledging the securities have not been registered under any security laws and making reference to the restriction on transfer of the securities; c) whether stop transfer instructions were issued to the issuer's transfer agent; d) whether there was a signed representation from the purchaser that the securities would not be sold without first obtaining registration or another exemption; e) whether written disclosure to the purchaser was made acknowledging that the purchaser bears the significant economic risk of not being able to sell the securities for an extended period of time due to the restriction on resale.<sup>58</sup>

5) Annual limit on non-accredited purchasers. There can be no more than 35 non-accredited purchasers during any 12 month period.<sup>59</sup>

### C. Rule 505

Rule 505 allows the offering of \$5,000,000 in securities less the aggregate amount of all securities offered within the 12 month period before and during the current offering pursuant to section 3(b), or in violation of section 5(a).<sup>60</sup> Under Rule 505, the total number of purchasers is limited to 35.<sup>61</sup> However, there is an objective safe haven in the event the issuer surpasses the 35 subscriber limit. If the "issuer reasonably believes that there are no more than 35 purchasers," then the Rule 505 exemption is not forfeited.<sup>62</sup> Of course, this is always a question of fact.

Rule 505 incorporates the Rule 502 limitation on general solicitations of securities.<sup>63</sup> General solicitation under Rule 502 includes, but is not limited to, the following: 1) any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media, or broadcast over television or radio; and 2) any seminar or meeting whose attenders have been invited by general solicitation or general advertising.<sup>64</sup> Nevertheless, Rule 135(c)<sup>65</sup> provides an oppor-

58. TEX. ADMIN. CODE tit. 7, § 109.13(j)(1)-(5) (1995).

59. *Id.* § 109.13(l)(7).

60. 17 C.F.R. § 230.505(b)(2)(i) (1994).

61. *Id.* § 230.505(b)(2)(ii).

62. *Id.*

63. *Id.* § 230.505(b).

64. *Id.* § 230.502(c)(1)-(2).

65. *Id.* § 230.135 et seq.

tunity for the issuer to publish a limited notice of the offering if the terms of the rule are followed precisely.<sup>66</sup>

Rule 505 provides for limitations on the resale of securities.<sup>67</sup> The exemption under Rule 505 only applies to issuers, and not to underwriters or resalers.<sup>68</sup> The issuer has an affirmative duty to exercise reasonable care to assure that the purchasers of the securities from the issuer are not underwriters pursuant to section 2(11) of the Securities Act of 1933.<sup>69</sup> Rule 502 provides guidelines for reasonable care to be taken by an issuer: 1) the issuer must make reasonable inquiry of the purchaser to determine if the purchaser is acquiring the securities for himself or for other persons; 2) the issuer must provide written disclosure to each subscriber prior to the sale indicating that the securities have not been registered with the SEC, *and* that the securities cannot be resold unless the securities are registered with the SEC, *or* unless an exemption from registration is available; and 3) the issuer must place a legend on the actual stock certificates or other documents evidencing ownership in the securities stating that the securities have not been registered with the SEC, and setting forth the restrictions on transferability and resale of the securities.<sup>70</sup>

#### D. Texas Regulation of Rule 505 Offerings

Texas has adopted Rule 505 in order to comply with uniform regulation of securities with the SEC.<sup>71</sup> In adopting Rule 505, Texas sets forth the following conditions and limitations:

1) No commission can be paid to any person for soliciting subscribers unless such person is duly registered in Texas.<sup>72</sup> A violation of this requirement is defensible if the issuer “sustains the burden of proof to establish” it did not know, and in the exercise of reasonable care, could not have known the person who received a commission was not duly registered in Texas.<sup>73</sup>

2) There is a general provision precluding any issuer that is a bad person from qualifying for an exemption pursuant to section 109.13(k)(2).<sup>74</sup> There is a bad person’s exception if the person subject to disqualification is duly registered to conduct “securities related business” in Texas.<sup>75</sup> The Texas Securities Commissioner can waive any disqualification cause pursuant to section 109.13(k)(2).<sup>76</sup>

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66. *Id.* § 230.135(c).

67. *Id.* § 230.502(d).

68. *Id.*

69. *Id.*

70. *Id.* § 230.502(d)(1)-(3).

71. TEX. ADMIN. CODE tit. 7, § 109.13(k) (1995).

72. *Id.* § 109.13(k)(1).

73. *Id.*

74. *Id.* § 109.13(k)(2)(A)-(C),(E).

75. *Id.* § 109.13(k)(3).

76. *Id.* § 109.13(k)(4).

3) Form D,<sup>77</sup> that must be filed with the SEC within 15 days of the first sale, must also be filed with the State Securities Board within 15 days after receipt of consideration.<sup>78</sup> Unlike the SEC filing, the Texas Securities Board requires a filing fee to be paid in the amount of 1/10th of 1% of the aggregate amount of securities being offered for sale (not actually sold), up to a maximum of \$500.<sup>79</sup> The State Securities Board has held in at least one opinion the requirement to file Form D with the State Securities Board is required to perfect the Texas exemption.<sup>80</sup>

4) Either one of the following criteria must be met for all sales to non-accredited investors, or the issuer must have “reasonable grounds to believe and after making reasonable inquiry shall believe” one of the following criteria is met: a) the investment must be suitable for the purchaser. If the investment does not exceed 10% of the investor’s net worth, it will be presumed suitable; or b) the investor must have the knowledge and experience to be capable of evaluating the merits and risks of the investment. A purchaser’s representative may meet this exception.<sup>81</sup>

5) Failure to comply with one of the preceding requirements will not cause a loss of the exemption, if the issuer relying on the exemption shows one of the following: a) the failure to comply did not pertain to a term or requirement directly intended to protect the particular investor; or b) the failure to comply was insignificant with respect to the offering as a whole; or c) the issuer made a good faith and reasonable attempt to comply with the above provisions.<sup>82</sup>

6) All sales to non-accredited investors must comply with section 109.13(a)(1) requiring a prospectus or offering memorandum in a fair and actual presentation to disclose the plan of business, the history, and the financial statements of the issuer, including any material facts necessary to make the prospectus or offering memorandum not misleading.<sup>83</sup>

7) Rule 505 offerings cannot be combined with other offers or sales exempt under any other rule or section of the Texas Securities Act.<sup>84</sup>

8) Generally nothing in this transactional exemption can be construed to relieve an issuer from the affirmative duty of providing adequate disclosure to prospective investors to satisfy the anti-fraud provisions of the Texas Securities Act.<sup>85</sup>

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77. *Id.* § 109.13(k)(5).

78. *Id.* § 109.13(k)(5)(A).

79. *Id.* § 109.13(k)(5)(D).

80. Great Southwest Energy, Inc., Docket No. 90-016, Order No. CD-893, (Tex. State Sec. Bd. Feb. 8, 1991).

81. TEX. ADMIN. CODE tit. 7, § 109.13(k)(6) (1995).

82. *Id.* § 109.13(k)(7).

83. *Id.* § 109.13(k)(8).

84. *Id.* § 109.13(k)(9).

85. *Id.* § 109.13(k)(12).

*E. Rule 506*

Rule 506 allows for securities of unlimited dollar amounts. There can be an unlimited number of accredited investors, and 35 non-accredited investors, or investors who either alone, or with a purchaser's representative, have the ability and experience necessary to evaluate the investment.<sup>86</sup> Although the same limitation applies to Rule 506 in Texas, in limiting the total number of investors to 35, the Texas limitation is less stringent than the express provisions in Rule 506, therefore, the federal rule controls.<sup>87</sup>

Rule 506 employs an objective test to determine whether an issuer reasonably believes the purchaser meets the qualification requirements prior to the transaction.<sup>88</sup> If the purchaser, in fact, is not an accredited investor, or otherwise meets the exception to an accredited investor, the issuer can attempt to show good faith reliance based on the facts available at the time prior to the transaction.<sup>89</sup>

Rule 506 incorporates the Rule 502 limitation on general solicitations of securities.<sup>90</sup> Rule 502 general solicitations include, but are not limited to, the following: "(1) any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and (2) any seminar or meeting whose attenders have been invited by any general solicitation or general advertising."<sup>91</sup> Rule 135(c) provides an opportunity for an issuer to publish a limited notice of the offering, if the terms of the rule are followed precisely.<sup>92</sup>

Rule 506 provides for limitations on the resale of securities. An exemption under Rule 506 only applies to issuers and not to underwriters or resalers.<sup>93</sup> The issuer has an affirmative duty to exercise reasonable care to assure that the purchasers of the securities from the issuer are not underwriters pursuant to section 2(11) of the Securities Act of 1933.<sup>94</sup> Rule 502 provides guidelines for reasonable care to be taken by the issuer by setting forth the following criteria: 1) the issuer must make reasonable inquiry of the purchaser to determine if the purchaser is acquiring the securities for himself or for other persons; 2) the issuer must provide written disclosure to each subscriber prior to the sale indicating the securities have not been registered with the SEC *and* the securities cannot be resold unless the securities are registered with the SEC, *or* unless an exemption from registration is avail-

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86. 17 C.F.R. § 230.506 (1994).

87. TEX. REV. CIV. STAT. ANN. art. 581-7 (Vernon 1964 & Supp. 1995); 17 C.F.R. § 230.506 (1994).

88. 17 C.F.R. § 230.506 (1994).

89. *Id.* § 230.506.

90. *Id.* § 230.502, 505.

91. *Id.* § 230.502.

92. *Id.* § 230.135(c).

93. *Id.* § 230.502.

94. *Id.*

able; and 3) the issuer must place a legend on the actual stock certificates or other documents evidencing ownership in the securities stating the securities have not been registered with the SEC, and setting forth the restrictions on transferability and resale.<sup>95</sup>

#### F. Texas Regulation of Rule 506 Offerings

Texas has adopted Rule 506 in order to comply with the uniform regulation of securities by the SEC.<sup>96</sup> In adopting Rule 506, Texas sets forth the following conditions and limitations:

1) No commission can be paid to any person for soliciting subscribers unless such person is duly registered in Texas.<sup>97</sup> A violation of this requirement is defensible if the issuer “sustains the burden of proof to establish” it did not know and in the exercise of reasonable care could not have known the person who received a commission was not duly registered in Texas.<sup>98</sup>

2) There is a general provision precluding any issuer that is a bad person from qualifying for the exemption pursuant to section 109.13(k)(2).<sup>99</sup> There is a bad person’s exception if the person subject to disqualification is duly registered to conduct “securities related business” in Texas.<sup>100</sup> In addition, any disqualification cause pursuant to section 109.13(k)(2) can be waived by the Texas Securities Commissioner upon a showing of good cause.<sup>101</sup>

3) Form D must be filed with the SEC within 15 days of the first sale and must be filed with the State Securities Board within 15 days after receipt of consideration.<sup>102</sup> Unlike an SEC filing, the Texas Securities Board requires a filing fee to be paid in the amount of 1/10th of 1% of the aggregate amount of securities being offered for sale (not actually sold), up to a maximum of \$500.<sup>103</sup> The State Securities Board held in one opinion the requirement to file Form D with the State Securities Board is required to perfect the Texas exemption.<sup>104</sup>

4) One of the following criteria must be met for all sales to non-accredited investors, or the issuer must have reasonable grounds to believe, and after making reasonable inquiry shall believe, one of the following criteria is met: a) the investment must be suitable for the purchaser. If the investment does not exceed 10% of the investor’s net worth, it is presumed suitable; or b) The investor must have the

95. *Id.* § 230.504.

96. TEX. ADMIN. CODE tit. 7, § 109.13(k) (1995).

97. *Id.* § 109.13(k)(1).

98. *Id.*

99. *Id.* § 109.13(k)(2).

100. *Id.* § 109.13(k)(3).

101. *Id.* § 109.13(k)(4).

102. *Id.* § 109.13(k)(5).

103. *Id.* § 109.13(k)(5)(D).

104. See *Great Southwest Energy, Inc.*, Docket No. 90-016, Order No. CD-893 (Tex. State Sec. Bd., Feb. 8, 1991).

knowledge and experience to be capable of evaluating the merits and risks of the investment. A purchaser's representative may meet this exception.<sup>105</sup>

5) Failure to comply with one of the preceding requirements will not cause a loss of the exemption, if the issuer relying on the exemption shows one of the following: a) the failure to comply did not pertain to a term or requirement directly intended to protect the particular investor; b) the failure to comply was insignificant with respect to the offering as a whole; or c) the issuer made a good faith and reasonable attempt to comply with the above provisions.<sup>106</sup>

6) All sales to non-accredited investors must comply with section 109.13(a)(1)<sup>107</sup> requiring a prospectus or offering memorandum, in a fair and actual presentation, to disclose the plan of business, the history and the financial statements of the issuer, including any material facts necessary to make the prospectus or offering memorandum not misleading.<sup>108</sup>

7) Rule 506 offerings cannot be combined with other offers or sales exempt under any other rule or section of the Texas Securities Act.<sup>109</sup>

8) Generally nothing in this transactional exemption can be construed to relieve an issuer from the affirmative duty of providing adequate disclosure to perspective investors to satisfy the anti-fraud provisions of the Texas Securities Act.<sup>110</sup>

Rule 508 grants issuers additional leeway by holding insignificant deviations from the provisions of Rules 504, 505, or 506 will not cause the exemption to fail if the following conditions exist: 1) the deviation did not pertain to a requirement directly intended to protect the particular investor; 2) the deviation was insignificant when the offering was viewed as a whole; and 3) the issuer made a good faith and reasonable attempt to comply with all of the requirements of the appropriate rule.<sup>111</sup>

Any offering made pursuant to Rule 504, 505, or 506 must file a Form D with the SEC within 15 days after the first sale of securities.<sup>112</sup> Five copies of Form D must be filed, and one copy of every notice on Form D must be manually signed by a person duly authorized to sign on behalf of the issuer.<sup>113</sup> In addition to the Rule 508 insignificant deviation outlined above, the preliminary notes to Reg D hold:

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105. TEX. ADMIN. CODE tit. 7, § 109.13(k)(6) (1995).

106. *Id.* § 109.13(k)(7).

107. TEX. ADMIN. CODE tit. 7, § 109.13(a)(1) (1995).

108. *Id.* § 109.13(k)(8).

109. *Id.* § 109.13(k)(9).

110. *Id.* § 109.13(k)(12).

111. 17 C.F.R. § 230.508 (1994).

112. *Id.* § 239.500.

113. *Id.*

Attempted compliance with any rule and Regulation D does not act as an exclusive election; the issuer can also claim the availability of any other applicable exemption. For instance, an issuer's failure to satisfy all the terms and conditions of Rule 506 shall not raise any presumption that the exemption provided by §4(2) of the act is not available.<sup>114</sup>

Registering the offering with the State Securities Board can circumvent most of the limitations and restrictions promulgated by the State of Texas for Reg D offerings.<sup>115</sup>

### III. EXEMPT TRANSACTIONS OTHER THAN REG D

In addition to the Reg D Rules 504-506, congressional enabling legislation contained in the Securities Act of 1933 provides transactional exemptions.<sup>116</sup> As previously noted, the SEC promulgated Reg D to provide issuers with safe harbors on which to rely.

#### A. Section 4(6) of the Securities Act of 1933

Section 4(6) of the Securities Act of 1933 allows for the offer and sale by an issuer of up to \$5,000,000 of securities.<sup>117</sup> There can be no advertising or public solicitation in connection with a transaction under this section by the "issuer or anyone acting on the issuer's behalf."<sup>118</sup> Section 4(6) allows for an unlimited number of accredited investors to purchase the offering.<sup>119</sup> As with Reg D offerings, Form D must be filed with the SEC within 15 days of the first sale of securities.<sup>120</sup>

As with other exempt transactions, Texas significantly restricts sales pursuant to this federal exemption. Unless state registration is obtained, section 4(6) offerings are subject to article 581-5(I)(a), and the Texas Administrative Code section 109.31(a)-(j) as discussed under Rule 504 above.<sup>121</sup>

#### B. Intrastate Offerings

Section 3(a)(11) of the Securities Act of 1933<sup>122</sup> provides for the offering of securities, in an unlimited amount, if "offered and sold only to persons resident within a single state" where the issuer is a resident of such state and doing business therein, or if the issuer is a corpora-

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114. *Preliminary Notes, Regulation D.*

115. TEX. REV. CIV. STAT. ANN. art. 581-7 (Vernon 1964 & Supp. 1995).

116. 15 U.S.C. § 77d (1988).

117. *Id.* § 77c(b).

118. *Id.* § 77d.

119. *Id.*

120. 17 C.F.R. § 239.500 (1994).

121. TEX. REV. CIV. STAT. ANN. art. 581-5(I)(a) (Vernon 1964 & Supp. 1995); TEX. ADMIN. CODE tit. 7, § 109.13(a)-(j) (1995).

122. 15 U.S.C. § 77c(a)(11) (1988).

tion, if the corporation is incorporated and doing business in the state.<sup>123</sup>

The SEC has promulgated Rule 147<sup>124</sup> to aid issuers in complying with this intrastate offering. Rule 147 does not preclude an offering pursuant to section 3(a)(11) of the Securities Act of 1933 in the event the issuer fails to satisfy all of the provisions of Rule 147.<sup>125</sup>

Rule 147 is strictly applied against the issuer. All terms and conditions of the rule must be satisfied for the exemption to be available.<sup>126</sup> Persons claiming an exemption pursuant to the rule possess the burden of proof that they have satisfied all of the provisions of the rule.<sup>127</sup> If the issuer is a corporation, Rule 147 sets forth specific requirements for the issuer to be considered a resident of the state or doing business in the state.<sup>128</sup> Offers and sales of securities made pursuant to Rule 147 must only be made to persons resident within the state.<sup>129</sup>

Rule 147 contains an express limitation on resales of securities sold pursuant to its provisions:

During the period in which securities that are part of an issue are being offered and sold by the issuer, and for a period of nine months from the date of the last sale by the issuer of such securities, all resales or any part of the issue, by any person, shall be made only to persons resident within such state or territory.<sup>130</sup>

By the express provisions of Rule 147, the issuer must take affirmative actions to avoid the interstate sale of securities.<sup>131</sup> The issuer must place a legend on the certificate denoting the securities have not been registered, and setting forth the limitations on resale as outlined above,<sup>132</sup> give the issuer's transfer agent stop transfer instructions so that the transfer agent does not allow the securities to be transferred in an interstate transaction,<sup>133</sup> and obtain written representations from the subscribers as to their residence.<sup>134</sup>

### *C. Texas Regulation of Intrastate Offerings*

Intrastate offerings are not exempt under the Texas Securities Act, but are exempt pursuant to the Texas Administrative Code, if ten specific conditions are met.<sup>135</sup> These conditions are as follows:

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123. *Id.*

124. 17 C.F.R. § 230.147.

125. *Id.* § 230.147 (Preliminary Notes) (1994).

126. *Id.* at Preliminary Note 3.

127. *Id.*

128. *Id.* § 230.147(d)(1-3).

129. *Id.* § 230.147(d).

130. *Id.* § 230.147(e).

131. *Id.* § 230.147(d).

132. *Id.* § 230.147(f)(1)(i).

133. *Id.* § 230.147(f)(1)(ii).

134. *Id.* § 230.147(f)(1)(iii).

135. TEX. ADMIN. CODE tit. 7, § 109.13(l) (1995).



1) The offering must be made by the issuer and not a resaler or underwriter.<sup>136</sup> The State Securities Board is presented with a request for a no-action letter wherein the general partner of a Texas limited partnership wishes to purchase the remaining unsubscribed limited partnership units, and subsequently sells those limited partnership units to prospective investors “who [meet] the same suitability standards as required by the original offering memorandum.”<sup>137</sup> In *Bellaire General Hospital, Ltd. and Proposal Offering by Amisub (Bellaire), Inc.*,<sup>138</sup> the State Securities Board held the general partner did not meet the definition of issuer of the securities and therefore denied the no-action letter.<sup>139</sup>

2) The sale must be made without any public solicitation or advertisements to no more than 35 non-accredited investors, plus an unlimited number of accredited investors.<sup>140</sup>

3) Neither the issuer nor the registered dealer can be a bad person pursuant to the provisions contained in section 109.13(l)(2), (3), (4) and (5).<sup>141</sup>

4) There can be no public solicitation. An issue does not involve public solicitation if all of the investors are well informed and sophisticated, or well informed investors who have a relationship with the issuer such as a close business relationship or family member. For an investor to be well informed requires a prospectus or offering memorandum to set forth the plan of business, the history of the issuer, the financial statements of the issuer, and any material facts necessary to determine the statements contained therein are not misleading and must be provided to the investor prior to the investor’s purchase of the securities.<sup>142</sup> The following factors must be considered to determine whether an investor is a sophisticated investor: a) whether the investor’s proposed investment is not material when compared to the investor’s total net worth. If the investment does not exceed 20% of the investor’s net worth, it is presumed that it is not material; b) whether the investor generally has knowledge of the securities markets and the investment; and c) whether the investor has experience and skill in investments based on actual participation. This requirement may be met if the purchaser’s representative has no business relationship with the issuer, and represents the investor, and not the issuer, and is compensated only by the investor.<sup>143</sup> Additionally, per-

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136. *Id.* § 109.13(l).

137. *Bellaire Gen. Hosp., Ltd. & Proposed Offering by Amisub (Bellaire), Inc.*, 1989 WL 407256 (Tex. State Sec. Bd. Mar. 1, 1989).

138. *Id.*

139. *Id.*

140. TEX. ADMIN. CODE tit. 7, § 109.13(l)(1)(A)-(B) (1995).

141. *Id.* § 109.13(l)(2-5).

142. *Id.* § 109.13(l)(6).

143. *Id.* § 109.13(l)(6) (referring to *Id.* § 109.13(a)(1) and (2)).

sons who are defined as accredited investors in section 9 below are sophisticated investors.<sup>144</sup>

5) The intrastate offering must be made without advertisements. A prospectus or offering memorandum is not considered an advertisement pursuant to this offering as long as several conditions are met: a) there is limited printing of the prospectus; b) distribution of the prospectus is limited only to sophisticated investors, or to persons who have a relationship with the issuer; c) there is control of the printing and distribution of the prospectus; and d) there are prohibitions printed on the front of the prospectus in large type stating the prospectus is for the investor's confidential use only and may not be reproduced, and further warning any action to the contrary of these restrictions could place the investor in violation of the Texas Securities Act.<sup>145</sup>

The Dallas Court of Appeals held in *Sibley v. Horn Advertising, Inc.*<sup>146</sup> an offering memorandum explaining the issuer's business and proposed method of financing, along with a sales brochure prepared for mailing to prospective customers, complied with section 109.13.<sup>147</sup> However, *Sibley* should not be relied upon outside of its context. *Sibley* involved a favorable fact situation to the issuer where there were no more than 20 offerees of the prospectus and sales brochure.<sup>148</sup> The *Sibley* court distinguished *Tumblewood Bowling Corp. v. Maise*,<sup>149</sup> where there was an offering to a large number of potential purchasers. Both cases were decided prior to the enactment of the Texas Administrative Code § 109<sup>150</sup> and should be impliedly overruled by the same.

6) Number of investors. Section 109.13(c)<sup>151</sup> sets forth the manner in calculating the number of investors. This section allows for closely related individuals to be counted as one investor.

7) Limitation on resale. The issuer and any person acting on the issuer's behalf have an affirmative duty to exercise reasonable care to assure the purchasers are purchasing the securities for their personal investment and not for resale. Reasonable care is determined by reviewing the following five criteria which are not exclusive: a) whether reasonable inquiry was made to assure the purchaser is acquiring these securities for his personal investment; b) whether a legend was placed on the certificate to the effect that the securities have not been

144. *Id.* § 109.13(l)(6).

145. *Id.* (referring to *Id.* § 109.13(b)).

146. 505 S.W.2d 417 (Tex. Civ. App.—Dallas 1974, writ ref'd n.r.e.) *cert. denied*, 420 U.S. 929 (1975).

147. *Id.*

148. *Id.* at 420.

149. 388 S.W.2d 479 (Tex. Civ. App.—Beaumont 1965, writ ref'd n.r.e.).

150. Act of Apr. 30, 1975, 64th Leg., R.S. ch. 79, 1975 Tex. Gen. Laws 208.

151. TEX. ADMIN. CODE tit. 7, § 109.13(l)(6) (1995) (referring to *Id.* § 109.13(c)); See *Nicholas v. Crocker*, 687 S.W.2d 365, 369 (Tex. App.—Tyler 1984, writ ref'd n.r.e.).

registered under any security laws and making reference to the restriction on the transfer of the securities; c) whether stop transfer instructions were issued to the issuer's transfer agent; d) whether a signed representation from the purchaser of the securities was obtained stating that the securities are not to be sold without first obtaining registration or another exemption; and e) whether written disclosure to the purchaser to the effect that the purchaser acknowledges that the purchaser must bear the significant economic risk of not being able to sell the securities for an extended period of time due to the restriction on resale.<sup>152</sup>

8) There can be no more than 35 non-accredited purchasers during any 12 month period.<sup>153</sup>

9) Filing requirements. Form 133.29 must be filed with the State Securities Board "not less than 10 business days before any sale claimed to be exempt under this subsection."<sup>154</sup> There is a filing fee for Form 133.29 in the amount of 1/10th of 1% of the aggregate amount of securities being offered for sale (not actually sold), to a maximum of \$500.<sup>155</sup> Notice is not required if the securities sold pursuant to this intrastate exemption are sold through security dealers registered in Texas.<sup>156</sup>

10) Accredited investors. Section 109.13(1)(11) defines accredited investors as any bank, insurance company, employee benefit plan, any organization meeting the definition of section 501(c)(3) of the Internal Revenue Code with assets in excess of \$5,000,000, any insider of the issuer, any person who purchases \$150,000 of the securities offered, if the purchase price does not exceed 20% of the purchaser's net worth, any person whose net worth is in excess of \$1,000,000, and any person whose income exceeds \$200,000 for the previous two years and who reasonably expects an income in excess of \$200,000 for the current year.<sup>157</sup>

#### IV. CONCLUSION

The advantages to issuing an exempt security as opposed to issuing a non-exempt security in an exempt transaction in Texas are significant. A majority of the regulatory requirements outlined above can be avoided. However, exempt securities are limited, and only available normally to a select group of issuers. Overlapping federal and state rules and regulations make this an area requiring knowledge, compliance, and accurate record keeping by the issuer. Remember the burden of proof is on the person seeking the exemption.

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152. TEX. ADMIN. CODE tit. 7, § 109.13(l)(6) (1995) (referring to *Id.* § 109.13(j)).

153. *Id.* § 109.13(l)(7).

154. *Id.* § 109.13(l)(9).

155. *Id.*

156. *Id.* § 109.13(l)(8).

157. *Id.* § 109.13(l)(11).