PRACTICAL CONSIDERATIONS FOR REGISTERING SECURITIES PURSUANT TO THE TEXAS SECURITIES ACT

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BIOGRAPHICAL INFORMATION

GENERAL

Ryan Cox is an associate in the Corporate Practice Group of Haynes and Boone where he focuses primarily on general corporate and securities law matters and mergers and acquisitions. Ryan specifically focuses his practice on the representation of publicly traded and privately held companies, public and private equity transactions, SEC reporting and compliance and corporate governance. He has also assisted public and private companies in connection with mergers and acquisitions, divestitures, recapitalizations and restructurings.

MEMBERSHIPS AND HONORS

- Member of the State Bar of Texas (admitted in 2005)
- Selected for inclusion in Texas Super Lawyers – Rising Stars Edition 2010 & 2011

EDUCATION

- J.D., Southern Methodist University Dedman School of Law, 2005, *cum laude*, Order of the Coif, Associate Managing Editor, *International Law Review Association*
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I. INTRODUCTION

Prior to adoption of the National Securities Markets Improvement Act of 1996 ("NSMIA"),[1] many practitioners routinely wrestled with state securities laws (commonly referred to as "blue sky" laws) in conjunction with a proposed offering of securities regardless of whether such offering was registered under the federal Securities Act of 1933 (the "Securities Act"). Since 1996, however, the blue sky analysis has been simplified considerably because of NSMIA's preemption of state regulation as it relates to certain "covered" securities. As a result, many securities practitioners have little experience when it comes to registering securities pursuant to the Texas Securities Act. This article provides an analysis of the state registration process in Texas and issues frequently encountered.

II. WHEN IS STATE REGISTRATION REQUIRED?

NSMIA amended Section 18 of the Securities Act to prohibit states from regulating or otherwise imposing any conditions (other than a notice filing in certain cases) or disclosure requirements on, or conducting a merit review of, offerings of "covered securities."[2] The "covered security" definition is sufficiently broad enough to allow many customary transactions to escape the reach of state regulation. Nevertheless, private and non-listed issuers desiring access to capital within the state of Texas should, in addition to complying with the applicable federal securities laws, routinely evaluate the facts and circumstances of their proposed offering to ensure that: (1) state registration is preempted by NSMIA or (2) such offering is properly exempted from registration in accordance with the Texas Securities Act.

A. "Covered Securities" Preempted by NSMIA

The crux of the federal preemption of state law lies in the definition of "covered securities." This term refers to certain securities that are exempt without regard to the persons or transactions involved as well as to specified categories of transactions. The term "covered security" is defined in Section 18 of the Securities Act to include:

- Exchange-Listed Securities – Securities listed, or authorized for listing, on the New York Stock Exchange, NYSE Euronext or The NASDAQ Stock Market;
- Securities of Registered Investment Companies – Securities issued by an investment company that is registered under the Investment Company Act of 1940;
- Sales to "Qualified Purchasers" – Securities offered or sold to certain qualified purchasers, as defined by the Securities and Exchange Commission (the "SEC") by rule;[3]
- Secondary Market Transactions – Transactions in securities that are exempt from registration under federal law pursuant to Sections 4(1) and 4(3) of the Securities Act, provided that the issuer of the security files reports with the SEC pursuant to Sections 13 or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act");
- Section 3(a) Exempt Securities and Transactions – Most securities and transactions that are exempt from registration under federal law pursuant to Section 3(a) of the Securities Act; and
- Rule 506 Securities – Securities that are issued pursuant to a transaction that is exempt from registration under federal law pursuant to Rule 506 of the Securities Act, provided that this particular category of the covered security definition permits states to impose certain notice filing requirements.

Rule 506 of the Securities Act is a heavily relied upon preemptive provision because, so long as the prescribed conditions are satisfied, it provides public and private companies with safe harbor protection from the registration provisions of the Securities Act without regard to the dollar amount raised in the offering. Among other things, Rule 506 limits these "private placements" to 35 non-accredited investors. Importantly, the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") may impact an issuer's ability to rely on Rule 506 because it: (1) modified the definition of "accredited investor" in a manner that makes it more difficult for individuals to qualify and (2) requires the SEC to adopt rules restricting certain "bad actors" from

[1] National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3435 (Oct. 11, 1996).

[2] 15 U.S.C. § 77r (2010).

[3] In late 2001, the SEC proposed but has not yet adopted a definition based on the definition of "accredited investor" in Rule 501 promulgated pursuant to the Securities Act.

selling securities pursuant to Rule 506.[4] As a result of these modifications, state registration is expected to become increasingly relevant.

B. Exemptions from Registration Provided by the Texas Securities Act

Section 7.A(1) of the Texas Securities Act provides that "[n]o dealer or agent shall sell or offer for sale any securities … until the issuer of such securities or a dealer registered under the provisions of this Act shall have been granted a permit by the [Texas] Securities Commissioner."[5] It is important to note that offers and sales of securities by an issuer or its selling agent to non-Texas residents not present in Texas when the offer is made are exempt from the registration provisions of the Texas Securities Act.[6] Section 5 of the Texas Securities Act also sets forth more than 20 transactional exemptions and authorizes the Texas State Securities Board (the "Board") to adopt additional exemptions by rule, regulation or order. The burden of proof of any exemption is upon the issuer claiming it. Several commonly relied upon exemptions are briefly described below:

- Accredited Investor Exemptions – Texas has adopted accredited investor and "individual accredited investor" exemptions that cover offers and sales by the issuer or a registered dealer without advertising (other than certain limited advertisements) of any security to an accredited investor or an "individual accredited investor," as applicable.[7] Board rules define accredited investor by cross reference to Rule 501(a) of the Securities Act and "individual accredited investor" by cross reference to the accredited investor definition for natural persons in Rule 501(a)(5) and (a)(6) of the Securities Act (as amended by Dodd Frank).[8]
- Limited Offering Exemptions – Texas has adopted three limited offering exemptions:
  (1) Sales of any security by an issuer so long as the total number of security holders of the issuer does not exceed 35 persons (in certain cases excluding security holders that are accredited investors) after taking such sale into account;[9]
  (2) Sales of any security by an issuer during any 12 month period to not more than 15 persons (excluding accredited investors and purchasers of securities pursuant to certain other exempt transactions);[10] and
  (3) Offers and sales of securities in compliance with Rule 505 of the Securities Act (which is limited to not more than 35 non-accredited investors and $5.0 million in any 12 month period), provided that certain additional Texas-specific conditions are satisfied.[11]
- Existing Security Holder Exemption – Offers to and transactions with one or more of the issuer's existing security holders are exempt.[12]
- Exemption for Compensatory or Benefit Plans – Sales and distributions by an issuer (including a participating subsidiary) pursuant to a bona fide thrift, savings, stock purchase, retirement, pension, profit-sharing, option, bonus, incentive or similar written compensation plan or written compensation contract for the benefit of the issuer's (or its subsidiary's) employees, directors, general partners, managers, officers, consultants or advisors providing bona fide services are exempt.[13]
- Exemption for Mergers, Consolidations and Sales of Assets – The issue or sale of securities by one corporation to another corporation or the security holders thereof pursuant to a vote by one or more classes of such security holders, as required by the certificate of incorporation or the applicable corporate statute, in connection with a merger, consolidation or sale of assets are exempt.[14] In addition, securities issued by a parent corporation for outstanding securities or the assets of a corporation in connection with a merger of such

[4] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 413 & 926, 124 Stat. 1376, 1577-78, 1851 (2010).

[5] TEX. REV. CIV. STAT. ANN. art. 581-7.A(1) (Vernon 1964 & Supp. 2010).

[6] 7 TEX. ADMIN. CODE § 139.7 (West 2010). An issuer or selling agent who makes offers or sales from Texas may, however, be subject to the dealer registration requirements of the Texas Securities Act. *Id.*

[7] 7 *See id.* §§ 139.16 & 139.19.

[8] *See id.* § 107.2(40) – (42).

[9] *See* TEX. REV. CIV. STAT. ANN. art. 581-5.I(a) & 7 TEX. ADMIN. CODE § 109.13(l)(10).

[10] TEX. REV. CIV. STAT. ANN. art. 581-5.I(c).

[11] 7 TEX. ADMIN. CODE § 109.13(k).

[12] *Id.* § 109.1.

[13] TEX. REV. CIV. STAT. ANN. art. 581-5.I(b).

[14] *Id.* art. 581-5G.

corporation into a wholly-owned or materially-owned (80%) subsidiary are exempt.[15]

- Exemption for Stock Dividends and Stock Splits – The distribution by a corporation of securities directly to its security holders as a stock dividend, stock split, reverse stock split or other distribution paid out of earnings or surplus is exempt.[16]
- Exemption for Resales under Rule 144 and Rule 145(d) – Resales of any security by the owner thereof that are made in compliance with Rule 144 or Rule 145(d) of the Securities Act are exempt.[17]

In the event an offering does not fit within the preemptive provisions of NSMIA and an exemption from registration under the Texas Securities Act is not available, it is likely that such offering must be registered with the Board. Section 7 of the Texas Securities Act affords an issuer the option of registration by notification, coordination or qualification. Registration by notification is the easiest of these three options followed by registration by coordination. These two options should be ruled out first before undertaking the process of registering an offering by qualification. Registration by qualification is the most cumbersome option and is the focus of this article.

C. Registration by Qualification

Similar to the federal securities laws, the Texas Securities Act and applicable Board rules require an issuer to provide investors with full and fair disclosure of all material facts about the issuer and the securities offered. Texas securities laws, however, also regulate specific substantive terms of the offering and require the Board to deny any offering where the proposed plan of business of the issuer appears to be "unfair, unjust or inequitable."[18] This merit review process is employed to prevent unfair, oppressive and sometimes fraudulent securities from being offered within the state. As discussed further in Part IV below, areas of substantive regulation include:

- Voting and other rights of the securities being offered;
- Investor suitability;
- Sales commissions and other offering expenses;
- Cheap stock held by "promoters;"
- Affiliate transactions;
- Investments by promoters; and
- Offerings of "insolvent" issuers.

Merit reviews are often unpredictable and the Board has ample latitude to determine which aspects of an offering to review. As a result, the issuer and its counsel are wise to address the implications of state registration early in the planning stages of the offering and should expect the unexpected.

III. PLANNING FOR AND MANAGING THE REGISTRATION PROCESS

Administration of the Texas Securities Act is vested in the Board. The Board maintains a professional staff of attorneys, accountants and financial examiners and is perceived as one of the preeminent state securities regulators in the country. While an issuer will benefit from working with the Board's knowledgeable staff, it should nevertheless allocate significant time to the registration process. As with SEC registration, Texas registration often takes longer than expected.

At the outset of an offering and immediately after it is determined that state registration is required, an issuer should engage legal counsel that has experience with the state registration process. The issuer and its counsel should initially identify any potential issues or "deal killers" that may arise as a result of certain of the more restrictive Texas regulations. Many problems can be avoided by considering the fundamental regulatory requirements early, thus avoiding last minute modifications to the terms of the offering and costly delays. An experienced practitioner can often anticipate the Board's objections to the terms of a proposed offering and may be able to assist the issuer in restructuring the offering to accommodate the Board's position while maintaining the issuer's desired results. Alternatively, a practitioner can help the issuer prepare a persuasive cover letter to accompany the registration application that addresses any issues that may be regarded as problematic and provides justification for deviating from the requirements of an established Board policy or rule.

An issuer can also eliminate unnecessary delays by making certain that all required applications, forms and other required documents are fully and accurately submitted. See Part VI below for a list of documents and fees frequently required in conjunction with applications for registration in Texas. If an application is incomplete in any way, within seven days of receipt of the application, the Board is required to send the issuer a deficiency letter setting forth a list of items that have not been filed and that, pursuant to requirements of the Texas Securities Act or Board

[15] 7 TEX. ADMIN. CODE § 109.1.

[16] TEX. REV. CIV. STAT. ANN. art. 581-5.D.

[17] 7 TEX. ADMIN. CODE § 139.13.

[18] TEX. REV. CIV. STAT. ANN. art. 581-10.A.

rules, must be filed.[19] If the issuer can afford some additional expense, it is best to send all filings and any amendments or other documents to the Board by courier service.

Within 45 days of receipt by the Board of all required documents, the Board is required to review the application and send an initial comment letter setting forth deviations from the substantive requirements of the Texas Securities Act or Board rules.[20] Legal counsel is often helpful in facilitating and expediting the Board review process. In some cases, counsel may even reach out to a Board examiner before an application is filed. This can be helpful if questions arise prior to the filing or if the issuer simply wants to inform the Board that the application is forthcoming. If the Board raises an issue concerning the terms of the offering, the issuer and its counsel should determine whether to modify the terms of the offering to accommodate the Board's comment or otherwise attempt to overcome the Board's comment by providing justification for the issuer's offering terms. It is important to recognize that this process can be a negotiation and that the Board has sufficient authority to make compromises. In any event, the issuer should promptly respond to all correspondence from the Board.

Within 21 days of receipt by the Board of a complete application and the issuer's response to all Board comments, the Board examiner is required to make a recommendation to the director (or assistant director) of the registration division of the Board and the Texas Securities Commissioner to either grant, deny or allow withdrawal of the application.[21] The final decision must then generally be made and communicated to the issuer within 14 days.[22]

If the offering goes as planned, the Board will grant the issuer a permit authorizing it to issue and dispose of the registered securities. Registration approval usually occurs by telephone with written confirmation to follow. As indicated in the sections below, Board approval is not the end of the registration process and Texas securities laws impose numerous post-effective burdens on the issuer. An issuer and its counsel should prepare a calendar identifying the required post-registration filings and other obligations. In the event that the issuer's registration is rejected by the Board or the Board imposes conditions that an issuer is unwilling to accept, the issuer should withdraw its application.

[19] 7 TEX. ADMIN. CODE § 104.4(a).

[20] 7 TEX. ADMIN. CODE § 104.4(b).

[21] *Id.* § 104.4(e).

[22] *Id.* § 104.4(g).

IV. COMMON REGULATORY OBSTACLES

Although the hurdles imposed by Texas securities laws will vary depending on the business of the issuer and the type of security involved, an issuer is strongly encouraged to review the North American Securities Administrators Association ("NASAA") Statements of Policy (the "Statements of Policy"), most of which have been adopted by the Board.[23] Particular attention is directed to the Omnibus Guidelines, which apply to offerings for which a "specialized" Statement of Policy has not been adopted. Several common regulatory obstacles imposed by Texas securities laws are discussed below.

A. Financial Statements

An issuer is required to submit a balance sheet prepared in accordance with generally accepted accounting principles ("GAAP").[24] The balance sheet must reflect all assets and liabilities of the issuer as well as the financial condition of the issuer not more than 90 days prior to the date the financial statement is filed with the Board. The issuer is also required to submit a detailed income statement prepared in accordance with GAAP covering the last three years of the issuer's operations (or if the issuer has been in business less than three years, then the period that the issuer has been in business). Except as set forth below, all financial statements submitted to the Board must be audited and include an opinion of the issuer's independent certified public accountant.[25]

If the issuer's application for registration is filed more than 90 days after the end of its fiscal year, then the balance sheet (which must be as of a date not more than 90 days prior to the date of filing) is not required to be certified by an independent certified public accountant if the issuer also submits the certified balance sheet as of the end of the preceding fiscal year. For certain small business offerings up to $500,000, required financial statements may be reviewed by an independent certified public accountant in accordance with the Statements on Standards for Accounting and Review Services, issued by the American Institute of Certified Public Accountants, in lieu of being audited.[26]

Following completion of the offering, the issuer is also generally required to provide its investors with

[23] *See* 7 TEX. ADMIN. CODE § 113.14. *See also NASAA Statements of Policy/Model Rules, available at* http://www.nasaa.org/industry___regulatory_resources/corporation_finance/1248.cfm.

[24] TEX. REV. CIV. STAT. ANN. art. 581-7.A(1)(f)(1).

[25] 7 TEX. ADMIN. CODE § 113.5.

[26] *Id.* § 113.(5)(c)-(d).

semi-annual and annual reports. The semi-annual report should be provided to investors within 60 days of the end of the first six months of each fiscal year and consist of unaudited financial statements for the period then ended, which should include a balance sheet, income statement, statement of stockholders' equity, statement of cash flows and other pertinent material regarding the issuer's business during the period covered by the semi-annual report.[27] The annual report should be provided to investors within 120 days of the end of the issuer's fiscal year and consist of audited financial statements for the period then ended and other pertinent material regarding the issuer's business during the period covered by the annual report.[28]

In addition to the financial statements required of the issuer, corporate and/or partnership "sponsors" (*i.e.,* the general partner of a limited partnership) may be required to submit an audited (and, if applicable, unaudited) balance sheet in conjunction with the offering.[29] Certain experience, net worth and other financial conditions and reporting obligations may also be required of such sponsors.[30]

B. Broker-Dealers

Section 12.A of the Texas Securities Act provides that any person, firm, corporation or dealer must be registered in the state of Texas in order to offer for sale, sell or make a sale of any securities in the state. As a result, in order for an issuer to offer or sell its securities in Texas, it must either register as a broker-dealer (commonly referred to as an issuer/dealer) or enlist the services of a broker-dealer registered in Texas.

The services of a broker-dealer in this instance can be expensive and may not be readily available because of the duties imposed on the broker-dealer by applicable Texas securities laws. Alternatively, if an issuer wishes to register as an issuer-dealer, it is required to submit the following documents to the Board:

- A Form BD and a filing fee of $275 – This form requires the issuer to disclose background information, including management policies that direct the company; the names of executives, directors, general partners and/or principal security holders; and any current legal proceedings or previous security law-related violations.
- A Form U4 and a filing fee of $285 for each officer or director that intends to participate in the issuer's selling efforts for the offering – This form requires these persons to disclose background information, including any past criminal history, regulatory violations, employment and other business experience. In addition, each officer or director filing a Form U4 must also submit to the exam requirements listed in Board rule 115.3. A partial waiver of the exam requirements is afforded to applicants who are officers, partners or employees of an issuer if the issuer's securities will be registered for sale only in Texas. These applicants are only required to pass an examination on state securities law.[31]
- The name of a "control person" to be registered as the designated principal of the issuer. One control person of a corporation, limited liability company or partnership must be registered, even if none is actively engaged in securities activities under the registration.

These broker-dealer requirements are critical because sales effected by unregistered agents may be subject to rescission, which could nullify the entire purpose of the offering.

C. Voting Rights

Texas securities laws require that the voting rights of equity securities being offered to the public at least equal those of all other classes of authorized or outstanding equity securities unless any inequality is otherwise justified.[32] Preferential rights to dividends or distributions or special rights upon liquidation may justify unequal voting rights. In a partnership context, the partnership agreement is required to provide at least majority voting protection to amend the partnership agreement, dissolve the partnership, remove the general partner (or for the general partner to withdraw voluntarily), appoint a new general partner and approve or disapprove of any proposed merger or sale of all or substantially all of the partnership's assets.[33] In addition, the general partner and its affiliates may not vote partnership interests owned by them with respect to any vote to remove the general

[27] *See* NASAA's Omnibus Guidelines § VI.C.2, *available at* http://www.nasaa.org/content/Files/Omnibus_Guidelines.pdf.

[28] *Id.* § VI.C.3.

[29] *Id.* § VIII.C.2.

[30] *Id.* § II.

[31] *See* 7 TEX. ADMIN. CODE § 115.3(b)(4)

[32] *See id.* § 113.4(b)(11).

[33] *See* the NASAA's Omnibus Guidelines § VI.B, *available at* http://www.nasaa.org/content/Files/Omnibus_Guidelines.pdf.

partner or any transaction between the partnership and the general partner.[34]

D. Investor Suitability

If an issuer intends to offer securities to non-accredited investors, it should be aware that Texas securities laws may impose minimum income and net worth standards. For instance, section III of the Omnibus Guidelines (applicable to most offerings by non-corporate issuers) requires the "sponsor(s)" of the offering to propose minimum income and net worth standards that are reasonable in light of the business of the issuer and the associated risks. These standards will then be subject to review and approval by the Board. The Omnibus Guidelines further provide that unless the Board determines that the risks associated with the offering would permit lower standards, each investor must have a minimum annual gross income of $70,000 and a minimum net worth of $70,000 or, alternatively, have a minimum net worth of $250,000.[35] Net worth is determined exclusive of an investor's home, home furnishings and automobiles.

The issuer and each person participating in the selling efforts for the offering (*i.e.*, any broker-dealer) are also required to make every reasonable effort to determine that the securities offered are a suitable and appropriate investment for each prospective purchaser. This determination must be made based on information obtained from the investors. Applicable Texas regulations impose an affirmative obligation on the issuer and its agents to elicit specific information from prospective investors and prohibit the issuer from shifting subjective and unreasonable burdens to the investors through the representation and warranty provisions of the subscription agreement.[36]

E. Sales Commissions and Other Offering Expenses

Texas securities laws also impose limits on offering expenses, including underwriter compensation. Section 9.B of the Texas Securities Act prohibits total expenses for marketing securities, including all commissions for the sale of such securities, and all of the incidental selling expenses, from exceeding, in the aggregate, 20 percent of the gross proceeds from the offering.[37] Section 9.B further provides the Board with authority to impose additional limitations on these expenses if, in its opinion, it is fair, just and equitable under the facts of the particular offering. In addition to underwriters' commissions, selling expenses would include accounting and legal fees, printing costs, registration and other filing fees.

Specific limitations are also imposed on certain types of offerings. For instance, the Board may deny any registration of corporate securities if the underwriting expenses exceed 17 percent of the gross proceeds from the offering or if selling security holders are offering more than 10 percent of the securities for sale in the offering.[38] In this context, underwriting expenses would include commissions, the value of any warrants or rights of first refusal issued or payable to the underwriters and any solicitation, consulting or finders' fees.[39]

F. Cheap Stock Held by Promoters

By adoption of the NASAA's Statement of Policy Regarding Promotional Shares, the Board maintains authority to reject offerings where the "promoters" of the issuer hold a significant amount of cheap stock. "Promoters" generally include the persons and entities that founded or control the issuer as well as the issuer's officers, directors and 5 percent shareholders.[40] Cheap stock is defined as equity securities issued to (or to be issued to) these promoters within the last three to five years for consideration that is less than the proposed offering price.[41] In offerings where cheap stock has been issued, the Board may require the issuer to cause all cheap stock to be placed in an escrow account, subject to an "earn-out" procedure that can last as long as five years.[42]

G. Transactions with Affiliates/Promoters

Because of the potential for conflicts of interest, Texas securities laws are skeptical of transactions between an issuer and its affiliates and often require such transactions to be fully disclosed, restructured or

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[34] *Id*.

[35] *Id.* § III.B.

[36] *See id.* § III.C-D.

[37] TEX. REV. CIV. STAT. ANN. art. 581-9.B.

[38] NASAA' Statement of Policy Regarding Underwriting Expenses and Underwriter's Warrants § III, *available at* http://www.nasaa.org/content/Files/UNDERWRITING_EXPENSES.pdf.

[39] *See* NASAA' Statement of Policy Regarding Corporate Securities Definitions § II.Z, *available at* http://www.nasaa.org/content/Files/DEFINITIONS_SOP_2008.pdf.

[40] *Id.* § II.O.

[41] *See id.* § II.R & NASAA's Statement of Policy Regarding Promotional Shares § III.A, *available at* http://www.nasaa.org/content/Files/PROMOTIONAL_SHARES.pdf. For purposes of determining the consideration paid by promoters, non-cash consideration is excluded unless the Board approves the valuation thereof. *Id.*

[42] NASAA's Statement of Policy Regarding Promotional Shares § IV.

eliminated in connection with a registered offering. For instance, unless the issuer is a bank or other financial institution, loans (or loan guarantees) to the issuer's promoters are permissible only if they relate to ordinary business expenditures or purchases of equity of the issuer.[43] If non-permissible loans exist at the time of the application for registration, they must either be repaid before the offering, from proceeds of the offering (if a portion of the offering is made on behalf of the promoters) or after the offering based on an amortization schedule approved by the Board.[44] Affiliate transactions must be fully disclosed in the prospectus (or other offering document).

As a general rule, offerings should be structured in a manner that minimizes the potential for conflicts of interest between management and those investors with whom a fiduciary relationship is appropriate. If an issuer has a history of making loans to, or entering into material transactions with, its promoters, the issuer may be required to reserve at least two seats on its board of directors (or other governing body) to be filled by disinterested or independent directors. Such independent directors would have full access to separate legal counsel and would be required to approve affiliate transactions by at least a majority vote.[45]

H. Investments by Promoters

Texas securities laws expect an issuer's promoters to have a reasonable equity investment in the issuer. Promoter investment requirements are typically imposed on start-up or development stage companies, and the minimum investment can vary depending on the size of the offering.[46] Promoters of an offering are generally required to provide up to 10 percent of the total equity capital at the conclusion of an offering, which investment may take the form of cash contributions, retained earnings or contributed assets. Contributed assets, however, must be valued by a qualified independent appraiser.

I. "Insolvent" Issuers

The Board may deny the application for registration of any offering by an "insolvent" issuer. For these purposes, an issuer is insolvent if it: (i) has an accumulated deficit, (ii) has negative shareholders' equity, (iii) has negative cash flows, (iv) has a going concern qualification in its audit report or (v) is unable to satisfy current obligations as they come due.[47] An issuer falling into this category will have to prove to the Board that it has a long-term business plan for improving its financial condition and becoming profitable. If the Board permits the offering to move forward, it will likely impose additional investor suitability and disclosure requirements on the issuer's offering.[48]

V. DISCLOSURE REQUIREMENTS

As previously indicated, similar to the federal securities laws, the Texas Securities Act and Board rules require an issuer to provide investors with full and fair disclosure of all material facts about the issuer and the securities comprising the offering. This affirmative duty of disclosure is present regardless of whether an offering is registered or if an exemption from registration is available.

Full disclosure of information to prospective investors in an offering is typically presented in a document called a prospectus in the case of a public offering or private placement memorandum or offering circular in the case of an offering made pursuant to an exemption. This document is often the primary means through which information about the issuer is communicated to prospective investors and helps to ensure that the issuer's disclosure to prospective investors remains consistent. The offering document also has the added benefits of creating a record of regulatory compliance and can protect the issuer from future disputes with disgruntled investors. Although Texas securities laws may require disclosure in addition to those typically required by federal securities law requirements (see Part IV.G and IV.I above for examples), strict compliance with the federal registration forms and Regulations S-K and S-X is encouraged and will generally satisfy state regulations. This section summarizes some of the more common disclosure requirements.

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[43] NASAA's Statement of Policy Regarding Loans and Other Material Transactions § IV, *available at* http://www.nasaa.org/content/Files/LOANS_AND_OTHER_MATERIAL_TRANSACTIONS.pdf.

[44] *Id.* § V.

[45] *Id.* § VI.

[46] *See* NASAA's Statement of Policy Regarding Promoters' Equity Investment § III, *available at* http://www.nasaa.org/content/Files/PROMOTERS_EQUITY_INVESTMENT.pdf.

[47] NASAA' Statement of Policy Regarding Corporate Securities Definitions § II.X, *available at* http://www.nasaa.org/content/Files/DEFINITIONS_SOP_2008.pdf.

[48] NASAA's Statement of Policy Regarding Unsound Financial Condition §§ IV-V, *available at* http://www.nasaa.org/content/Files/UNSOUND_FINANCIAL_CONDITION_SOP_2008.pdf.

A. Description of the Issuer's Business

The offering document should describe the general development of the issuer's business, including when the issuer was formed, any bankruptcy or receivership proceedings and any material mergers, acquisitions or similar transactions. This description should specifically focus on the issuer's business during the past five years and include a description of: (i) the products or services it provides and the method of distribution of each, (ii) the sources and availability of any raw materials, (iii) whether it depends on one or a few major customers or suppliers, (iv) the location of its facilities, (v) trends in the industry and (vi) the effects of any government regulation of the issuer's business. For additional guidance, see Item 101 of Regulation S-K.[49]

B. Risk Factors

The offering document should also include a comprehensive listing of the material risks to prospective investors in the offering. These factors will vary depending upon the issuer and the nature of its business and may include risks such as a lack of operating history, inexperienced management, lack of liquidity, competition, conflicts of interest, significant litigation and the absence of a trading market for the issuer's securities. These risks should be organized in order of significance and the risk factor section is almost always located in the forefront of the offering document, immediately following the cover or the summary section.[50] Each risk factor caption should appear in italicized, bold-face or underlined type. An issuer should be careful to describe only risks that are material to the particular offering and should avoid generic, boiler-plate risk factors. Specific cross-references to detailed disclosure appearing elsewhere in the offering document can also enhance a prospective investor's understanding of these risks. For additional guidance on the preparation of risk factor disclosure, see the NASAA's Risk Disclosure Guidelines[51] and Item 503(c) of Regulation S-K.[52]

C. Use of Proceeds

The use of the funds to be received from the offering should be broken down with a high degree of specificity in the offering document. Categories of potential uses may include indebtedness, payroll, leases, utilities or prospective acquisitions. The issuer should estimate the amount to be used for each purpose and prioritize them by amount. An issuer is generally prohibited from reserving more than 15 percent of the proceeds for working capital or general corporate purposes (or for any other unspecified use).[53]

If an issuer intends to use any part of the proceeds to acquire property or businesses otherwise than in the ordinary course of business, the issuer must disclose the name and address of the seller(s), the purchase price, the name of any persons who received a commission in connection with the acquisition and the amount of such commission.[54] If an issuer plans to use any material part of the proceeds to repay indebtedness, the issuer must disclose the terms of the indebtedness (including the interest rate), whether the indebtedness includes unpaid salaries to promoters and, if the indebtedness was incurred during the current or previous fiscal year, how the issuer used the proceeds of the indebtedness.[55]

D. Key Personnel and Shareholders

The offering document should also identify the names, ages and relevant experience of all officers, directors or other individuals who direct the issuer's operations or otherwise make significant contributions to the business of the issuer as employees, independent contractors or consultants. It may also be necessary to disclose whether such individuals are parties to significant legal proceedings. In addition, the issuer should identify its principal shareholders, including the number and percentage of securities beneficially owned by each. For specific guidance regarding disclosures relating to key personnel and shareholders, see Item 401 and Item 403 of Regulation S-K.[56]

E. Financial Statements and Data

The financial information submitted to the Board in accordance with the requirements discussed in Part IV.A above should also be included in the offering document and provided to prospective investors. In addition, the issuer should expand upon these financial statements by including management's discussion and analysis, or "MD&A," of its results of operations. Tabular disclosure of the issuer's results of operations

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[49] 17 C.F.R. § 229.101 (2010).

[50] *See* NASAA's Statement of Policy Regarding

[51] NASAA's Risk Disclosure Guidelines, *available at* http://www.nasaa.org/content/Files/Risk_Disclosure.pdf.

[52] 17 C.F.R. § 229.503(c) (2010).

[53] NASAA's Statement of Policy Regarding Specificity in Use of Proceeds § VII, *available at* http://www.nasaa.org/content/Files/SPECIFICITY_IN_USE_OF_PROCEEDS.pdf.

[54] *See* NASAA's Statement of Policy Regarding Specificity in Use of Proceeds § V, *available at* http://www.nasaa.org/content/Files/SPECIFICITY_IN_USE_OF_PROCEEDS.pdf.

[55] *Id.* § VI.

[56] 17 C.F.R. § 229.401 & 403 (2010).

are also strongly encouraged. For additional information with respect to the preparation of the MD&A section, see Item 303 of Regulation S-K.[57]

VI. DOCUMENTS REQUIRED FOR REGISTRATION

This section contains a checklist of documents and other information frequently required in connection with an issuer's application for registration of securities pursuant to Section 7.A of the Texas Securities Act.

- Application for Registration of Securities (Form 133.7) – This form elicits basic information about the issuer and the proposed offering. It also identifies many of the other items required to be submitted by the issuer. The Board also accepts the uniform "Form U-1" in lieu of Texas Form 133.7.
- Power of Attorney (Form 133.8) – If the issuer is not organized under the laws of Texas, this form is required and allows for service of process upon the issuer by service upon the Texas Securities Commissioner as the attorney in fact for the issuer in any action against the issuer arising out of any transaction subject to the Texas Securities Act. The Board also accepts the uniform "Form U-2" in lieu of Texas Form 133.8.
- Organizational Documents – The issuer must submit copies of its charter or certificate of formation and all amendments thereto as well as copies of its bylaws, limited partnership or other operating agreement and all amendments thereto.
- Offering Agreements – The issuer must submit copies of any underwriting agreement, agreement among the underwriters and dealers and any firm offering price commitment from any managing underwriter.
- Prospectus or Offering Document – A preliminary prospectus or any other offering document should be submitted with the application. As discussed in Part V above, this offering document should contain detailed information about the issuer, its directors, officers, capitalization and planned use of proceeds. All changes or amendments to the offering document are also required to be submitted to the Board with changes, additions or deletions marked.
- Financial Statements – Audited or, in some cases, reviewed financial statements must be submitted to the Board. See Part IV.A of this article for a detailed description of the financial statements that are required. Where audited financial statements are required, the financial statements must be accompanied by an opinion of the issuer's independent certified public accountant.
- Opinion of Counsel – The issuer should submit any opinion of counsel as to the legality of the securities offered. This is typically only required in underwritten offerings or offerings that are also registered pursuant to the Securities Act.
- Cross-Reference Sheet – If an issuer's offering falls within the Omnibus Guidelines, the Mortgage Program Guidelines or the Statements of Policy Regarding Real Estate Investment Trusts, Real Estate Programs or Equipment Programs, it must provide a cross-reference sheet indicating compliance with such guidelines or statements of policy.
- Filing Fees – Section 35.A(1) of the Texas Securities Act requires an issuer to pay a $100 filing fee in connection with the submission of an application to register securities.[58] In addition, the issuer is required to pay an examination fee equal to 1/10 of 1 percent of the aggregate amount of the securities proposed to be sold.[59] All checks should be payable to the "State Securities Board."

VII. CONCLUSIONS

State registration may not be appropriate for all offerings and the complexity of this task will depend on numerous factors that can usually be identified with the assistance of experienced legal counsel. An issuer should never offer or sell securities in Texas unless such offering is first registered pursuant to Section 7 of the Texas Securities Act or unless an exemption from registration is available or such offering is otherwise preempted from state regulation by NSMIA. Failure to comply with Texas securities laws can lead to administrative, injunctive and criminal penalties. Also, any new application for registration by the issuer could be denied based upon a previous violation. While experience with the federal securities laws is helpful, it is important for the issuer and its counsel to appreciate the principles of fairness underlying the Texas laws and to be willing to accept a certain degree of unpredictability during the registration process. If these state law implications are considered early in the offering process, the issuer can avoid unnecessary expenses and costly delays.

[57] *Id.* § 229.303.

[58] TEX. REV. CIV. STAT. ANN. art. 581-35.A(1).

[59] *Id.* art. 581-35.B(2)