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Decoding the US Federal Securities Laws

Compliance and Ethics

As convoluted as the the US federal securities laws are, there is unfortunately no secret corporate counsel decoder ring to explain its complex scheme of statutes and implementing regulations. But this summary of the primary US securities laws and their application will help you to identify securities law issues before they become securities problems. We will briefly walk through the primary securities law regulators, the four primary federal securities law regimes, and provide some brief scenarios explaining where each may come into play.

The securities law regulators

The US Securities and Exchange Commission (SEC) is the primary federal regulator with broad authority to enforce the federal securities laws, and its disciplinary sanctions can be extremely costly to a company's reputation and bottom line. The SEC's primary deputy is the Financial Industry Regulatory Authority (FINRA). FINRA is a self-regulatory organization (SRO) that is subject to SEC oversight and is primarily tasked with regulating broker-dealers. Each state also has its own body of securities laws and its own securities law regulatory division, but for purposes of this discussion, we will focus on the federal securities laws.

What's a security?

Before we get into our overview of the federal securities laws, it's important to know that for any of these laws to apply there must be a "security." Conveniently, the term security is defined by statute. Inconveniently, the definition includes a broad list of products (e.g., notes, stocks, bonds, security futures, certificates of interest, investment contracts, and evidence of indebtedness) that are subject to extensive common law interpretation.

Although it can be complicated, the breadth is intentional. As the US Supreme Court stated in *SEC v. Howey* (1946), the breadth is meant to embody "a flexible, rather than static, principle." As a rule of thumb, if you're not a securities law practitioner and you find yourself questioning whether you have a security, it's probably time to find an expert.

Securities Act of 1933

If your company wants to raise capital by issuing a security like stock or bonds, then your first potential issue is the Securities Act of 1933. A securities offering must be registered under the Securities Act of 1933, or be exempt from registration. The registration requirements of the Securities Act are designed to ensure full and fair disclosure concerning the securities being offered for public sale.

The Act requires disclosures about the company whose securities are offered (e.g., information on financials and company executives), and prohibits fraud, deceit, and misrepresentations. The registration exemptions are limited to certain types of offerings and can be complex. If you get the analysis wrong, then the offering is illegal, so most companies without in-house securities counsel will use outside experts to conduct or confirm their analysis.

Securities Exchange Act of 1934

Let's say your company determines that it wants to raise capital by selling securities in compliance with the Securities Act of 1933. You will then need to consider the Securities Exchange Act of 1934. It provides the SEC with broad authority to regulate the securities markets and the various actors within it, including broker-dealers and public companies. Once you become a public company, you may need to comply with the periodic reporting requirements of the Exchange Act.

Additionally, you will want to ensure that you aren't inadvertently conducting broker-dealer activity. A broker-dealer is generally any person or entity engaged in the business of effecting securities transactions for their own account, or for the account of another. Broker-dealers are required to register with both the SEC and FINRA before operations begin. Be wary of transaction-based compensation — or compensation that is based on the size, value, or completion of a securities transaction — as it is regularly viewed as one of the hallmarks of broker-dealer activity and a determinative factor in the analysis of whether a company has triggered broker-dealer status.

Investment Advisers Act of 1940

Aside from guiding your company through the offer and sale of its own securities, there are still other potential securities law hurdles you may face. As the name suggests, the Investment Advisers Act of 1940 regulates investment advisers, which are generally defined as any person or entity that provides advice about securities to others for a fee.

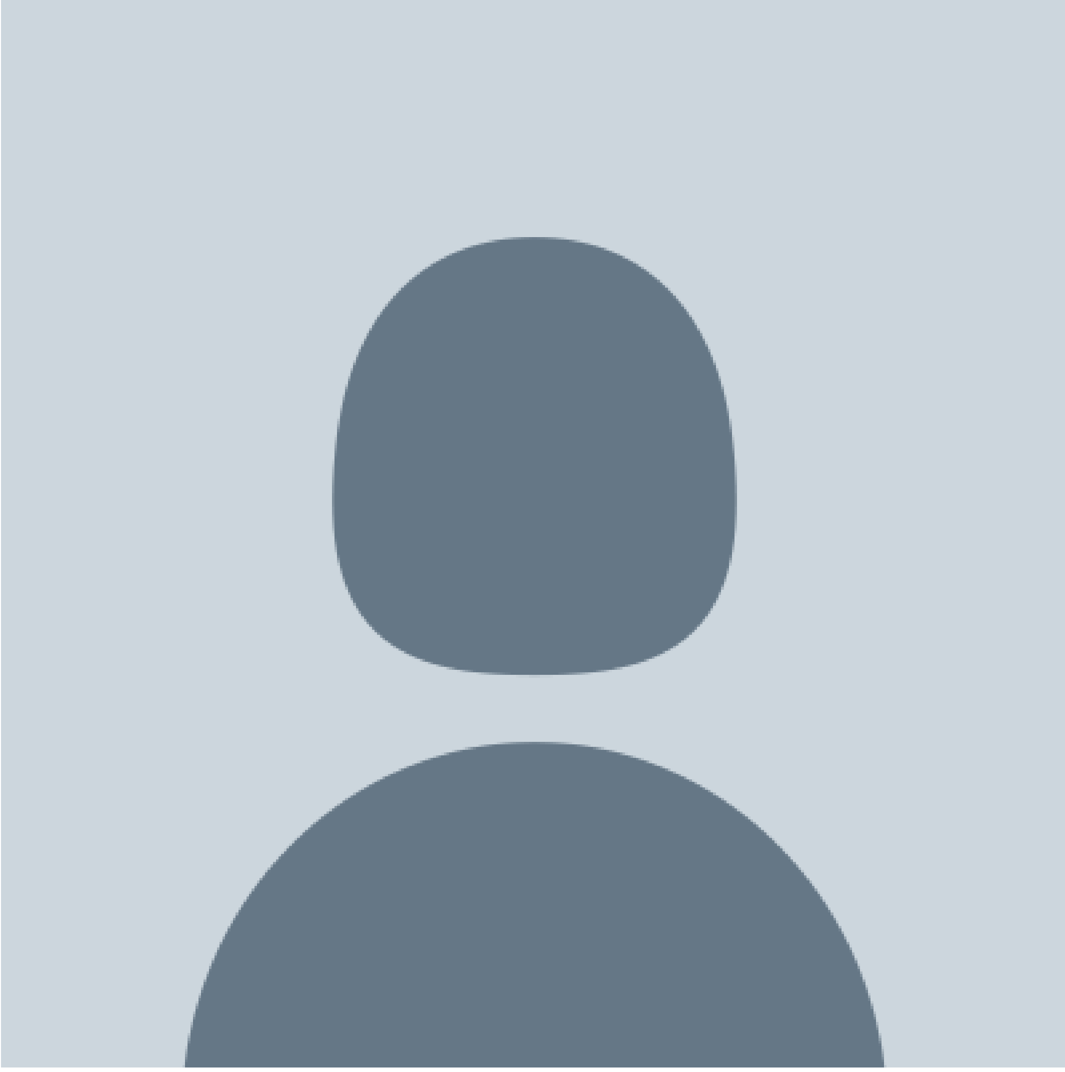
If your company decides to expand the business by issuing custom reports to clients on the securities markets, you should analyze such expansion carefully. While the investment adviser definition is commonly understood to capture money managers, investment consultants, and financial advisers, the definition can pull in other types of distinct business activities as well, such as certain research firms that are paid to issue reports or analyses about securities.

Investment Company Act of 1940

Finally, your company may have a retirement plan that includes available investments in mutual funds. These funds are regulated as "investment companies" under the Investment Company Act of 1940 and are subject to detailed registration, disclosure and periodic reporting requirements. What many companies don't realize is that the investment company definition is broad and it can be accidentally triggered.

For example, if your company is an issuer of securities, and it primarily engages or proposes to engage in the business of investing in securities, it may be an investment company. If the company owns or proposes to own investment securities with a value that exceeds 40 percent of the company's assets, it also may be an investment company. Accidentally becoming an investment company can be costly and complex to resolve, so it's best to avoid it before it happens.

Chris Chase



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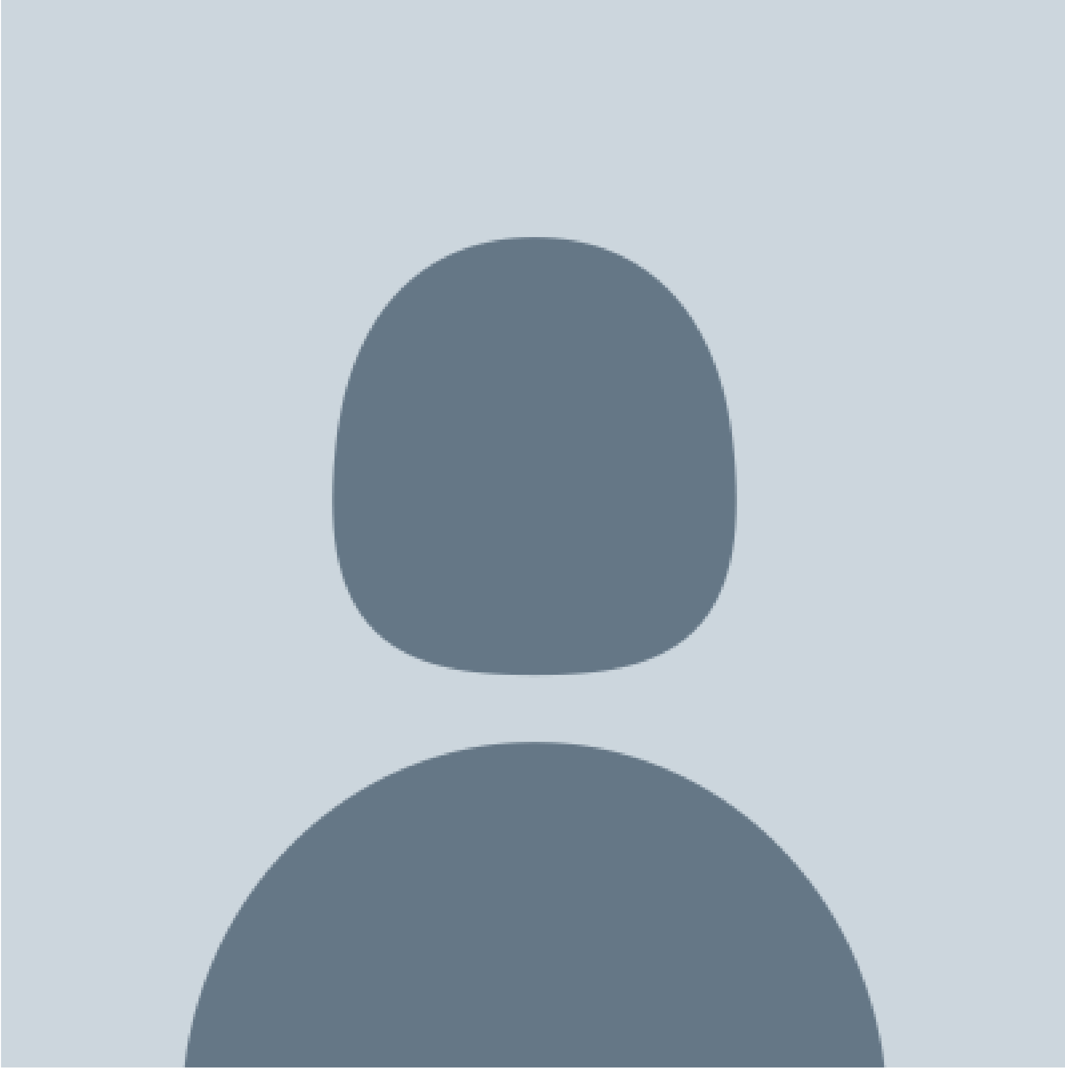

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