

## **Chapter 11**

# **SECURITIES REGULATION**

## **INTRODUCTION**

Raising capital is highly regulated in the United States and penalties for violating securities laws can be severe. However, the law does not create insuperable barriers to raising capital if the entrepreneur understands how it applies.

This chapter discusses federal securities law, the penalties for non-compliance, and exceptions or safe harbors in the law. Initial Public Offering (IPO's) will be discussed briefly in this chapter and more extensively in chapter 12 Initial Public Offerings. This chapter will also discuss private placements, which are much simpler than public offerings and are the vehicle used to raise capital from angel investors and venture capitalists.

This chapter will also discuss how to find SEC required forms and regulations and provide some information on the key elements of those forms. Regulatory filings are a function of the amount raised and the sophistication of the company's investors. Those defined as accredited investors are assumed at law to be sophisticated and this chapter will discuss how to tell whether an investor is accredited.

## **SECURITY DEFINED**

The Federal Securities Act of 1933, section 2(1) defines a security as:

“Any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in profit sharing agreement, collateral trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil...”<sup>1</sup>

and so forth for half a page. Almost any interest in anything can be construed as a security. The Securities Exchange Act of 1934 (SEA) has a similar definition of a security SEA section 3(a) (10)<sup>2</sup>.

The Securities Act of 1933 requires every new issue of securities to be registered. The Securities Exchange Act of 1934 requires that every corporation with assets of more than \$10 million, whose securities are held by more than 500 owners, shall make annual and other reports as outlined by the Act and by SEC regulations.<sup>3</sup> Unless otherwise indicated, section numbers in this chapter refer to sections in the Securities Act of 1933.

## **WHY ARE THERE SECURITIES LAWS?**

In the 1920s, companies sold stocks based on promises of enormous profits but with little information that investors could use to determine whether promises were reasonable. The frenzy of uninformed investment fueled speculation that led to the stock market crash of 1929. In response, Congress passed a number of laws requiring “full disclosure” of all “material facts,” about companies that people invest in. The two main laws were the Securities Act of 1933 and Securities Exchange Act of 1934, which are administered and enforced by the SEC. This regulatory scheme is not designed to evaluate the merit of an investment, but is only designed to make sure investors have the information to make their own judgment.<sup>4</sup>

## **WHY BOTHER WITH SECURITIES LAWS?**

Securities laws are complex and compliance is both time consuming and expensive, so why bother to comply? Section 12 of the 1933 Act imposes civil liability on sellers of securities under two independent circumstances:<sup>5</sup>