Chapter 1

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Federal Securities Laws

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This guide presents several financing options for farmers who intend to acquire capital from their existing customer base, neighbors, friends, family or others within their communities. Chapters 1 and 2 cover basic legal issues to consider before going too far down the road of choosing the right option(s), advertising the need for funding and crafting agreements with community capital partners. By becoming familiar with these issues, parties to financial transaction(s) might take steps to avoid the risk of expensive court actions from regulatory bodies, or prevent unnecessary litigation brought on by unsatisfied parties. The information provided is for educational purposes only, and does not substitute the need for representation by a qualified attorney.

The Securities Act of 1933 and the Securities Exchange Act of 1934 regulate the selling and trading of "securities" across state lines. The definition of "security" is broad and encompasses a variety of instruments and transactions. The term "security" in common parlance indicates stock, notes or bonds; but legally and theoretically, anything can be a security: stocks, promissory notes, distribution rights, chinchillas, whiskey warehouse receipts, and beavers. Anything that resembles an "investment contract" will be regulated as a security. **Many transactions and financial arrangements used to finance the Community Supported Farm *could* be considered securities, depending on how they are structured. It is therefore important for farmers to have an understanding of the laws in order to determine what steps to take to reduce legal liability potentiated by any given arrangement.**

In determining whether an instrument is a security, courts look beyond the name of the instrument. **The test is whether there is an investment of money in a common enterprise with profits to come solely from the efforts of others.**[1] The courts will look to the substance of the instrument, and apply what is referred to as the "economic reality" test. Merely labeling something a security or investment contract means less than how the instrument is actually used. Also relevant in determining if certain financing amounts to a security, the farm operation must consider the investor's overall participation. The instrument will less likely be considered a security if the investor has any level of managerial capacity in the business enterprise generating the returns. The decisive factor here is the investors' actual power to exercise managerial control, rather than their legal right to exercise their ability to be repaid. For example, general partnership interests, or active members and managers of a Limited Liability Company (LLC) carry the right to participate in management. They differ significantly from limited, investor partners, or passive members of an LLC, whose interests are more likely to be considered securities. The more active a limited partner in the operation, the less the chance their business transactions with the entity will meet the legal definition of security.

What's a "No-Action Letter"?

For a $250 filing fee, the securities division responds to a written request to determine whether the actions or transactions described amount to a security, or are otherwise compliant with the relevant securities laws. A No-Action Letter will be issued if the described activities do not amount to a violation of securities regulations. The letter provides that no action will be taken against the particular party in connection with the facts described in the written request. Reliance on the No-Action Letter may justify only the actions of the particular party addressed, and only insofar as the facts described in the request sufficiently describe the action taken.

Securities laws were intended to regulate transactions where marketing efforts and promotion attract otherwise passive investors, who rely on the expertise of the promoters or managers of the venture seeking investment.[2] Financial deals among a limited number of individuals, all with expertise in the field of the business, on the other hand, may be less likely to be characterized as securities transactions.

The general intent of federal securities regulation is to protect ordinary individuals from fraudulent investment claims. The regulations serve to:

- Identify certain investment transactions ("securities") in which the returns on investment to the investor depend on how others manage a business venture;
- Require that these types of transactions or "securities" be registered with the federal Securities and Exchange Commission (SEC). The registration process is designed to ensure that investors are provided full disclosure about the nature of the transaction or investment;
- Identify types of financial offerings that are exempt from the requirement to file registration with the SEC or appropriate state agencies; and
- Provide anti-fraud provisions that further protect investors.

1 S.E.C. v. W. J. Howey Co., 328 U.S. 293 (1946). This case established a four-point test to determine whether a transaction qualifies as a security as defined by the Federal Securities and Exchange Act of 1933. According to the "Howey Test," a security is any interest that involves (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profits, (4) that come solely from the efforts of others. "Investment" in this test means any instance in which money or capital has been expended or contributed. "Common enterprise" has been defined by courts in various ways, but generally means that the fate of the investor's return is linked to the fate of the business enterprise responsible for generating the returns.

2 Parker v. Broom, 820 F.2d 966 (8th Cir. 1987).

Offers or sales of financial transactions that meet the definition of "securities" must be registered with the SEC unless the transaction is exempt from the requirement to register according to Federal law.[3] For more information on the exemptions, see the section in Chapter 2 entitled, "Securities Registration Exemptions Most Applicable to the Small Farm."

Are CSA Membership Shares "Securities"?

Where Community Supported Agriculture (CSA) shares serve as prepayment for goods and services as opposed to a vehicle for earning the shareholder profit, they would typically not be considered securities. CSA's are common means through which farmers raise cash to cover operating expenses of furnishing products or services to the CSA membership. The farmer might also put the cash towards some capital expenses (e.g., fencing, barns or greenhouses) that are necessary for producing food. CSA membership fees used to cover these expenses enable "consumer consumption," which generally falls outside the umbrella of federal and state securities regulations.[4]

The most commonly used legal test for determining whether any type of transaction is a "security" is known as the ***Howey*** test.[5] It presents four criteria for making the determination. Courts examine whether there is a clear:

1) Investment of money
2) in a common enterprise,
3) with an expectation of profits, and
4) these profits derive solely from the promoter of the investment or another third party (in other words, from the efforts of someone other than the investor).

All four of the Howey test criteria must be met in order for the transaction to be defined as a security. "Investment" in this test means any instance in which money or capital has been expended or contributed.[6] "Common enterprise" has been defined by courts in various ways, but generally means that the fate of the investor's return is linked to the fate of the business enterprise responsible for generating the returns.[7] For example, in a "common enterprise," if the business does poorly, the investor does not receive as much as would otherwise be available if the business performed well.

It is clear that there are scenarios in which CSA shares *could* meet the criteria of the Howey test and trigger securities regulation. For example, if the agreement between the farmer and CSA member stated that the community member "invests" his or her money in the farm enterprise or there is a potential for "profit" above the share price in the form of food produced by the farmer's efforts, courts might deem the purchase of the CSA membership to be a security transaction. Even if the CSA share was found to be a security, there is a chance that the transaction is exempt from registration requirements (see Chapter 2: "Securities Registration Exemptions Applicable to Farms"), and the farmer could avoid the time and expense involved in registration or penalty fees for not following SEC or state securities requirements for registration. Nonetheless, making sure that any kind of CSA membership agreement clearly disclaims any sort of profit expectation and clearly affirms that the money is used for pre-purchase of goods and services might further reduce legal risk.

Another less frequently used legal test for determining whether a transaction meets the definition of security is the ***Risk Capital*** test.[8] This test has only been adopted by courts at the state level, and its statutory use is mandated in only a few states.[9] No courts in the Northeast have used the test, but could conceivably do so in the future. Hence it is worth mentioning here. The test is whether or not one party is putting capital **at significant risk for the "development" or start-up of the business** of another. The test was first used by the California Supreme Court, who found country club memberships to meet the SEC definition of securities because there was insufficient infrastructure in place to be able to provide the membership benefits, thereby putting the "member's" capital at enough risk to warrant the protections intended by SEC regulations. Theoretically, CSA memberships used to finance farm start-up could be treated similarly if courts were to use the Risk Capital test.

To summarize, to reduce the likelihood that a CSA share, membership or subscription will be viewed as a security, the farmer can emphasize that proceeds from the CSA will not be used to finance start-up costs, there is an opportunity for customers to pre-purchase food or services and **not invest in or loan to the farm business** (see Chapter 5 for a summary of the difference between a CSA and a loan).

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3 Registration should involve a legal expert. Following is a general list of filing requirements. Registration statements for federal securities generally are filed at the Security Exchange Commission's main office in Washington, D.C. The registration fee is 1/29th of one percent of the maximum aggregate price at which the securities are offered, but not less than $100, payable the time the registration statement is filed. In addition to payment of the registration fee, there are particular requirements as to the proper form of the statement. To ensure proper form of your particular statement, a professional opinion should be sought. But, before any of this, be sure what you have is a security.

4 JA Blomberg and HE Forcier, 2005. But Is It a Security? Business Law Today, American Bar Association Business Law Section's Online Resource. Volume 14, number 5. Accessed online 1/10/2012 at: http://apps.americanbar.org/buslaw/blt/2005-05-06/forcier.shtml.

5 S.E.C. v. W. J. Howey Co., 328 U.S. 293 (1946).

6 CJ Russ, 2010. What is a Security? Online newsletter, Business Law Section of the North Carolina Bar Association. Accessed online 1/10/2012 at http://businesslaw.ncbar.org/newsletters/nbinov2010/security.aspx.

7 R Borneman, 2005. Why the Common Enterprise Test Lacks a Common Definition: A Look Into the Supreme Court's Decision of SEC v. Edwards 5 U.C. Davis Business Law Journal 16. Accessed online 1/10/2012 at: http://blj.ucdavis.edu/archives/vol-5-no-2/Why-the-Common-Enterprise-Test.html.

8 The California Supreme Court in its 1961 case, Silver Hills Country Club v. Sobieski, is noted for creating the "risk capital" test .

9 According to Steinberg, author of Securities Regulation: Liabilities and Remedies (2005, American Lawyer Media, Inc., Law Journal Press, New York, New York), at least six states have adopted the "risk capital" test by statute: Alaska, Georgia, Michigan, North Dakota, Oklahoma and Washington; and at least four states have adopted the test by regulatory rule: New Mexico, North Carolina, Wisconson, Wyoming.

When a CSA is structured as a pre-purchase, the customer pays an agreed on price up front that will be applied to later purchases. In a sense, the pre-paid CSA share acts as a ***gift certificate*** to purchase future farm produce.

In certain situations the farmer may wish to provide a "bonus" or "incentive" to the pre-purchaser. To lessen the likelihood that this triggers securities laws, the bonus can be offered as a predetermined or specified amount rather than an open-ended potential for profit or gain. The bonus should be tied directly to the pre-purchase. For example, a farmer may provide a customer who buys a CSA share before May 1 a $50 bonus to apply to the customer's purchase. The pre-purchase price and any bonus credit are put towards the purchase of the farmer's produce, meats, etc., for the duration of the specified CSA share period.

There have been no court cases to date that call into question whether a farm CSA membership in particular situations should be treated as a security. When in doubt about how to interpret the laws, consult a qualified securities law attorney. For more information, including considerations for reducing risk when crafting CSA arrangements, see Chapter 9: "Multi-year CSA."

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