

## NAPLES ETHICS GROUP, LLC

*Solid Foundations for Professional Ethics*

September 23, 2013

Elizabeth M. Murphy, Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, D.C. 20549-1090

Re: File Number S7-06-13

Ladies and Gentlemen:

I am writing to propose comments on the Securities and Exchange Commission (the “Commission”) regarding the proposed amendments to Regulation D, Form D, that the Commission proposed in Release 33-9416 (the “Release”) issued on July 10, 2013. I am an expert in accounting ethics and the nature of professionalism in accountancy, and I am the author of two text books on these areas, used widely in college instruction, including most recently (with Mark Cheffers), *Accounting Ethics and the Near Collapse of the World’s Financial System* (Allen David Press, 2010). I am the founder and president of Naples Ethics Group, LLC. I consult as a Senior Research Analyst and Public Policy Analyst with the IVES Group, Inc., the parent company of Audit Analytics, which is the premier market intelligence service for the audit industry. I teach accounting ethics in the Boston Tax Institute, and I am a professor of philosophy at Ave Maria University in Naples, FL, and the author of several books and dozens of scholarly papers. The views expressed in this comment letter express only my views and not necessarily the views of any institution with which I am affiliated or any of its members.

### Request for Comment

My comments concern part II.D, “Proposed Amendments to the Content Requirements of Form D,” RFC (28):

Should we require issuers to provide additional information in Form D filings as we have proposed? Should this additional information be required only for Rule 506(c) offerings?

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If so, why and what should that information be? For example, should the Commission require issuers to provide information in Form D about counsel representing the issuer (if any) or the issuer's accountants or auditors (if any), as some have suggested? If the additional information were required only for Rule 506(c) offerings, what impact would this requirement have on the use of Rule 506(c) as compared to the use of Rule 506(b)? ... Would the additional information that we propose to request in Form D provide useful information to state securities regulators in responding to inquiries from constituents about offerings conducted under Rule 506 and in enforcement efforts?

Comment

I wish to argue that the Commission should require issuers to provide information in Form D about the issuer's auditor, if any, for Rule 506(c) offerings especially, but also for 506(b) offerings. This information would indeed be useful to state securities regulators.

Rationale

I argue for this view on the basis of three types of arguments: (1) fundamental considerations involving the purpose of the Securities Acts and the nature of accountancy; (2) considerations pertaining to the Commission's stated purpose in evaluating the development of market practices in connection with Rule 506 offerings; and (3) considerations related to investor protection and the enforcement efforts of both federal and state regulators.

*(1) Fundamental considerations involving the purpose of the Securities Acts and the nature of accountancy.*

Regulation D and Form D need to be viewed in relation to the Securities Acts, of course. Regulation D represents a "safe haven" under §4(2) of the 1933 Securities Act for exempt offerings as regards the burdensome process of registration solely. As the Commission stresses, the usual standards of fair disclosure and laws concerning fraud continue to apply.

It was an important element of the Securities Acts that financial statements of issuers be audited by independent public accountants. In doing so, the federal government specifically declined to take the role

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of auditor to itself and by design gave scope to the accounting profession to work in partnership with the Commission, to help refine accounting standards and insure high levels of accounting professionalism among public accountants. One therefore needs to ask in what way this provision of the Securities Acts applies to offerings exempt from the registration requirement, as, for the reasons given, there should be such an application. To put the point briefly, the Securities Acts require the “involvement” of the independent public accountant in certifying the financial statements of issuers: therefore, it can be asked how this involvement is respected even in offerings that are exempt under Rule 506.

In accordance with Rule 502(b)(2), issuers under Rule 506 offerings must supply financial statements subject in some respect to an audit. It might be argued, then, that to that extent the independent public accountant is involved. However, this degree of involvement, although necessary, seems not sufficient. The reason is that the nature of an audit is to attest, and an attestation is a public act of certification or assurance, which depends crucially on the reliability of the attesting agent. The mere representation that financial statements are audited, without the identification of the auditor, is of relatively little value. The public disclosure of the auditor helps to insure that the requirement of the audit has the necessary effect and force. Thus, the intention of the Securities Acts is best respected by requiring the disclosure of the auditor even for offerings that are exempt under Rule 506.

This consideration is strengthened as regards Rule 506(c) offerings, if one considers the role of the public accountant as a “public watchdog.” As the Supreme Court observed in *U.S. v. Arthur Young*:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to investing public. This ‘public watchdog’ function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

The public accountant is that professional who is tasked precisely with the responsibility of attesting to the reliability of financial statements, both to sophisticated investors and the general public. One might

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even argue, then, that if any information is to be filed with the Commission at all about an offering, exempt or not, the most important and first thing to be filed should be identity of the auditor of the financial statements.

Another way to put this last point in connection with Regulation D is the following. The twofold aim of the Securities Acts was the promotion of the national public interest through the protection and support of its equity markets, and the protection of the investor. The JOBS act mandated a change in Rule 506 offerings, a liberalization of past restrictions, in permitting general solicitation for Rule 506(c) offerings. The Commission should implement this change in a way that corresponds to the mentioned twofold aim of the Securities Acts. As the Investor Advisory Committee pointed out in its comment letter on Rule 506 general solicitations: “lifting the solicitation ban can and should be done in a manner that simultaneously promotes investor protection, facilitates efficient capital formation, and provides regulators with the tools they need to police the market effectively.... The Commission retains both the authority and the responsibility to ensure that investors are adequately protected as the ban on general solicitation is lifted” I have presented an argument based on fundamental principles for the recommendation also affirmed by the Investor Advisory Committee in this connection, that the issuer be required to state its auditor (if any) on Form D.

On its website the Commission has a page for investors, entitled, “All about Auditors: What Investors Need to Know.” After explaining what an auditor is, and what auditors do, the Commission poses the question, “What’s the Purpose of an Audit?” Tellingly, the Commission answers its own question in the following way:

An audit provides the public with additional assurance — beyond managements' own assertions — that a company's financial statements can be relied upon. As the U.S. Supreme Court stated in the landmark case of *U.S. v. Arthur Young*: "The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the Nation's industries." That has important implications for investors making investment decisions, for banks and financial institutions that may extend credit or make loans to the company, and for other businesses and members of the public who deal with the company.

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Note that because the Commission mentions “banks and financial institutions,” it is clear that the Commission regards auditors as important for “accredited investors” as well as the ordinary investing public. The next question that the Commission poses on that same information page is, “How Can I Find Out Who Audits a Particular Company?” The Commission grants the importance of this question and responds by saying that an investor should check the EDGAR database for a company’s 10-K filings. However, suppose that instead of giving that pertinent question, the Commission had instead replied, “It is not important to know who audits a company. It is only important *that* a company is audited.” Clearly, that would be a silly and implausible answer. Yet to require that (with limited exceptions) an issuer of a Rule 506 offering must provide audited financial statements, but not to require the disclosure of the identity of the auditor, seems to make almost as little sense.

*(2) Considerations pertaining to the Commission’s stated purpose in evaluating the development of market practices in connection with Rule 506 offerings.*

To argue that the auditor (if any) should be disclosed in Form D, it is enough to argue that the auditor’s identity is as important a piece of information as anything else disclosed on Form D. If it is as important, then any reasons for including that other information also count as reasons for including the identity of the auditor. But it seems obviously more important in understanding an offering to know that it is audited (say) by a Big Four firm, or one of the top ten firms, than that (say), the type of security offered is a Tenant-in-Common security, or that its sector is Lodging & Conventions.

But there are independent reasons why the identification of the auditor is important for the market. One is that the audit industry is itself an important part of the market, and so the study of the role of the audit industry in a market is important for understanding that market. The other is that the auditor is so intimately interconnected with other variables—involving internal control, disclosure, compliance, and a host of other matters—that to know the auditor is to understand in part the connection of a company with those other variables.

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(3) Considerations related to investor protection and the enforcement efforts of both federal and state regulators.

To underscore the importance of the auditor to regulators, it is enough to cite the Commission's "Report of Investigation, Case No. OIG-509: Investigation of the Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme." Page 149 of that report refers to "Significant Red Flags" and states that:

At the outset, the rumors and mystery surrounding Madoff made some Renaissance employees uneasy. Simons had heard Madoff kept a restricted floor at BMIS. (Simons Interview Tr. at pgs. 44-45.) The secrecy of the floor coupled with the rumors about the lack of auditor independence was a red flag for Simons. (Id. at p. 45.) Similarly, the small size of Madoff's auditor was an issue for Broder because Madoff was reportedly managing billions of dollars for investors. (Broder Interview Tr. at p. 33.)" (emphasis mine).

Again, on page 418 the report has a section entitled, tellingly, "The Identity of Madoff's Auditor Was Also a Concern," which reads:

The CEO of the fund of funds firm also noticed on Madoff's Securities balance sheet that Madoff was "audited by a firm in New City, NY," which he had never heard of and thus, had to be "some suburban little shopping mall kind of accounting firm." (CEO of Fund of Funds Firm Interview Tr. at pgs. 10-11.) Similarly, the research firm was suspicious when they found out that Madoff's auditor was a firm named Friehling and Horowitz, who they had never heard of even though they had been in the industry for a long time. (CEO of Research Firm Interview Tr. at p. 44.) The research firm said that they "had never seen them before in [their] entire existence and it [was] very, very, very rare that [they would] run across an accountant that [they had] never seen in [their] years." (Id.) They asked around and "googled" the accounting firm and no one had heard of them and they found very little information about them. (Id. at pgs. 44-45.) The research firm then hired a private investigator to find out more about the auditor and discovered that the firm had three employees, Friehling, Horowitz, and a secretary, and that Jerome Horowitz was

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78 years old and lived in Florida. (Id. at p. 47.) Similarly, the small size of Madoff's auditor was an issue for Renaissance, particularly because Madoff was reportedly managing billions of dollars for investors. (Broder Interview Tr. at p. 33.)

This passage speaks for itself. Everyone knew that Madoff's firm was audited; what was relevant was the identity of the auditor. We submit that federal and state regulators will be assisted by a Form D disclosure of the auditor of the issuer for just the same reason that it was important to pay attention to the identity of Madoff's auditor.

I respectfully conclude that for several, powerful reasons, related to fundamental considerations about the purpose of the Securities Acts and the nature of the accounting professional, and for other considerations which are motivating the Commission to consider amendments to the required content of Form D at all, the Commission should require that the issuer's auditor (if any) also be disclosed on Form D.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael Pakaluk". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Michael Pakaluk, Ph.D.  
President, Naples Ethics Group, LLC