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Office of Inspector General

Office of Audits

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# Regulation D Exemption Process



March 31, 2009  
Report No. 459



OFFICE OF  
INSPECTOR GENERAL

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

**MEMORANDUM**

March 31, 2009

**To:** Shelley Parratt, Acting Director, Division of Corporation Finance  
Charles Boucher, Director, Office of Information Technology  
Lori Richards, Director, Office of Compliance Inspections and  
Examinations  
Robert Khuzami, Director, Division of Enforcement

**From:** H. David Kotz, Inspector General *HDK*

**Subject:** *Regulation D Exemption Process, Report No. 459*

This memorandum transmits the U.S. Securities and Exchange Commission Office of Inspector General's (OIG) final report detailing the results of our audit on the Commission's Regulation D Exemption Process. The audit was conducted by the OIG as part of our continuous effort to assess the management of the Commission's programs and operations and was based on our audit plan.

The final report contains 17 recommendations that were developed to strengthen the Commission's Regulation D Exemption process. The Division of Corporation Finance fully concurred with 10 of 15 recommendations that pertained to its office and partially concurred with the remaining 5 recommendations. The Office of Information Technology, the Office of Compliance, Inspections and Examinations and the Division of Enforcement agreed with all of the recommendations that pertained to these units.

Should you have any questions regarding this report, please do not hesitate to contact me. We appreciate the courtesy and cooperation that you and your staff extended to our auditor.

Attachment

cc: Didem Nisanci, Chief of Staff, Office of the Chairman  
Kayla J. Gillan, Deputy Chief of Staff, Office of the Chairman  
Brian Breheny, Deputy Director, Division of Corporation Finance  
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# Regulation D Exemption Process

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## Executive Summary

### Background

The Office of Inspector General (OIG) reviewed the Division of Corporation Finance's (CF) process for assessing whether companies appropriately use Regulation D exemptions from registration requirements of the Securities Act of 1933 (Securities Act).

The Securities Act generally requires each sale of a security to be registered with the Securities and Exchange Commission (SEC or Commission).<sup>1</sup> However, the law contains certain statutory exemptions and allows the SEC to establish additional regulatory exemptions from registration when it determines that its securities registration procedure is not required for the protection of investors because of the small size or limited nature of the offering. In 1982, the SEC adopted rules known as Regulation D, which contain exemptions from federal registration for limited offerings of securities.

Companies that sell securities in reliance on an exemption pursuant to Regulation D are required to file an SEC Form D<sup>2</sup> notice with the Commission. Companies also may be required to file Form D with their respective state regulators. Form D serves as the official notice of an offering of securities made without registration under the Securities Act, in reliance on an exemption provided by Regulation D. The information in Form D assists the SEC and state securities regulators to administer the securities laws. By requiring a company to report detailed information about the nature of an offering such as the amount of money intended to be raised, the type of exemption on which the company is relying upon, and the date of the first sale of securities, regulators can use this information when they investigate whether a company acted in accordance with the information it reported on Form D, whether the company appropriately relied on the exemption claimed, and whether the company timely filed Form D. Both public and nonpublic companies report information using Form D.

On September 15, 2008, the Commission put into effect a revised Form D to clarify and simplify the reporting process and to eliminate the reporting of unnecessary information. Also, as of September 15, 2008, companies were able to file Form D electronically with the SEC, as opposed to sending the Form to the SEC in hard copy. On March 16, 2009, the SEC launched a system enabling

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<sup>1</sup> 15 U.S.C. § 77e.

<sup>2</sup> See Form D in Appendix II.

SEC staff to analyze Form D information in the aggregate and develop management reports. Also on March 16, 2009, all Form D filers were required to file Form D electronically, as opposed to submitting paper filings to the SEC.

## **Objectives**

The OIG initiated this audit in accordance with our audit plan because of the high dollar amount of capital that is raised through the Regulation D exemption process. The objectives of the audit were to evaluate the effectiveness of SEC's oversight of the Regulation D exemption process and to identify areas for improvement. We also followed up on recommendations that were made in the OIG's prior audit report on this process, *Small Business Regulation D Exemption Process*, Report No. 371, issued on March 29, 2004.

## **Implementation of Prior OIG Audit Report Recommendations**

The OIG's 2004 audit report of the Regulation D exemption process contained five recommendations. We determined that CF implemented two of the recommendations, did not implement two recommendations and partially implemented one recommendation.

CF implemented the prior report's recommendations D and E to revise Form D and enable companies to file Form D electronically.

CF did not implement recommendations A and C as follows. Recommendation A stated that CF should expand its review of SEC registration statements to determine if companies that file SEC registration statements also file a Form D when required. The prior audit found that 16 of a sample of 18 companies that filed SEC registration statements disclosing unregistered sales of securities, failed to file a corresponding Form D. Recommendation C stated that CF should track data on Regulation D offerings. CF stated that the costs of implementing these recommendations outweighed the benefits.

We also found that CF partially addressed recommendation B from the prior OIG audit report, which stated that CF should consult with the Office of Compliance Inspections and Examinations (OCIE) to obtain information regarding Regulation D compliance issues noted during examinations. We believe that CF and OCIE should further coordinate with each other. In response to this recommendation, OCIE began to forward some, but not all, copies of its examination reports that discuss Regulation D issues. Further, OCIE does not copy CF on the referral memoranda that it sends to the Division of Enforcement (Enforcement) regarding Regulation D issues.

## Results

Overall, we found that CF does not generally take action when CF staff learn that issuers have not complied with the requirements of the Regulation D exemptions. Further, CF does not substantively review the more than 20,000 Form D filings that it receives annually, which in 2008, identified total estimated offerings of \$609 billion dollars.<sup>3</sup>

Our audit found that it is important for CF to further utilize the information that is provided in the Form D filings and take appropriate action when CF staff become aware of Regulation D abuses. Through our own analysis and our review of OCIE examinations, we identified several instances of misuse, non-compliance, and illegal acts regarding the Regulation D exemptions, as well as errors in the Form D filings. Further, we believe that the Form D filings contain valuable information regarding the size and nature of the reporting firms (including hedge funds), the amount of capital being raised, the types of exemptions that companies use, and the number of investors involved in Regulation D issuances. However, the Commission staff generally do not utilize this information, which, if aggregated, could identify the size and nature of Regulation D offerings. Using the database that the SEC launched on March 16, 2009, the Commission now has enhanced tools to analyze and make use of the Form D information.

Monitoring compliance with the requirements of the Regulation D exemptions is important to ensure the integrity of the Form D filing process and to ensure that companies appropriately use the exemptions. Taking action when deficiencies are identified helps to achieve the SEC's mission of investor protection. Investor protection is particularly important with regard to Regulation D because offerings issued pursuant to Regulation D are exempt from SEC's securities registration process.

We found that certain revisions should be made to Form D to better ensure that potential investors are not misled by the information in a Form D filing and to further clarify the information that is reported on the Form.

Our audit also found that firms lack formal, written guidelines from the SEC on filing waivers of disqualification pursuant to Rule 505 of Regulation D. Companies may seek these waivers when they are found to be non-compliant with certain provisions of the securities laws and therefore become disqualified from relying upon Rule 505. CF management told us that initial waiver requests are often deficient and firms typically need to redraft and resend the waiver requests to CF. Firms occasionally contact CF seeking written guidance on this process, but CF has not issued any formal written guidance describing how firms may apply for the waivers and when they are appropriate. Instead, CF provides

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<sup>3</sup> See footnote 18 and the Scope and Methodology section of report (Appendix IV).

oral guidance and refers requestors to the samples of successful waiver requests on the Commission's website.

In addition, we determined that the Office of Information Technology (OIT) and CF did not timely or effectively simplify the SEC's Electronic Data Gathering and Retrieval (EDGAR) authentication process for new filers, as was expected. SEC officials estimated that approximately 19,000 new Form D filers will file Form D electronically as a result of a new electronic filing requirement that took effect on March 16, 2009,<sup>4</sup> making this the second largest group of new filers to EDGAR. The current authentication process is overly complex and time-consuming. In a Commission meeting in December 2007, OIT and CF agreed to begin working together to simplify this process.<sup>5</sup> In fact, CF informed us that its staff had been working with OIT staff for several years to simplify the process, even prior to the Commission meeting. The simplified process, which took effect on March 16, 2009, merely consists of allowing new filers to attach a notarized document to an online submission to the SEC as a PDF document, as opposed to faxing the document to the SEC, as was previously required, and is therefore inadequate.<sup>6</sup> Moreover, in our opinion, and according to OIT and CF staff, an adequate simplification process should have been implemented prior to March 16, 2009.

Further, the Commission needs to continue to improve its coordination with state regulators to ensure greater uniformity in federal and state securities regulation. In particular, further coordination is needed to assist the North American Securities Administrators' Association (NASAA), the organization of state securities regulators, in building an electronic system that could be linked to EDGAR and allow companies to file Form D with the states electronically. Currently, issuers can only file Form D electronically with the Commission and must file paper Form Ds with the states.

We found the staff in CF's Office of Small Business Policy to be extremely knowledgeable of the Regulation D process and believe they could provide expertise to staff in OCIE and Enforcement regarding Regulation D issues that arise in OCIE examinations and Enforcement investigations and actions. We also noted that the Commission finalized a rule in February 2008, which provided for a revised Form D and enabled issuers to file Form D electronically with the SEC, as of September 15, 2008.<sup>7</sup> The staff in CF's Office of Small Business Policy worked diligently to make these changes, which are significant improvements to the Regulation D filing process.

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<sup>4</sup> OIT approximates that there are currently 200,000 to 300,000 EDGAR filers in total. This includes filers that file Form D, as well as other filings with the SEC.

<sup>5</sup> Transcript of an Open Commission meeting on December 11, 2007, page 37.

<sup>6</sup> Commission staff noted that they plan to further simplify the authentication process.

<sup>7</sup> SEC Final rule: Electronic Filing and Revision of Form D, Release No. 33-8891, 73 FR 10592, February 27, 2008.

## Summary of Recommendations

Our audit report contains the following recommendations. CF and the Commission should develop a process to assess and better ensure issuers' compliance with Regulation D and take appropriate action when CF finds that companies have materially misused the Regulation D exemptions. CF should establish a means to review Form D information in the aggregate and develop meaningful management reports.

CF, in consultation with Enforcement, should take appropriate action when issuers fail to file Form D in accordance with Rule 503. For example, CF could establish general criteria or guidance describing when it believes it is appropriate for the Commission to initiate an Enforcement action against an issuer that fails to file a Form D, and request that a court enjoin an entity from violation Rule 503. Currently, issuers do not face any tangible consequences for failing to file a Form D.

CF should reintroduce its Early Intervention Program, which is designed to identify potential securities' laws violators and notify them of potential violations. CF should develop criteria describing when it is appropriate to refer potential Regulation D abuses to its Office of Enforcement Liaison and subsequently to Enforcement. CF should continue to discuss with the Chairman, the Commissioners and Commission senior staff, the merits of the Commission's proposed rule regarding Regulation D and any changes that should be made to this proposed rule.<sup>8</sup> In addition, CF should raise with the Commission, the option of making the filing of Form D a required condition for issuers to claim the Regulation D exemptions contained in Rules 504, 505 and 506.

CF should work with OIT to make certain changes to Form D to better ensure that potential investors do not rely upon erroneous or misleading information in Form D filings and to further clarify the Form. One improvement includes adding a statement to Form D stating that the Commission has not necessarily reviewed the information in Form D and that the reader should not assume that the information in the Form is accurate or complete. Other Commission filings contain similar disclaimers.

CF and OIT should work together to further simplify the EDGAR authentication process for new EDGAR filers. CF should issue written guidance to the public on how firms may apply for waivers of disqualification under Rule 505 of Regulation D. CF should also continue to improve its coordination with State regulators regarding Regulation D issues.

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<sup>8</sup> See SEC Proposed rules; request for additional comments, Revisions of Limited Offering Exemptions in Regulation D, Release No. 33-8828, 72 FR 45116, August 10, 2007.

CF should provide additional guidance to issuers on the Form D filing requirements. Finally, CF should implement the outstanding recommendations that were made in the OIG's prior audit report, which was issued in 2004.<sup>9</sup>

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<sup>9</sup> OIG Audit Report: *Small Business Regulation D Exemption Process*, Report No. 371, issued on March 29, 2004.

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# Background and Objectives

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## History of Regulation D

Regulation D was part of a U.S. Securities and Exchange Commission (SEC or Commission) initiative to provide a more coherent pattern of exemptive relief from the registration requirements of the Securities Act, and to address the capital formation needs of small businesses. The Commission adopted Regulation D and Form D in 1982.<sup>10</sup>

In 1986, the Commission modified the requirements relating to Form D, making the Form a uniform notification that could be filed with state securities regulators. This effort was undertaken with the cooperation of the North American Securities Administrators' Association (NASAA) to help reduce the costs of capital formation for small businesses and to promote uniformity between federal and state securities regulation.

In 1989, the Commission amended the Regulation D exemptions to eliminate the requirement to file Form D as a condition of relying upon the Regulation D exemptions. At that time, the SEC also added Rule 507 to Regulation D to provide an incentive for issuers to make a Form D filing, even though it was no longer a condition for claiming the Regulation D exemptions.<sup>11</sup>

In 1996, the Commission issued a proposed rule to eliminate the requirement to file Form D with the SEC and instead require issuers to complete a Form D and retain it for a period of time. After considering the comments received on this proposed rule, the Commission determined that the information collected in Form D filings was still useful in conducting economic and other analyses of the private placement market and retained the filing requirement.<sup>12</sup>

## Regulation D Provisions

The Securities Act of 1933 (Securities Act)<sup>13</sup> generally requires each sale of a security to be registered with the SEC. However, the law contains certain statutory exemptions and allows the SEC to establish additional regulatory exemptions from registration when it determines that its securities registration

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<sup>10</sup> SEC Adoption of final rules, rule amendments, and form, and rescission of rules and forms: Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Release No. 33-6389, 47 FR 11251, March 16, 1982.

<sup>11</sup> SEC Final rules: Regulation D; Accredited Investor and Filing Requirements, Release No. 33-6825, 54 FR 11369, March 20, 1989.

<sup>12</sup> SEC Final rules: Phase Two Recommendations of Task Force on Disclosure Simplification, Release Nos. 33-7431 and 34-38850, 62 FR 39755, July 24, 1997, at 39755-56.

<sup>13</sup> 15 U.S.C. § 77e.

procedure<sup>14</sup> is not required for the protection of investors<sup>15</sup> because of the small size or limited nature of the offering. In 1982, the SEC adopted rules known as Regulation D, which contain exemptions from federal registration for private securities offerings.<sup>16</sup>

Regulation D was designed to facilitate capital formation, while protecting investors, by simplifying and clarifying the existing exemptions for private or limited offerings, expanding their availability, and providing more uniformity between federal and state exemptions. Although Regulation D originated as an effort to assist small business capital formation, companies of all sizes may use the Regulation D registration exemptions.<sup>17</sup>

In general, to qualify for a Regulation D exemption, a company that is selling securities is prohibited from advertising or otherwise offering the sale of the securities to the general public. For the exemptions to apply, a company may offer and sell the securities to only a limited group of investors. Further, securities sold pursuant to a Regulation D exemption cannot be resold unless they first are registered or are subject to an exemption covering the resale.

### **Capital Intended to be Raised Using the Regulation D Process**

Issuers report the amount of capital they intend to raise on Form D. By analyzing a sample of data, the OIG estimated that in 2008, companies intended to raise approximately \$609 billion<sup>18</sup> by relying on the Regulation D exemption process.

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<sup>14</sup> In general, registration statements require companies to provide a description of the company's properties and business, a description of the security to be offered for sale, information about the management of the company, and financial statements certified by independent accountants. Registration statements become public shortly after the company files them with the SEC. See <http://www.sec.gov/answers/regis33.htm>.

<sup>15</sup> Section 3(b) of the Securities Act, 15 U.S.C. § 77c(b) provides that “[t]he Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds \$5,000,000.”

<sup>16</sup> SEC Adoption of final rules, rule amendments, and form, and rescission of rules and forms: Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Release No. 33-6389, 47 FR 11251, March 16, 1982. See 17 C.F.R. §§ 230.504, 230.505 and 230.506.

<sup>17</sup> See SEC Proposed rules; request for additional comments, Revisions of Limited Offering Exemptions in Regulation D, Release No. 33-8828, 72 FR 45116, August 10, 2007, page 5.

<sup>18</sup> This figure does not take into account the number of companies that raised capital through unregistered securities offerings without filing a Form D with the Commission; this information is unknown and therefore could not be included in the estimate. The OIG made this estimate by examining 323 electronic Form D filings made between September 15, 2008 and December 31, 2008. The OIG recorded the total amount of capital the 323 issuers intended to raise and then

According to the OIG's 2004 report on the Regulation D process, the Commission recorded that the nation's small businesses reported unregistered offerings of \$1.2 trillion in securities from January 2000 to March 2001.<sup>19</sup> Neither the Commission, nor any other entity of which we are aware of, collects aggregate information on the dollar amount of capital raised or intended to be raised through Regulation D offerings. Thus, we have no firm way of determining whether or not the amount of money raised through this process has actually decreased since January 2000 to March 2001.

The Division of Corporation Finance's (CF) Office of Small Business Policy administers the Regulation D program. The staff consists of five lawyers, one of whom is the Office Chief, and a secretary.

### Regulation D Rules

Regulation D consists of Rules 501-508.<sup>20</sup> A description of these eight rules is shown in Table 1 below.

**Table 1: Regulation D Rules 501 - 508**

Rule	Description
501 & 502	Contain definitions and general conditions that apply throughout Regulation D.
503	Requires that a company offering securities in reliance upon Rules 504, 505 or 506, must file a Form D no later than 15 calendar days after the date of the first sale of securities in the offering, unless the end of that period falls on a Saturday, Sunday or holiday, in which case the due date would be the first business day following. Also describes when issuers must file an amendment to a Form D.
504	Provides exemptions for companies that are not subject to reporting requirements under the Securities Exchange Act of 1934 <sup>21</sup> for the offer and sale of up to \$1,000,000 of securities in a 12-month period.
505	Exempts offers by companies of up to \$5,000,000 of securities in a 12-month period to "accredited investors" <sup>22</sup> and a limited number of other persons, so long as offers are made without general solicitation or

calculated the average capital amount per filing. The OIG multiplied this average capital amount by the total number of Form D filings that SEC received in calendar year 2008. A more detailed description of this estimate is provided in the report's Scope and Methodology section in Appendix IV.

<sup>19</sup> See OIG Report: Small Business Regulation D Exemption Process, Report No. 371, issued on March 29, 2004, p.1.

<sup>20</sup> 17 C.F.R. §§ 230.501 – 230.508.

<sup>21</sup> 15 U.S.C. § 78a et seq.

<sup>22</sup> Accredited investors include certain banks, private businesses and other organizations, as well as any individual with an annual income in excess of \$200,000 or a net worth (individually or with the person's spouse) in excess of \$1 million. See complete definition at 17 C.F.R. § 230.501(a).

	advertising.
506	Provides for a safe harbor for the private offering exemption under Section 4(2) of the Securities Act <sup>23</sup> without any limit on the offering amount, so long as offers are made without general solicitation or advertising and sales are made only to “accredited investors” and a limited number of non-accredited investors who satisfy an investment sophistication standard.
507	Disqualifies issuers from relying on Regulation D, under certain circumstances, for the failure to file a Form D notice.
508	Provides a safe harbor for certain insignificant deviations from a term, condition, or requirement of Regulation D.

Source: OIG Generated

### **Form D, Notice of Exempt Offering of Securities**

Form D serves as the official notice of an offering of securities made without registration under the Securities Act, in reliance on an exemption provided by Regulation D. Both public and nonpublic companies file information using Form D.

According to CF, companies that offer securities in reliance on a Regulation D exemption pursuant to Regulation D are required to file an SEC Form D notice with the Commission.<sup>24</sup> They are also required to make disclosure information available to their investors regarding the issuer and the offering. Companies usually meet this requirement by delivering a document, frequently called a “private placement memorandum,” to prospective investors. For Regulation D offerings, companies are not required to file this memorandum with the Commission, nor are companies required to file registration statements with the Commission.

CF staff stated that the SEC Form D is not a disclosure document for investors. However, Form Ds are available to the public on Internet and the public may rely upon the information contained in the Form D filings.

In contrast to Regulation D offerings, companies that make public offerings to investors are required to file registration statements with the Commission, which serve as both a notice to the Commission and a disclosure document for investors, according to CF.

A Form D filer may file an amendment to a previously filed Form D notice at any time.<sup>25</sup> A filer is required to file an amendment to a previously filed notice to

<sup>23</sup> 15 U.S.C. 77d(2).

<sup>24</sup> 17 C.F.R. § 230.503(a)(1). See Form D in Appendix II.

<sup>25</sup> 17 C.F.R. § 230.503(a)(2).

correct material mistakes, to reflect certain changes in information<sup>26</sup> and, as of March 16, 2009, on an annual basis provided the offer is continuing at that time.

## Filing Requirements

While filing a Form D is a requirement of Rule 503(a), it is not a condition for claiming the exemptions in Rules 504, 505 and 506 of Regulation D.<sup>27</sup> Rule 503(a) states that any issuer that offers or sells securities in reliance on Rules 504, 505, or 506 of Regulation D must file Form D with the SEC within 15 days after the first sale of the securities in the offering.<sup>28</sup> Although the obligation to file Form D is not a condition for claiming a valid exemption under Regulation D, an issuer could be disqualified from use of Regulation D for future transactions if the issuer or any of its predecessors or affiliates, have been temporarily, preliminarily, or permanently enjoined by a court for failure to file Form D.<sup>29</sup> However, CF staff said that to date no court has enjoined an issuer based upon its failure to file a Form D, nor has the Commission ever sought such relief.

## Purpose of Filing Form D

The Form D filing requirement is intended to serve two primary purposes:

- Collection of data for use in the Commission's rulemaking efforts; and
- Enforcement of the federal securities laws, including the Regulation D exemptions.<sup>30</sup>

The information in Form D also assists state securities regulators and the Financial Industry Regulatory Authority (FINRA)<sup>31</sup> to enforce securities laws and the rules of the securities self-regulatory organizations.

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<sup>26</sup> 17 C.F.R. § 230.503(a)(3).

<sup>27</sup> Securities Act Rules, Questions and Answers of General Applicability, <http://sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm>, Answer to Question 257.07.

<sup>28</sup> 17 C.F.R. § 230.503(a).

<sup>29</sup> 17 C.F.R. § 230.507. Under Rule 507(b), the Commission may determine, upon a showing of good cause, that it is not necessary under the circumstances for the exemption to be denied.

<sup>30</sup> SEC final rule: Electronic Filing and Revision of Form D, Release No. 33-8891, 73 FR 10592, February 27, 2008, page 7.

<sup>31</sup> FINRA is the largest non-government regulator for all securities firms doing business in the United States. FINRA oversees nearly 5,000 brokerage firms, 172,000 branch offices and 663,000 registered securities representatives. FINRA's chief role is to protect investors by maintaining the fairness of the United States' capital markets. See <http://www.finra.org/index.htm>.

## Recent Changes to Form D

On September 15, 2008, the SEC put into effect a new version of Form D to:

- Clarify and simplify the reporting process;
- Ensure that pertinent information was required to be reported; and
- Eliminate the reporting of unnecessary information.

Unlike the prior Form D, the new Form D requires the issuer to disclose the date of the first sale of securities, additional information about the issuer, as well as additional information about the recipients of sales commissions. Also, the new Form D no longer requires issuers to name beneficial owners or provide details regarding the use of offering proceeds. The new form D clarifies when issuers are required to file amendments.

## Electronic Filing of Form D

Up until September 15, 2008, a company's only option was to file the prior Form D with the SEC in paper form. During a transition period from September 15, 2008, through March 15, 2009, companies were able to file either the old version of Form D with minor changes (such as the number of copies to be filed) on paper or the new version of Form D on paper or electronically. Electronic submissions are made through the SEC's Electronic Data Gathering and Retrieval (EDGAR) filing system.<sup>32</sup>

As of March 16, 2009, the SEC no longer accepts paper filings, nor does the SEC accept the prior Form D. Thus, the SEC now requires all filers to submit the new Form D electronically. Also, on March 16, 2009, the SEC launched a database of Form D information, which enables SEC staff to examine the data in the aggregate and produce management reports.

## Federal and State Coordination

Form D serves as a uniform notification that can be filed with the Commission and most states.<sup>33</sup> Although state securities regulators have access to the Form D filings made with the Commission, SEC is currently working with NASAA, the organization of state securities regulators, to establish a "one-stop" filing system. This system would link SEC's Form D filing system with a NASAA-sponsored system to be developed by state securities regulators, thereby enabling filers to submit their Form D filings to the SEC and their appropriate state regulators in

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<sup>32</sup> EDGAR is the Commission's database that companies use to file registration statements, periodic reports and other forms electronically with the SEC.

<sup>33</sup> According to the American Bar Association, forty eight states, the District of Columbia, Puerto Rico and the U.S. Virgin Islands accept the SEC's Form D as the state filing for unregistered securities offerings. New York prescribes a separate filing, and Florida does not require any filing.

one electronic transmission. This system is expected to enhance uniformity and coordination among the SEC and the states. Until the anticipated “one-stop” filing becomes available, issuers will continue to file a paper copy of Form D with their respective states, if required. A timetable has not been established to link the two systems.

## Objectives

The OIG initiated this audit in accordance with our audit plan because of the high dollar amount of capital raised through the Regulation D exemption process. The objectives of the audit were to evaluate the effectiveness of the SEC’s oversight of the Regulation D exemption process and identify areas for improvement. The OIG also followed up on recommendations made in the OIG’s prior audit report on this process, *Small Business Regulation D Exemption Process*, Report No. 371, issued on March 29, 2004.

# Findings and Recommendations

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## Finding 1: CF is Not Taking Effective Action in Response to Regulation D Deficiencies

CF does not substantively review Form D filings, determine whether issuers appropriately use the Regulation D exemptions, and generally does not take action when CF staff learn that issuers are non-compliant with the rules of Regulation D. There are many different types of abuses and non-compliance issues involving Regulation D, including illegal securities offerings, which could be addressed by appropriate CF or Commission action.

### No Review of Form D Filings

The Commission received 28,594 and 27,107 Form D filings in calendar years 2007 and 2008, respectively.<sup>34</sup> CF informed the OIG that SEC staff does not substantively review the information in the Form D filings, and that the filings are only intended to be notice filings. CF officials said that the Commission only reviews Form D filings or makes substantive use of the information on a selective basis, in connection with investigations conducted by the Division of Enforcement (Enforcement), program monitoring and rulemaking. CF officials also said that Form D was not designed for the purpose of determining if the Regulation D exemptions are being misused and that the purpose of the Form D filing was to ensure adequate notice to federal and state regulators of Regulation D offerings and to provide empirical data for further Commission rulemaking.

Nevertheless, without reviewing even a sample of Form D filings, we believe that CF deprives itself of the opportunity to obtain information regarding the types of exemptions on which issuers rely upon, the amount of capital intended to be raised, whether issuers erroneously fill out portions of Form D, whether companies misuse the Regulation D exemptions, and whether the Forms were filed timely.<sup>35</sup> Thus, the SEC's overall Form D review process does not ensure that issuers adequately disclose information about their offerings because the

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<sup>34</sup> These figures are derived from the Commission's EDGAR system and include Form D amendments. In 2007, the SEC received 20,966 Form Ds and 7,628 Form D amendments. In 2008, the SEC received 20,021 Form Ds and 7,086 Form D amendments.

<sup>35</sup> The Commission issued a revised Form D, which became effective on September 15, 2008. Unlike the prior Form D, the new Form D requires information enabling one to determine whether the Form was filed timely.

Forms do not receive appropriate scrutiny. Thus, we concluded that the SEC relies upon the “honor system” for filers to fill out Form D.

The information reported on Form D is important because it could alert SEC staff to deficiencies in the filing process and “red flags” that could be indicative of serious problems, such as filing a Form D as part of an illegal offering. The Form D information could also assist SEC staff to evaluate the effectiveness of the filing process, to enhance that process and develop future rules changes, policies and procedures.

CF staff stated that it was too burdensome for them to review the Form D filings when they were in paper form. However, Form D is now filed electronically and the Office of Information Technology (OIT) launched a system on March 16, 2009, which enables SEC staff to analyze the Form D data in the aggregate and produce management reports. Using this system, SEC staff are now able to ascertain quickly the total amount of capital intended to be raised through Regulation D, whether issuers timely filed Form D, the types of exemptions used, and compliance with some of the requirements of those exemptions.

Further, in a Commission meeting on December 11, 2007, Commission staff discussed their desire to begin using the information reported in the new Form D about hedge funds to learn more about their size and the extent to which hedge funds raise capital through the Regulation D exemption process.<sup>36</sup> The prior Form D did not specify any information related to hedge funds, even though hedge funds might be identifiable from the information reported or required to be reported. The new system could be used to obtain much better information about the size and number of hedge funds that file Form D with the Commission.<sup>37</sup>

### **CF Staff Generally Do Not Contact Companies that Misuse the Regulation D Exemptions**

CF staff generally do not contact companies when the staff become aware that companies are misusing the Regulation D exemptions. Staff in CF’s Office of

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<sup>36</sup> Transcript of Open Commission meeting on December 11, 2007, pages 37-39.

<sup>37</sup> Staff in CF’s Office of Small Business Policy are alerted by other Commission staff or outside sources, including state regulators, to non-compliance with the Regulation D filing requirements. OCIE staff periodically send CF’s Office of Small Business Policy staff copies of OCIE examination reports that detail violations or abuses related to Regulation D. These CF staff also review Commission action memoranda and other information from Enforcement pertaining to Regulation D issues that are discussed or reviewed by the Chairman and the Commissioners. Additionally, CF may receive tips and referrals from the public concerning issuers that are misusing the Regulation D exemptions. CF’s Office of Enforcement Liaison reviews all Action Memoranda relating to violations of Section 5 of the Securities Act, including those alleging failures to comply with Section 5 due to an entity’s failure to satisfy the conditions of Regulation D exemptions.

Small Business Policy are extremely knowledgeable of the Regulation D exemption process and in an excellent position to take appropriate action when certain Regulation D compliance issues arise, especially if they are not so material as to warrant a referral to Enforcement. Taking appropriate action when deficiencies are identified is important because the SEC is responsible for enforcing the securities laws in order to achieve the SEC's mission of investor protection. Investor protection is particularly pertinent to the Regulation D filing process because offerings issued pursuant to Regulation D are exempt from SEC's securities registration process.

CF staff stated that the program was not designed for them to contact companies that misused or violated the Regulation D rules, but they could refer issues to Enforcement for its consideration and possible investigation or enforcement action. As discussed on pages 13-14 of this report, however, CF rarely refers Regulation D issues to Enforcement and there is no guarantee that a referral to Enforcement will result in an investigation or enforcement action.

### **Lack of Consequences for an Issuer's Failure to File Form D**

Rule 507 disqualifies an issuer from using a Regulation D exemption in the future if the issuer has been enjoined by a court for failure to comply with Rule 503, which requires companies to file Form D information with the Commission.<sup>38</sup> The Commission added Rule 507 to Regulation D to provide an incentive for issuers to make a Form D filing, even though the Form D filing is no longer a condition for claiming the Regulation D exemptions. An issuer may have an incentive to file Form D because, by doing so, it avoids the possibility that a court will enjoin the issuer for violating Rule 503 and disqualify the issuer from conducting future Regulation D private offerings.<sup>39</sup>

CF management informed the OIG that apparently, the SEC originally intended for Rule 507 to serve as the basis for a compliance program to enforce the filing requirement of Rule 503, but Rule 507 has not actually been used in that way. The SEC has never brought a single action against a company for violating Rule 503 by not filing a Form D. Also, according to CF, no court has ever enjoined a company for its failure to comply with Rule 503, as contemplated by Rule 507. While staff in CF's Office of Small Business Policy stated that they strongly encourage companies to comply with Rule 503, they are aware of instances in which issuers have failed to comply with Rule 503, and the SEC does not have an effective compliance program for this Rule. As a result, there are simply no tangible consequences when a company fails to file a Form D. Further, the Commission's objective in adding Rule 507 as an incentive for issuers to file

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<sup>38</sup> 17 C.F.R. § 230.507.

<sup>39</sup> SEC Final rule: Electronic Filing and Revision of Form D, Release No. 33-8891, 73 FR 10592, February 27, 2008, pages 5-6.

Form D has not been achieved since no issuers have been enjoined for violating Rule 503.

According to an examination report issued by the Office of Compliance Inspections and Examinations (OCIE), in August 2008, the importance of enforcing Rule 503 should not be underestimated. Such enforcement would send a strong message to issuers and their affiliated parties who exploit Regulation D, that these offerings cannot be conducted secretly, without the necessary disclosures. According to this report, when an issuer fails to file a Form D, the market, specifically the individual retail investors who purchase and hold the shares, lack necessary information such as the size of the issuance. This typically dilutes the value of the stock holdings in that issue and accordingly, reduces the price of the stock.<sup>40</sup>

### **OCIE Examination Reports Revealed Illegal Activities**

OCIE staff examine SEC registered entities, including broker-dealers, investment companies and investment advisers. The OIG reviewed the reports for 14 OCIE examinations conducted between October 1, 2007 and December 31, 2008, that discussed issues related to Regulation D.

Four of these OCIE examinations identified instances where individuals exploited certain loopholes afforded to issuers in offerings made under Rule 504 of Regulation D. Specifically, these OCIE examinations found that issuers relied upon vague exemption statutes of certain states, as a way of obtaining significant amounts of unrestricted Rule 504 stock and then immediately selling the stock into the marketplace, without a registration statement having been filed or in effect, and for which no exemption was, or is, truly available. These activities result in “pump and dump” schemes, whereby individuals purchase securities, fraudulently inflate their value and then immediately sell them into the marketplace. The immediate resale of such securities is not consistent with Rule 504 of Regulation D, according to Commission staff. In one instance, an OCIE examination reported that an individual generated over \$24 million through such transactions.

Seven OCIE examinations identified misuses of Rule 506 because general solicitations were used to offer and sell securities.<sup>41</sup> One examination found that an issuer failed to meet the exemption of the safe harbor provision of Rule 506 by selling securities to too many non-accredited investors. Three examinations

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<sup>40</sup> This information was identified in an OCIE examination report that was issued in 2008, which identified Rule 504 abuses.

<sup>41</sup> In one of these seven instances, the OCIE exam noted the “possible” use of general solicitation.

found that issuers failed to file a Form D or did not timely file Form D, in violation of Rule 503.<sup>42</sup>

The above-described OCIE examinations, which identified misuses of the Regulation D exemptions, including fraudulent activities, further illustrate the need for CF to contact companies that abuse the Regulation D provisions or take other appropriate action.

### **Recommendation 1**

The Division of Corporation Finance (CF) should develop a process to assess and better ensure issuers' compliance with Regulation D. CF should include in this process a periodic review of the Form D filings, an assessment of the accuracy and timeliness of the filings, and the identification of problems or "red flags" with the filings. When CF believes that companies have materially misused the Regulation D exemptions, CF should take appropriate action such as contacting the offenders, and/or referring the matter(s) to the Division of Enforcement, the appropriate state regulator or other regulatory authority.

### **Recommendation 2**

The Division of Corporation Finance (CF) should establish a procedure to review Form D information in the aggregate and develop meaningful management reports that provide information about the filings, such as:

- The aggregate amount of capital intended to be raised on an annual basis;
- The average amount of capital intended to be raised per filing;
- The number of filings that were filed timely;
- The number of filings made by hedge funds and the aggregate net asset value of those funds;
- The number of filings made pursuant to Rules 504, 505, 506;
- The types of companies that use the Regulation D filing process; and
- The extent to which small businesses use the Regulation D process to raise capital.

CF should use the information in the management reports to further understand the size and nature of the companies that raise capital through the Regulation D process and to assist CF in developing future policies, procedures and rule changes.

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<sup>42</sup> In one of these three instances, the OCIE exam noted a "possible" failure to file a Form D.

### **Recommendation 3**

The Division of Corporation Finance (CF), in consultation with the Division of Enforcement, should take appropriate action when issuers fail to file Form D in accordance with Rule 503. For example, CF could establish general criteria or guidance describing when it believes it is appropriate for the Commission to initiate an Enforcement action against an issuer that fails to file a Form D and request that a court enjoin an entity from violating Rule 503.

## **Finding 2: The Commission Has Not Taken Advantage of Certain Opportunities to Address Regulation D Deficiencies**

CF has a centralized office for reviewing and forwarding referrals to Enforcement for possible investigation or enforcement action. This office, however, only referred one issue involving Regulation D to Enforcement from October 1, 2007 to December 31, 2008.

CF no longer runs an “Early Intervention Program,” whereby CF staff actively looked for potential violations of the securities laws and sent letters to potential violators.

CF drafted a proposed rule in 2007, which contained provisions designed to strengthen Regulation D. Despite efforts by CF to have the rule approved, the Commission has neither finalized nor set a timeframe for finalizing this rule.

Finally, the Commission does not require issuers to file a Form D notice as a condition for claiming the exemptions in Rules 504, 505 and 506 of Regulation D.

### **CF’s Referral Process**

CF refers certain potential violations or abuses to its Office of Enforcement Liaison (OEL). This office within CF reviews the merits of each issue and determines whether to refer the issue to Enforcement for further consideration. Enforcement is responsible for conducting investigations into possible violations of the federal securities laws and prosecuting the Commission's civil suits in the federal courts and in administrative proceedings.

If CF's OEL forwards an issue to Enforcement, Enforcement must then decide whether to open an inquiry and/or investigation into the matter. Enforcement's decision is often based on staff resources and the perceived severity of the potential violation or abuse.

CF stated that its OEL staff follow up with Enforcement about the status of referrals and provide guidance to Enforcement on Regulation D issues. However, staff in the Office of Small Business Policy do not ascertain whether CF's OEL referred Regulation D issues to Enforcement or whether Enforcement took action in response to such referrals. If the staff in CF's Office of Small Business Policy followed up with and offered guidance to Enforcement regarding Regulation D issues, these staff could share their Regulation D expertise with Enforcement, which could result in more effective Enforcement actions involving Regulation D abuses.

Staff in CF's Office of Small Business Policy estimated that they refer three to four Regulation D issues per year to CF's OEL. From October 1, 2007 to December 31, 2008, however, CF's OEL subsequently referred only two issues to Enforcement that involved Regulation D and/or Section 5 violations. (Section 5 violations often include Regulation D abuses.) One of these two referrals involved Regulation D offerings and the other did not. Thus, we determined that CF's OEL rarely refers issues related to Regulation D to Enforcement.

CF management expressed the belief that Enforcement will not routinely follow up on Regulation D issues due to resource constraints, the difficulty in proving Regulation D issues that tend to be highly technical, and the fact that Enforcement may choose to pursue more high profile violations or abuses rather than "less desirable" Regulation D abuses. Thus, CF generally believes that any referrals involving Regulation D violations will not result in subsequent Enforcement actions. As a result, we determined that CF's referral process for bringing issues related to Regulation D to Enforcement's attention is rarely used and needs improvement.

### **CF's Early Intervention Program**

CF worked with Enforcement to develop an Early Intervention Program, which began in 1999 and ended in August 2005. The program was intended to combat fraud and other securities law violations that were perpetrated through the Internet. This program provided CF with the ability to search for problems such as potential non-compliance with the securities laws and send out letters to potential violators. The program's goal was to encourage individuals and companies to comply with applicable securities laws.

Pursuant to the Early Intervention Program, CF staff checked the Internet and other electronic media and gathered information about securities offerings. CF

then sent letters to entities that CF believed were not in compliance with the federal securities laws and regulations, including Regulation D. CF staff sent letters to alleged violators requesting compliance within a specified timeframe, as well as a written response to CF. CF then reviewed each entity's subsequent response and actions. If the alleged violator did not take appropriate action, CF had the option of referring the issue to Enforcement for further investigation.

During its early intervention reviews, CF staff often identified abuses that were directly related to Regulation D, such as illegal advertising of securities pursuant to unregistered offerings

The OIG believes that the early intervention program was helpful because it allowed CF staff to intervene early enough to stop ongoing violations and abuses, which could be more efficient and effective than referring issues to Enforcement. Further, CF reported that it achieved about a seventy percent success rate in resolving issues through this program. CF management said that through this program, CF staff identified Regulation D abuses such as the solicitation of offerings to the general public and companies' failure to file Form Ds with the Commission.

The early intervention program ended in August 2005, when CF no longer had staff to administer the program. We determined that the demise of this program has reduced CF's opportunities to contact issuers who misuse the Regulation D exemptions. If the program were to be reintroduced, CF would have an additional opportunity to contact potential securities laws violators, including issuers that misuse the Regulation D exemptions.

### **SEC Proposed Rule**

CF drafted a proposed rule to revise Regulation D to provide additional flexibility to issuers and to clarify and modernize the rules to comport better with the modern marketplace.<sup>43</sup> The proposed rule was released for comment on August 3, 2007, and the SEC received 65 public comment letters.

In 2007 and 2008, CF discussed the merits of this rule with the former SEC Chairman Christopher Cox and SEC Commissioners and made efforts to finalize this rule. The Commission, however, has neither finalized, nor established a timeframe to finalize this rule. Finalizing a rule requires the Commission to consider and incorporate the public's comments into a final rule, which is then adopted by vote of the full Commission. Once adopted, the rule becomes a part of the official rules that govern the securities industry.

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<sup>43</sup> See SEC Proposed rules; request for additional comments, Revisions of Limited Offering Exemptions in Regulation D, Release No. 33-8828, 72 FR 45116, August 10, 2007.

While some aspects of the proposed rule may need to be revised due to major changes in the economy and marketplace that have occurred since the rule was proposed in 2007, certain provisions of this rule, if finalized, could assist both the Commission and state regulatory agencies in enforcing compliance with Regulation D. For example, the rule proposes to:

- Preclude securities law violators, especially repeat violators (recidivists), from participating in *all* Regulation D offerings. Currently, individuals who abuse Rule 505, are *only* precluded from participating in offerings pursuant to Rule 505, but may continue to participate in Rule 504 and 506 offerings. The proposed rule also includes disqualification provisions for offerings under Rules 504 and 506.

This provision, if adopted, would fill a gap, which resulted from the National Securities Market Improvement Act (NSMIA) of 1996.<sup>44</sup> Prior to NSMIA, recidivists were excluded from most Rule 506 offerings by state disqualification provisions. NSMIA preempted the states from enforcing those provisions in favor of federal regulation, which has raised the question of whether federal disqualification provisions should be adopted to replace the state provisions.

- Strengthen Rule 504 to limit the resale of certain securities by requiring certain investors to hold the securities for at least 12 months before the securities may be resold. This provision is intended to combat certain “pump and dump” schemes, whereby individuals purchase securities, fraudulently inflate their value and then immediately sell the securities for a profit.<sup>45</sup> OCIE examinations (as discussed on pages 11-12 of this report) have identified such abuses.

### **Filing a Form D Notice Should be a Required Condition for Claiming the Exemptions in Rules 504, 505 and 506 of Regulation D**

In 1989, the Commission amended Regulation D to eliminate the requirement to file Form D as a condition for the availability of the Regulation D exemptions.<sup>46</sup> The Commission implemented this change in response to industry comments that conditioning the availability of the exemptions on filing Form D was too draconian. Industry advocates claimed that an issuer could fail to file a Form D due to an inadvertent oversight and should not be punished for a minor technical violation. Further, the industry asserted that the provisions of Regulation D are

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<sup>44</sup> Public Law No. 104-290, October 11, 1996.

<sup>45</sup> SEC Proposed rules; request for additional comments; Revisions of Limited Offering Exemptions in Regulation D, Release No. 33-8828, 72 FR 45116, August 10, 2007, pages 72-74.

<sup>46</sup> SEC Final rules: Regulation D; Accredited Investor and Filing Requirements, Release No. 33-6825, 54 FR 11369, March 20, 1989.

not as critical as other provisions of the securities laws and regulations and that Form D is largely an information gathering device.

When Regulation D was amended in 1989, the Commission added Rule 507, which disqualifies an issuer from claiming a Regulation D exemption if it has been enjoined by a court for failing to file a Form D.<sup>47</sup> While Rule 507 was intended to be an incentive for issuers to file Form D,<sup>48</sup> the Commission has never sought or obtained any injunctions for failure to file a Form D to date. CF and Enforcement staff have informed us that Enforcement staff tend not to pursue such remedies because Regulation D abuses are not as attractive to the courts as fraud cases.

As a consequence, there is currently no effective method for the Commission to enforce the Rule Form D filing requirement. In fact, CF officials have informed us that many companies that rely on the Regulation D exemptions reportedly do not file a Form D, and that issuers' lawyers frequently advise their clients that filing Form D is essentially voluntary.<sup>49</sup> Further, as illustrated in this report, OCIE examinations identified several instances where issuers should have filed, but failed to file a Form D. Because many companies do not comply with the Form D filing requirement, the reliability and usefulness of the aggregate data from Form D filings is limited. We believe that requiring the filing of a Form D as a condition to claiming the Regulation D exemptions would assist the Commission in enforcing the Form D filing requirement and would increase the reliability and usefulness of the aggregate data obtained from Form D filings.

#### **Recommendation 4**

The Division of Corporation Finance should reintroduce its Early Intervention Program and utilize this program to assist in the enforcement of Regulation D and other securities laws and regulations.

#### **Recommendation 5**

The Division of Corporation Finance (CF) should develop criteria describing when it is appropriate to refer potential Regulation D abuses to its Office of Enforcement Liaison and when such referrals should subsequently be forwarded to the Division of Enforcement (Enforcement) for appropriate action. Additionally, CF and Enforcement should improve the communication and coordination

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<sup>47</sup> Id.

<sup>48</sup> SEC Final rule; Electronic Filing and Revision of Form D, Release No. 33-8891, 73 FR 10592, February 27, 2008, pages 5-6.

<sup>49</sup> While the Commission had proposed to eliminate the Form D filing requirement in 1996, it subsequently determined that the information collected in Form D filings as still useful to conduct economic and other analyses of the private placement market and retained the requirement. Id. at 10.

between staff in CF's Office of Small Business Policy and Enforcement staff. Specifically, staff in CF's Office of Small Business Policy should periodically remind Enforcement about the expertise that they could provide to Enforcement staff regarding Regulation D issues, assist Enforcement with specific aspects of referrals pertaining to Regulation D issues, and/or offer training sessions to Enforcement staff.

### **Recommendation 6**

The Division of Corporation Finance (CF) should take further efforts to finalize the Commission's proposed rule, "Revisions of Limited Offering Exemptions in Regulation D" (Release No. 33-8828, August 10, 2007, 72 FR 45116). For example, CF could discuss the merits of this proposed rule with the SEC's new Chairman, the Commissioners and Commission senior staff.

### **Recommendation 7**

The Division of Corporation Finance should raise with the Commission, the option of making the filing of Form D a required condition for issuers to claim the Regulation D exemptions contained in Rules 504, 505 and 506.

## **Finding 3: The OIG Identified Several Instances of Non-compliance with Regulation D**

The OIG judgmentally sampled 41 Form D filings and found that approximately one-third of the filers filed Form D late and one company solicited its offering on its Internet site, which is prohibited by Regulation D. The OIG also identified errors related to issuers' reported minimum investment amounts and the state of incorporation or organization.

These violations and abuses illustrate the need for CF to take a more active role in ensuring Regulation D compliance and to contact issuers that abuse the Regulation D provisions.

### **Deficiencies Identified by the OIG**

Beginning on September 15, 2008, companies were able to file SEC's new Form D electronically, on EDGAR, using the Internet. The completed Form Ds are available to the public, in their entirety, on EDGAR. As of December 16, 2008,

issuers had filed 322 electronic Form Ds on EDGAR. We judgmentally selected and reviewed 41 of 322 filings.<sup>50</sup>

We analyzed the 41 filings and identified the following deficiencies:

- Eighteen filers (43.9 percent) filed a form D late because they did not file the Form within 15 calendar days of the date of the first sale of securities, as required by Regulation D.<sup>51</sup> It is important to ensure that the purpose of having issuers file Form D timely is to allow regulators more time to intervene (before all the capital has been raised) in the event that fraud or other improprieties are identified. Further, according to an OCIE examination report issued in 2008, when an issuer files a Form D late or not at all, the marketplace, and specifically the individual retail investors who purchase and hold the shares, lack necessary information regarding the size of the issuance. This typically results in a dilution of the value of the stock holdings in the issuance, and accordingly, reduces the value of the stock.
- One filer (2.4 percent) solicited its offering on its public website. General solicitation of securities issued pursuant to a Regulation D exemption is prohibited. We identified this general solicitation on December 24, 2008, and alerted CF to this on January 2, 2009. On March 20, 2009, CF referred this issue to Enforcement.
- Only 14 filers (34.1 percent) included information about the size of their companies in terms of revenue range or aggregate net asset value range, as requested in item 5 of Form D. Most of these filers declined to disclose this information, as permitted by the new Form D. This information is important because the Regulation D program is intended to assist small businesses and, if issuers choose to not disclose this information, CF is hampered in its ability to determine to what extent small businesses benefit from the program. In a Commission meeting, a CF official stated that one objective for requesting this information was to determine how many smaller issuers use the Regulation D exemptions and for what purposes they are used.<sup>52</sup>

Further, the Commission's final rule regarding the revision of Form D states:

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<sup>50</sup> See Appendix IV for a detailed description of how the OIG judgmentally selected these 41 filings.

<sup>51</sup> The date of the first sale of securities is defined as the date on which the first investor is irrevocably contractually committed to invest.

<sup>52</sup> Transcript of SEC Open Commission meeting on December 11, 2007, page 38.

We continue to believe that this information [revenue range or aggregate net asset value range] will help us to determine the types and sizes of most issuers that rely on the Regulation D and Section 4(6) exemptions. For instance, as noted in the proposing release, this information will increase significantly the effectiveness of the data collected as a tool for assessing the use of the Regulation D exemptions for small businesses and other different sizes of issuers.<sup>53</sup>

We performed our analysis manually; as the SEC's electronic system for analyzing Form Ds was not functional at the time of our review. The SEC launched this system on March 16, 2009. CF has not performed a similar analysis. Using this new system, SEC staff now have the ability to analyze data much more quickly and in the aggregate.

During the audit, we provided CF with a spreadsheet detailing the results of our analysis, identifying the issuers that filed the 41 Form D filings we reviewed and the problems we identified with each filing.

### **Recommendation 8**

The Division of Corporation Finance (CF) should issue additional guidance to issuers on the Form D filing requirements. This could be accomplished by reiterating the Form D filing requirements at relevant meetings and symposiums and by adding information to CF's public website about the filing process. CF could also enhance compliance with the Form D filing requirement by developing and sending a "form" letter to issuers that failed to file a Form D or did not timely file a Form D.

## **Finding 4: Form D Should be Improved**

While the new electronic Form D is an improvement over the prior Form D, the Form should be further revised to clarify the form and help ensure that potential investors are not misled.

Based on our review of 41 Form D filings, we identified several revisions that should be made to the new Form, as described below.

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<sup>53</sup> SEC Final rule; Electronic Filing and Revision of Form D, Release No. 33-8891, 73 FR 10592, February 27, 2008, p.24.

- Form D should include a disclaimer statement, which conveys that the Commission has not necessarily reviewed the Form and has not determined if the information contained in the Form is truthful or complete and that any representation to the contrary is a criminal offense. The statement should also convey that the reader should not assume that the information in the Form is accurate or complete.

Prior to September 15, 2008, Form D filings were available from the Commission in paper form for free or at a modest cost. Individuals could also pay a fee to a third party vendor to access electronic copies of the Form D filings. Now, all Form D filings made on or after March 16, 2009, are available on EDGAR, in their entirety, at no cost, to anyone with an Internet connection. CF officials raised concerns that companies may try to solicit investors by representing or implying that the Commission “approved” the Form D filings. In fact, the SEC does not currently review any substantive information in the filings and has never “approved” any Form D filings. Further, SEC registration statements, such as the S-1 and S-3, contain disclaimer statements similar to those described above.

According to CF, SEC registration statements, unlike Form D, were designed to be investor disclosure documents and, therefore, are not comparable to Form D filings. Nevertheless, the public may still rely upon information contained in Form D filings and we believe that the Form D filings should contain a disclaimer statement.

- Item 1 of Form D (Issuer’s Identity) should be revised so to ensure that each issuer’s state of incorporation or organization appears as a valid entry on Form D. In our review of 41 filings, we found three instances where the issuer’s state of incorporation or organization appeared as “D0” or “E9”. CF informed us that these codes were displayed incorrectly due to a technical issue and CF has brought this issue to OIT’s attention.
- Item 5 of Form D (Issuer’s Size) should be revised to ensure that the electronic version of the Form contains the relevant headings in the text of the electronic Form. Currently, item 5 of the hard copy version of Form D contains brief headings, which convey that the issuer needs to fill in information related either to the “Revenue Range” or the “Aggregate Net Asset Value Range” of the offering. However, the electronic version of the Form does not contain these headings. As a result, it is not clear on the electronic Form D, which column issuers are required to fill in. CF informed us that it has already recommended that OIT implement this change.
- Item 11 of Form D (Minimum Investment Amount) should be revised to allow issuers to select a choice reflecting that an offering has no minimum

investment amount. This could be accomplished by replacing the current choice of “zero” with “no minimum investment.”

Currently, item 11 contains a “drop down” menu of choices, but the menu does not include a choice indicating that there is no minimum investment amount. As a result, issuers may instead select “zero” from the dropdown menu, as the minimum investment amount. Selecting “zero” as a minimum investment amount is erroneous because it is not possible to invest in a company without actually providing money or other assets to the company. In our sample of 41 filings, we found that eight (19.51%) issuers selected “zero” as the minimum investment amount.

### **Recommendation 9**

The Division of Corporation Finance should discuss the following enhancements to Form D with the Office of Information Technology (OIT) and work with OIT to make the following revisions to Form D:

- Form D should include a statement conveying that the Commission has not necessarily reviewed the Form and has not determined if the information contained in the Form is truthful or complete and that any representation to the contrary is a criminal offense. The statement should also convey that the reader should not assume that the information in the Form is accurate or complete;
- Item 1 of Form D (Issuer’s Identity) should be revised so to ensure that each issuer’s state of incorporation or organization appears as a valid entry on Form D;
- Item 5 of Form D (Issuer’s Size) should be revised to ensure that the electronic version of the Form contains headings in the text of the electronic Form stating that issuers need to fill in information related either to the “Revenue Range” or the “Aggregate Net Asset Value Range” of the offering; and
- Item 11 of Form D (Minimum Investment Amount) should be revised to allow issuers to select a choice indicating that an offering does not have a minimum investment amount. This could be accomplished by replacing the current choice of “zero” with “no minimum investment.”

## **Finding 5: CF Did Not Implement all of the Recommendations Made in the Prior OIG Audit Report**

The OIG's 2004 audit report on the Regulation D exemption process<sup>54</sup> contained five recommendations. We determined that CF effectively implemented two recommendations, did not implement two recommendations, and should further implement one recommendation.

### **Recommendations that Were Implemented**

The prior OIG report's recommendations D and E stated that CF should revise Form D and enable companies to file Form D electronically. CF, in consultation with other Commission divisions and offices effectively implemented these recommendations, which improved the Regulation D filing process.

### **Recommendations that Were Not Implemented**

CF did not implement recommendation A of the prior OIG report, which stated that CF should expand its review of SEC S-1 registration statements to determine if companies that file SEC registration statements also file a Form D when required. The prior audit found that 16 of a sample of 18 companies that filed SEC S-1 registration statements disclosing the sale of unregistered securities failed to file a required corresponding Form D. CF concluded that the costs of implementing this recommendation outweighed the benefits and therefore did not implement the recommendation.

Management in CF's Office of Small Business Policy stated that it is prudent for the staff in this office to coordinate with the CF staff who review S-1 registration statements, as well as SEC 10-K and 8-K reports, to determine if companies that file these statements also file a Form D when required.<sup>55</sup> All of these disclosure documents require filers to disclose the existence of private placement offerings. CF's Office of Small Business Policy staff could assist other CF staff in reviewing these disclosure documents and determining whether the companies filed corresponding Form Ds when SEC registration statements, 10-Ks and 8-Ks

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<sup>54</sup> OIG Report, *Small Business Regulation D Exemption Process*, Report No. 371, issued March 29, 2004.

<sup>55</sup> Form 10-K is the annual report that SEC registrants must file with SEC, which provides a comprehensive overview of the company's business and financial condition and includes the company's audited financial statements. Form 8-K is the report that SEC registrants must file with the SEC to announce major events that shareholders should know about.

identified the existence of private placement offerings. This process would assist CF to determine compliance with the Form D filing requirements.

CF also did not implement recommendation C of the prior OIG report, which stated that CF should track data on Regulation D offerings. CF stated that the costs of implementing this recommendation outweighed the benefits and therefore did not implement the recommendation. However, OIT has developed a system that will allow CF to analyze Form D data in the aggregate. The system was launched on March 16, 2009. Recommendation two of this report addresses this issue by stating that CF should track and analyze the Form D data in the aggregate and produce meaningful management reports. As a result, we are not making an additional recommendation in this section of the report.

### **CF Should Further Implement One Recommendation**

CF partially addressed the prior OIG audit report's recommendation B, which stated that CF should consult with OCIE to obtain information regarding Regulation D compliance issues noted during examinations. We believe, however, that CF and OCIE should further coordinate with each other. In response to this recommendation, OCIE now forwards some, but not all of its examination reports to CF, which discuss Regulation D issues.

According to CF staff, OCIE does not routinely send CF staff copies of pertinent broker-dealer examinations but does routinely forward its pertinent examinations of investment advisers to CF.<sup>56</sup> During the audit we forwarded copies of OCIE examinations to CF that discussed Regulation D issues. CF staff were aware of some but not all of these examinations. Further, OCIE does not send CF copies of its referral memoranda that it sends to the Enforcement for possible investigation. The prior OIG report did not specifically recommend that OCIE forward its referral memoranda to CF but we believe this additional step would be prudent.

If CF received all OCIE examinations and referral memoranda that discussed Regulation D issues, CF staff could better provide expertise or guidance to OCIE and Enforcement staff. This practice would also help CF staff to stay abreast of the different types and frequency of Regulation D abuses, which could assist CF in developing future policies and rules.

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<sup>56</sup> OCIE also examines investment companies, but issues related to Regulation D generally do not apply to these examinations. This is because investment companies do not typically solicit or recommend investment products to clients.

## **Recommendation 10**

The Division of Corporation Finance's (CF) Office of Small Business Policy staff should coordinate with CF staff who review Commission registration statements, 10-Ks and 8-Ks to determine if issuers also filed Form Ds when the registration statements, 10-Ks and 8-Ks indicated the existence of private placement offerings. CF should also follow up with delinquent Form D filers, as appropriate.

## **Recommendation 11**

The Office of Compliance Inspections and Examinations (OCIE) should further coordinate with the Division of Corporation Finance (CF) to ensure that CF timely receives copies of all OCIE examination reports that disclose misuses of the Regulation D exemption process and potential violations or abuses of the rules contained in Regulation D. OCIE should also provide CF with copies of all related Enforcement referrals. CF should follow up with and offer assistance to the Division of Enforcement and OCIE, as appropriate.

## **Finding 6: Firms Lack Written Guidance on Filing Requests for Waivers of Disqualification Under Rule 505 of Regulation D**

If firms or other issuers are found to be in violation of certain provisions of the securities laws, they may be prohibited from participating in offerings using the Rule 505 exemption of Regulation D and may wish to apply to the SEC for a waiver to participate in any future 505 offerings. Firms have contacted CF seeking guidance on this process and have asked whether formal, written guidance is available. CF provides oral guidance and refers inquirers to waiver requests from other firms, which are available on SEC's website. CF, however, has not issued any written guidance describing how to apply for the waivers and when a firm should consider applying for a waiver. Written guidance would clarify when a firm should seek a waiver and what information needs to be included in a waiver request.

If firms or other issuers are found to be in violation of certain provisions of securities laws,<sup>57</sup> they may be disqualified from participating in securities

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<sup>57</sup> Rule 262, 17 C.F.R. § 230.262, provides, among other things, that the exemption provided by Regulation "A" is not available if an issuer, or its affiliates, or its underwriter, or underwriter's partners, directors, or officers are subject to an administrative order, or an injunction involving

offerings using the Rule 505 exemption of Regulation D and must apply for a waiver to participate in future 505 offerings. There are no similar disqualification provisions in Rules 504 and 506, and therefore, no similar waiver provisions in Rules 504 and 506.

These firms are typically identified through an Enforcement action. Enforcement actions may be litigated or settled and ultimately result in the issuance of an Order by a federal court judge or an administrative law judge. A firm's legal counsel may advise the firm to seek a waiver of its Rule 505 disqualification.

Enforcement staff, during discussions leading up to a settlement agreement, may advise the counsel for the defendants or respondents (entities named in Enforcement actions) to contact CF to discuss the conditions under which granting a waiver of disqualification under Rule 505 would be considered. Defendants and respondents submit waiver applications to CF. CF then considers the facts and circumstances and may grant a waiver request. CF staff told us that they receive approximately one or two waiver requests a month, and that the requests are typically from large, prominent firms. In fiscal year 2007, CF granted one waiver request. In fiscal year 2008, CF granted seven waiver requests, several of which arose from related Enforcement proceedings.

Currently, CF has not issued any formal, written guidance on how to apply for waivers. CF staff told us that almost all of the waiver requests are initially deficient and need to be updated and resent to CF. Firms call CF for guidance and, in some instances, CF determines that waivers are not necessary and verbally advises firms not to submit a waiver application. When CF believes that a waiver request is appropriate, CF staff direct the firms to CF's website, which contains actual waiver requests and CF approvals. CF staff advise firms to rely upon waiver requests submitted by other firms as a guide.

A staff member of CF's Office of Small Business Policy has drafted waiver request guidance but the guidance has never been issued. CF staff stated that it would be useful to issue such guidance, possibly on SEC's website, but due to the small number of waiver requests that CF receives and the resources already available to requestors, CF did not prioritize issuing this guidance to the firms.

We believe that formal, written guidance would be especially useful if it contained clear instructions concerning:

- When a waiver request is and is not appropriate;
- How and when to submit a request;

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certain securities law violations. Similarly, Rule 505 of Regulation D is not available for the securities of any issuer who becomes disqualified under Rule 262 of the Securities Act. See 17 C.F.R. § 230.505(b)(2)(iii).

- The substantive requirements of the request; and
- Where to send the request.<sup>58</sup>

We believe that formal, written, publicly-available guidance would be useful to firms and reduce the number of questions that CF staff receives about the waiver process.

## **Recommendation 12**

The Division of Corporation Finance (CF) should issue formal, written, publicly-available guidance describing how to request a waiver of disqualification under Rule 505 of Regulation D and under what circumstances a waiver request may be appropriate.

## **Finding 7: OIT and CF Did Not Timely or Effectively Simplify the EDGAR Authentication Process for New Filers**

OIT and CF did not timely or effectively simplify the EDGAR authentication process for new filers. Commission staff estimated that approximately 19,000 new Form D filers are expected to file Form D electronically, but must first obtain an EDGAR authentication code. The current authentication process is overly complex and time-consuming and, in December 2007, OIT and CF agreed to work together immediately to simplify this process. The simplified process, which took effect on March 16, 2009, only consists of allowing new filers to attach a notarized document to their application as a PDF attachment, as opposed to faxing the document to the SEC. This simplified process is inadequate. Further, we agree with certain Commission staff who acknowledged that an effective simplification process should have been implemented well before March 16, 2009. As a result, a large number of new EDGAR filers will be subject to an authentication process that needs significant improvement.

CF estimated that it receives approximately 28,000 Form D filings each year<sup>59</sup> and that approximately 19,000 of those filings would be made by first-time

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<sup>58</sup> These instructions are already included in CF's draft guidance, which has not been issued to the public.

<sup>59</sup> The SEC received 27,107 Form D filings (including amendments) in 2008.

EDGAR filers after March 16, 2009, when filing Form D electronically became mandatory.<sup>60</sup> As a result, approximately 19,000 current Form D filers will need authentication codes prior to making their first electronic Form D filing. According to CF, this will make Form D filers the second largest initial registration group to the EDGAR system.<sup>61</sup>

Staff in CF and OIT process new EDGAR authentication codes. Prior to March 16, 2009, the EDGAR authentication process was overly complex, and Commission staff described it as error prone, cumbersome and time consuming.<sup>62</sup> Further, SEC support staff spent a considerable amount of time on the phone assisting filers. Filers continually complained that they did not receive e-mail messages sent from the SEC. Simplifying the EDGAR authentication process is important to alleviate these problems, especially given the huge expected increase in new EDGAR filers that will result from the mandatory electronic filing of Form D.

In a Commission meeting in December 2007, OIT and CF agreed to begin working together to simplify this process.<sup>63</sup> In fact, CF informed us that its staff had been working with OIT staff for several years to simplify the process, even prior to the Commission meeting. While CF and OIT have had at least one year to accomplish this task, the only simplification to the process, which took effect on March 16, 2009, was to allow filers to send a required notarized document to the SEC as a PDF attachment to an applicant's online application, as opposed to faxing the document to the SEC. This simplification addresses only one minor step in the authentication process, failed to address the inherent problems with the process and was not even being implemented in a timely fashion. As a result, many of the problems identified above with the EDGAR authentication process still remain. Commission staff noted that they plan to further simplify the authentication process.

The simplification process took effect on March 16, 2009, but certain SEC staff acknowledged that it was supposed to be in place well before this date. Simplifying the process prior to March 16, 2009, would have given Commission staff more time to address problems with the new process prior to receiving a potentially significant increase in the number of electronic Form D filings. While all of the estimated 19,000 new Form D filers did not need an authentication code by March 16, 2009, they will need an authentication code prior to filing their first electronic Form D or electronic Form D amendment with the SEC.

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<sup>60</sup> Transcript of SEC Open Commission meeting on December 11, 2007, pages 22 and 32.

<sup>61</sup> According to OIT, 200,000 to 300,000 individuals and entities currently have EDGAR authentication codes.

<sup>62</sup> The EDGAR authentication process is described in Appendix III.

<sup>63</sup> Transcript of an Open Commission meeting on December 11, 2007, page 37.

Based on our analysis and discussions with CF and OIT management, we concluded that these organizations did not effectively communicate or coordinate with each other to implement an adequate simplified authentication process in a timely manner. CF told us that OIT was not responsive to CF's proposed simplification processes, while OIT claimed that CF's proposed solutions were not feasible.

CF management suggested that the Commission ascertain how other agencies (federal and/or non-federal) have implemented similar authentication processes so that new system users can file documents electronically. We concur and note that by learning about other agencies' procedures, the SEC could better critique and further simplify its own authentication process.

### **Recommendation 13**

The Office of Information Technology (OIT), in consultation with the Division of Corporation Finance (CF), should evaluate the Commission's current EDGAR authentication process, and OIT should make necessary changes to further simplify or streamline the authentication process, as appropriate. To facilitate this process, CF should communicate related problems and proposed changes to OIT as soon as they become apparent and OIT should respond accordingly.

### **Recommendation 14**

The Office of Information Technology (OIT) should analyze how other agencies (federal and/or non-federal) have implemented authentication processes to enable new users to file documents electronically, and determine if the SEC should implement any of the processes used by other agencies. OIT should implement any appropriate procedures to further streamline and simplify its own EDGAR authentication process.

## **Finding 8: The Commission's Coordination with State Regulators Needs to Continue to Improve**

State regulatory staff at NASAA informed the OIG that the SEC has not effectively coordinated with them to implement a state-sponsored system that would enable issuers to file Form D electronically with the states, nor did the SEC seek NASAA's input on SEC proposed rules related to Regulation D. Further, SEC Commissioner Aguilar has recognized the need for increased SEC coordination with NASAA.

The primary mission of both the SEC and NASAA is to protect investors. Section 19(d) of the Securities Act,<sup>64</sup> authorizes the SEC to cooperate with any association (such as NASAA) comprised of state securities regulators that could assist in effectuating greater uniformity in federal-state securities matters and provides that the SEC shall, at its discretion, cooperate, coordinate, and share information with such an association to increase federal-state cooperation and uniformity in securities matters.

The Commission staff have drafted a proposed Memorandum of Understanding (MOU) for execution by the Commission and NASAA, regarding mutual cooperation. However, as of the issuance of this report, it had not been finalized. The MOU specifies coordination efforts between the SEC and NASAA, which would ultimately result in issuers being able to file Form D electronically with the states. Currently, issuers can only file Form D electronically with the SEC and must file paper Form Ds with their respective states.

Further, on January 10, 2009, in a speech addressed to NASAA, SEC Commissioner Aguilar stated:

I think a strong, collaborative relationship between NASAA and the SEC is critical to pursuing robust enforcement efforts. There are many ways to do this. One suggestion would be to consider establishing a standing SEC-NASAA Task Force in order to monitor financial activity across North America, consider the accumulated risk, and share and discuss recommendations for appropriate action. Another suggestion to improve and strengthen this relationship would be to have a NASAA representative at the SEC.

I think either idea, and perhaps others, could substantially improve collaborative efforts and would benefit investors around the nation and North America, as state, provincial, and federal enforcement officials work together to implement regulatory reform and spot fraudulent schemes.

We contacted five senior officials at NASAA to obtain their views on the SEC's coordination with NASAA and any areas in which they believe the SEC should improve its implementation of the Regulation D filing process. The comments from these officials are categorized and summarized below as follows:

**NASAA Has a Good Working Relationship with the SEC.** The NASAA officials said they have a good working relationship with the SEC, and particularly with the staff in CF's Office of Small Business Policy and the SEC's Fort Worth

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<sup>64</sup> 15 U.S.C. § 78s(d).

Regional Office. The NASAA officials also lauded the SEC for revising Form D and implementing a means to file the Form electronically.

**Better SEC Enforcement Related to Regulation D is Needed.** The NASAA officials said that the SEC does not enforce issuer compliance with the Regulation D filing process and relies upon the “honor system” to determine whether issuers are effectively carrying out the requirements of Regulation D. Further, the SEC does not impose any consequences on companies that fail to file a Form D or that file the Form late.

One NASAA official said the staff from one State routinely sends CF information about issuers that are engaged in fraudulent activities related to Regulation D, but the SEC never takes any action. Another NASAA official said that the regulatory tone is “set at the top,” and additional SEC enforcement of Regulation D would lead to more effective enforcement by the states.

**Better Communication with the SEC is Needed Regarding the NASAA-Sponsored Electronic Form D Filing System.** NASAA officials said that the SEC, including CF and OIT staff, did not effectively coordinate with NASAA staff to discuss how the SEC would link EDGAR to a NASAA-sponsored system that state securities’ regulators are expected to develop. This system would allow issuers to file Form D electronically with the SEC and the states in one filing session. While filers are now able to file Form D electronically with the SEC, the filers must mail a paper copy to their respective state regulators.

The states have not yet developed a system to accommodate electronic filing of Form D at the state level. The NASAA officials said this is partly because of the SEC’s lack of coordination with the state regulators, and NASAA’s lack of access to SEC officials to discuss the requirements that will be necessary for the future system to link to the SEC’s EDGAR system. One NASAA official said that NASAA staff met with the SEC twice in 2007 to discuss the electronic system, but the meetings were not very productive. This NASAA official also stated that the state securities regulators did not have the minimum amount of information required to make a decision regarding what type of system to develop until August 2008. NASAA staff said that going forward, additional communication with the SEC is needed to discuss the nature of the state filing system and the requirements that will enable it to link to EDGAR.

Finally, the NASAA officials expressed frustration that the state filing system was not launched in tandem with the EDGAR modification that allowed issuers to file Form D electronically with the SEC.

**The SEC Should Share its Regulation D Database with NASAA.** A NASAA official suggested that SEC should allow the states to access this system to analyze Form D data so the states can create management reports and analyze data in the aggregate.

**Better Communication with NASAA regarding SEC Rulemakings is Needed.** NASAA officials said the SEC did not include them in discussions about two recent rulemakings regarding Regulation D. A NASAA official said that it is important for the SEC to discuss issues with NASAA early in the course of such rulemakings, before proposed rules are issued for public comment, because NASAA staff, unlike SEC staff, enforce compliance with Regulation D and are routinely involved in related cases.

**NASAA Officials Expressed Frustration that Enforcement of Rule 506 has been Curtailed at the State Level.** Prior to the National Securities Market Improvement Act (NSMIA) of 1996,<sup>65</sup> recidivists (i.e., repeat securities law violators) were excluded from participating in most Rule 506 offerings by state disqualification provisions, and the states were able to enforce compliance with this exclusion. In 1996, NSMIA preempted the states from enforcing these provisions in favor of federal regulation. This change has raised the question of whether federal disqualification provisions should be adopted for offerings issued pursuant to Rules 504 and 506. Currently, recidivists are only precluded from participating in offerings pursuant to Rule 505.

In August 2007, the SEC proposed a rule that contained a provision to preclude recidivists from participating in all Regulation D offerings pursuant to Rules 504, 505 and 506.<sup>66</sup> The Commission has neither finalized, nor established a timeframe for finalizing this proposed rule.

**CF's Response to NASAA's Comments.** CF staff believe they have extensively and effectively coordinated with NASAA. CF staff stated that they sought the views of NASAA members on proposed rules regarding both Regulation D and Form D and provided a copy of the SEC's new Form D to NASAA before the Form was publicized. While CF stated that it regrets that a state electronic filing system was not launched in tandem with SEC's electronic filing system, CF noted that such coordination would have delayed any electronic filing by years. Further, CF stated that it is unaware of any allegations of fraudulent conduct on which CF has not acted.

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<sup>65</sup> Public Law No. 104-290, October 11, 1996.

<sup>66</sup> SEC Proposed rules; Request for additional comments; Revisions of Limited Offerings Exemptions in Regulation D, Release No. 33-8828, 72 FR 45116, August 10, 2007, pages 61-68.

### **Recommendation 15**

The Division of Corporation Finance (CF) should work with the North American Securities Administrators' Association (NASAA) to finalize the Commission's Memorandum of Understanding with NASAA and recommend that the Commission approve it.

### **Recommendation 16**

The Division of Corporation Finance should timely and appropriately coordinate with staff at the North American Securities Administrators' Association to develop a system that can be linked to the Commission's Electronic Data Gathering and Retrieval system, enabling issuers to file Form D electronically with the states.

### **Recommendation 17**

The Division of Corporation Finance (CF) should take into account all of the comments and suggestions described above and implement appropriate action. In particular CF should:

- Determine to what extent CF can further coordinate with staff at the North American Securities Administrators' Association (NASAA), as in the manner described by Commissioner Aguilar, and take appropriate action; and
- Contact appropriate staff at state regulatory organizations, such as NASAA, when CF staff are discussing and drafting proposed rule changes pertaining to Regulation D.

## Acronyms

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CF	Division of Corporation Finance
EDGAR	Electronic Data Gathering and Retrieval System
Enforcement	Division of Enforcement
FINRA	Financial Industry Regulatory Authority
MOU	Memorandum of Understanding
NASAA	North American Securities Administrators' Association
OCIE	Office of Compliance Inspections and Examinations
OEL	Office of Enforcement Liaison
OIG	Office of Inspector General
OIT	Office of Information Technology
SEC or Commission	U.S. Securities and Exchange Commission
Securities Act	Securities Act of 1933

# Form D

**FORM D**  
**Notice of Exempt**  
**Offering of Securities**

**U.S. Securities and Exchange Commission**  
Washington, DC 20549

(See instructions beginning on page 5)

OMB APPROVAL	
OMB Number: 3235-0076	
Expires: February 28, 2009	
Estimated average burden hours per response: 4.00	

Intentional misstatements or omissions of fact constitute federal criminal violations. See 18 U.S.C. 1001.

**Item 1. Issuer's Identity**

Name of Issuer

Jurisdiction of Incorporation/Organization

Year of Incorporation/Organization (Select one)  
 Over Five Years Ago     Within Last Five Years (specify year)      Yet to Be Formed

Previous Name(s)  None

Entity Type (Select one)  
 Corporation  
 Limited Partnership  
 Limited Liability Company  
 General Partnership  
 Business Trust  
 Other (Specify)

(If more than one issuer is filing this notice, check this box  and identify additional issuer(s) by attaching Items 1 and 2 Continuation Page(s).)

**Item 2. Principal Place of Business and Contact Information**

Street Address 1

City  State/Province/Country  ZIP/Postal Code  Phone No.

**Item 3. Related Persons**

Last Name  First Name  Middle Name

Street Address 1

City  State/Province/Country  ZIP/Postal Code

Relationship(s):  Executive Officer  Director  Promoter

Clarification of Response (if Necessary)

(Identify additional related persons by checking this box  and attaching Item 3 Continuation Page(s).)

**Item 4. Industry Group (Select one)**

<input type="radio"/> <b>Agriculture</b> <input type="radio"/> <b>Banking and Financial Services</b> <input type="radio"/> Commercial Banking <input type="radio"/> Insurance <input type="radio"/> Investing <input type="radio"/> Investment Banking <input type="radio"/> Pooled Investment Fund If selecting this industry group, also select one fund type below and answer the question below: <input type="radio"/> Hedge Fund <input type="radio"/> Private Equity Fund <input type="radio"/> Venture Capital Fund <input type="radio"/> Other Investment Fund Is the issuer registered as an investment company under the Investment Company Act of 1940? <input type="radio"/> Yes <input type="radio"/> No <input type="radio"/> Other Banking & Financial Services	<input type="radio"/> <b>Business Services</b> <input type="radio"/> <b>Energy</b> <input type="radio"/> Electric Utilities <input type="radio"/> Energy Conservation <input type="radio"/> Coal Mining <input type="radio"/> Environmental Services <input type="radio"/> Oil & Gas <input type="radio"/> Other Energy <input type="radio"/> <b>Health Care</b> <input type="radio"/> Biotechnology <input type="radio"/> Health Insurance <input type="radio"/> Hospitals & Physicians <input type="radio"/> Pharmaceuticals <input type="radio"/> Other Health Care <input type="radio"/> <b>Manufacturing</b> <input type="radio"/> <b>Real Estate</b> <input type="radio"/> Commercial	<input type="radio"/> Construction <input type="radio"/> REITS & Finance <input type="radio"/> Residential <input type="radio"/> Other Real Estate <input type="radio"/> <b>Retailing</b> <input type="radio"/> <b>Restaurants</b> <input type="radio"/> <b>Technology</b> <input type="radio"/> Computers <input type="radio"/> Telecommunications <input type="radio"/> Other Technology <input type="radio"/> <b>Travel</b> <input type="radio"/> Airlines & Airports <input type="radio"/> Lodging & Conventions <input type="radio"/> Tourism & Travel Services <input type="radio"/> Other Travel <input type="radio"/> <b>Other</b>
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FORM D

U.S. Securities and Exchange Commission  
Washington, DC 20549

**Item 5. Issuer Size (Select one)**

Revenue Range (for issuer not specifying "hedge" or "other investment" fund in Item 4 above)

- No Revenues
- \$1 - \$1,000,000
- \$1,000,001 - \$5,000,000
- \$5,000,001 - \$25,000,000
- \$25,000,001 - \$100,000,000
- Over \$100,000,000
- Decline to Disclose
- Not Applicable

OR

Aggregate Net Asset Value Range (for issuer specifying "hedge" or "other investment" fund in Item 4 above)

- No Aggregate Net Asset Value
- \$1 - \$5,000,000
- \$5,000,001 - \$25,000,000
- \$25,000,001 - \$50,000,000
- \$50,000,001 - \$100,000,000
- Over \$100,000,000
- Decline to Disclose
- Not Applicable

**Item 6. Federal Exemptions and Exclusions Claimed (Select all that apply)**

- |  |  |   |
|--|--|---|
| <input type="checkbox"/> Rule 504(b)(1) (not (i), (ii) or (iii)) | Investment Company Act Section 3(c)      |   |
| <input type="checkbox"/> Rule 504(b)(1)(i)                       | <input type="checkbox"/> Section 3(c)(1) | <input type="checkbox"/> Section 3(c)(9)  |
| <input type="checkbox"/> Rule 504(b)(1)(ii)                      | <input type="checkbox"/> Section 3(c)(2) | <input type="checkbox"/> Section 3(c)(10) |
| <input type="checkbox"/> Rule 504(b)(1)(iii)                     | <input type="checkbox"/> Section 3(c)(3) | <input type="checkbox"/> Section 3(c)(11) |
| <input type="checkbox"/> Rule 505                                | <input type="checkbox"/> Section 3(c)(4) | <input type="checkbox"/> Section 3(c)(12) |
| <input type="checkbox"/> Rule 506                                | <input type="checkbox"/> Section 3(c)(5) | <input type="checkbox"/> Section 3(c)(13) |
| <input type="checkbox"/> Securities Act Section 4(6)             | <input type="checkbox"/> Section 3(c)(6) | <input type="checkbox"/> Section 3(c)(14) |
|  | <input type="checkbox"/> Section 3(c)(7) |   |

**Item 7. Type of Filing**

- New Notice **OR**  Amendment

Date of First Sale in this Offering:  **OR**  First Sale Yet to Occur

**Item 8. Duration of Offering**

Does the issuer intend this offering to last more than one year?  Yes  No

**Item 9. Type(s) of Securities Offered (Select all that apply)**

- |  |   |
|--|---|
| <input type="checkbox"/> Equity  | <input type="checkbox"/> Pooled Investment Fund Interests |
| <input type="checkbox"/> Debt  | <input type="checkbox"/> Tenant-in-Common Securities      |
| <input type="checkbox"/> Option, Warrant or Other Right to Acquire Another Security                                  | <input type="checkbox"/> Mineral Property Securities      |
| <input type="checkbox"/> Security to be Acquired Upon Exercise of Option, Warrant or Other Right to Acquire Security | <input type="checkbox"/> Other (Describe)                 |
|  | <input type="text"/>                                      |

**Item 10. Business Combination Transaction**

Is this offering being made in connection with a business combination transaction, such as a merger, acquisition or exchange offer?  Yes  No

Clarification of Response (if Necessary)

Form D 2

FORM D

U.S. Securities and Exchange Commission

Washington, DC 20549

Item 11. Minimum Investment

Minimum investment accepted from any outside investor \$ [ ]

Item 12. Sales Compensation

Recipient [ ] Recipient CRD Number [ ] No CRD Number
(Associated) Broker or Dealer [ ] None (Associated) Broker or Dealer CRD Number [ ] No CRD Number
Street Address 1 [ ] Street Address 2 [ ]
City [ ] State/Province/Country [ ] ZIP/Postal Code [ ]
States of Solicitation [ ] All States
[ ] AL [ ] AK [ ] AZ [ ] AR [ ] CA [ ] CO [ ] CT [ ] DE [ ] DC [ ] FL [ ] GA [ ] HI [ ] ID
[ ] IL [ ] IN [ ] IA [ ] KS [ ] KY [ ] LA [ ] ME [ ] MD [ ] MA [ ] MI [ ] MN [ ] MS [ ] MO
[ ] MT [ ] NE [ ] NV [ ] NH [ ] NJ [ ] NM [ ] NY [ ] NC [ ] ND [ ] OH [ ] OK [ ] OR [ ] PA
[ ] RI [ ] SC [ ] SD [ ] TN [ ] TX [ ] UT [ ] VT [ ] VA [ ] WA [ ] WV [ ] WI [ ] WY [ ] PR
(Identify additional person(s) being paid compensation by checking this box [ ] and attaching Item 12 Continuation Page(s).)

Item 13. Offering and Sales Amounts

(a) Total Offering Amount \$ [ ] OR [ ] Indefinite
(b) Total Amount Sold \$ [ ]
(c) Total Remaining to be Sold \$ [ ] OR [ ] Indefinite
(Subtract (a) from (b))

Clarification of Response (if Necessary) [ ]

Item 14. Investors

Check this box [ ] if securities in the offering have been or may be sold to persons who do not qualify as accredited investors, and enter the number of such non-accredited investors who already have invested in the offering: [ ]

Enter the total number of investors who already have invested in the offering: [ ]

Item 15. Sales Commissions and Finders' Fees Expenses

Provide separately the amounts of sales commissions and finders' fees expenses, if any. If an amount is not known, provide an estimate and check the box next to the amount.

Sales Commissions \$ [ ] [ ] Estimate

Clarification of Response (if Necessary) Finders' Fees \$ [ ] [ ] Estimate

[ ]

Form D 3

FORM D

U.S. Securities and Exchange Commission

Washington, DC 20549

**Item 16. Use of Proceeds**

Provide the amount of the gross proceeds of the offering that has been or is proposed to be used for payments to any of the persons required to be named as executive officers, directors or promoters in response to Item 3 above. If the amount is unknown, provide an estimate and check the box next to the amount. \$   Estimate

Clarification of Response (if Necessary)

**Signature and Submission**

Please verify the information you have entered and review the Terms of Submission below before signing and submitting this notice.

**Terms of Submission.** In Submitting this notice, each identified issuer is:

Notifying the SEC and/or each State in which this notice is filed of the offering of securities described and undertaking to furnish them, upon written request, in accordance with applicable law, the information furnished to offerees.\*

Irrevocably appointing each of the Secretary of the SEC and the Securities Administrator or other legally designated officer of the State in which the issuer maintains its principal place of business and any State in which this notice is filed, as its agents for service of process, and agreeing that these persons may accept service on its behalf, of any notice, process or pleading, and further agreeing that such service may be made by registered or certified mail, in any Federal or state action, administrative proceeding, or arbitration brought against the issuer in any place subject to the jurisdiction of the United States, if the action, proceeding or arbitration (a) arises out of any activity in connection with the offering of securities that is the subject of this notice, and (b) is founded, directly or indirectly, upon the provisions of: (i) the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, the Investment Company Act of 1940, or the Investment Advisers Act of 1940, or any rule or regulation under any of these statutes; or (ii) the laws of the State in which the issuer maintains its principal place of business or any State in which this notice is filed.

Certifying that, if the issuer is claiming a Rule 505 exemption, the issuer is not disqualified from relying on Rule 505 for one of the reasons stated in Rule 505(b)(2)(iii).

\* This undertaking does not affect any limits Section 102(a) of the National Securities Markets Improvement Act of 1996 ("NSMIA") [Pub. L. No. 104-290, 110 Stat. 3416 (Oct. 11, 1996)] imposes on the ability of States to require information. As a result, if the securities that are the subject of this Form D are "covered securities" for purposes of NSMIA, whether in all instances or due to the nature of the offering that is the subject of this Form D, States cannot routinely require offering materials under this undertaking or otherwise and can require offering materials only to the extent NSMIA permits them to do so under NSMIA's preservation of their anti-fraud authority.

Each identified issuer has read this notice, knows the contents to be true, and has duly caused this notice to be signed on its behalf by the undersigned duly authorized person. (Check this box  and attach Signature Continuation Pages for signatures of issuers identified in Item 1 above but not represented by signer below.)

Issuer(s) <input type="text"/>	Name of Signer <input type="text"/>
Signature <input type="text"/>	Title <input type="text"/>
Number of continuation pages attached: <input type="text"/>	Date <input type="text"/>

Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number.

Form D 4

## EDGAR Filer Authentication Process

### Process up until March 15, 2009

Filers register on the EDGAR system by completing an electronic form. They use the EDGAR Filer Management website for this purpose and fill in the form giving information about the individual or company. The filer also enters a code, called a passphrase, which the filer uses later in retrieving the rest of its access codes. After the electronic form is completed, the EDGAR system gives the filer instructions as to the next step in the process and an accession number (a unique number by which EDGAR identified the filing) that the filer can use when referring to the electronic Form ID submission. The filer then prints the form and has the document notarized. The filer submits the notarized form via fax to CF filer support. The filer has two days to complete both of these processes, at which time the unmatched paper or electronic documents are discarded.

The CF filer support team receives the electronic forms as an EDGAR assignment in an inbox used expressly for this purpose. The team must then manually match the electronic form to the notarized paper form. Once they find the matching form, Filer Support staff release the assignment, which allows the submission to continue processing through the system. A message is sent to the filer via the e-mail address entered into the electronic Form ID. The message gives the filer a Central Index Key number, which uniquely identifies the entity as a filer. Using that number and the passphrase the filer created when it completed the Form ID, the filer can retrieve the rest of their access codes. (This includes the Company Confirmation Code that is used to give filing agents permission to do a third party filing, the password used to log into EDGAR, and the Password Modification Authorization Code used to change the password before it expires.) Of all the codes, only the password expires on an annual basis.<sup>67</sup>

### Process as of March 16, 2009

The process is the same as above, except filers were permitted to submit the notarized form as a PDF attachment to their electronic Form D application instead of faxing it to CF filer support.

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<sup>67</sup> We obtained a written overview of the EDGAR filer authentication process from OIT.

## Scope and Methodology

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We conducted this performance audit in accordance with generally accepted government auditing standards. These standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

**Scope.** We obtained information on applicable policies and procedures, background documents, CF's Early Intervention Program, CF's waiver review process, the Commission's EDGAR system, the Commission's simplified EDGAR authentication process, and applicable SEC proposed and final rules. We assessed the timeliness and accuracy of a sample of Form D filings. We obtained copies of OCIE examination reports and referrals to Enforcement covering the time period from October 1, 2007 to December 31, 2008. We obtained information showing the status of CF's implementation of prior OIG audit recommendations regarding the Regulation D program (*Small Business Regulation D Exemption Process*, Audit No. 371, March 29, 2004). We conducted our fieldwork from November 2008 to February 2009.

**Methodology.** We reviewed applicable policies and procedures, CF's Early Intervention Program, CF's waiver review process, applicable background documents and SEC proposed and final rules. We also reviewed OCIE examination reports that discussed issues related to Regulation D, as well as Enforcement referrals involving potential Regulation D abuses. We reviewed and relied upon workpapers from our prior audit on this program (*Small Business Regulation D Exemption Process*, Audit No. 371, March 29, 2004).

We reviewed data to determine the timeliness and accuracy of a sample of Form D filings and to estimate the average amount of capital intended to be raised through the Regulation D process for calendar year 2008.

We held discussions with representatives from CF, OCIE, OIT and OS to learn about the program and to discuss and confirm our findings. We also contacted officials at NASAA, to obtain their views on the Commission's Regulation D exemption program.

**Internal/Management Controls.** We reviewed internal/management controls as they pertained to the objectives of our audit.

**Use of Computer-Processed Data.** We relied on data from the SEC's EDGAR system, which included the number of Form D filings processed in calendar years 2007 and 2008, as well as the number of Form D filings received from September 15, 2008 through December 31, 2008. The EDGAR system does not process any of the data contained in the Form D filings, but rather only stores the filings in electronic format. As a result, we considered the relevant risks to be:

- An EDGAR system failure to receive or retain a Form D filing from an issuer; and
- Information security risks related to whether Form D information in the EDGAR system could be compromised.

We considered the risk surrounding information security. In November 2007, OIT certified and accredited the EDGAR system, as required by the Federal Information Security Management Act of 2002. Therefore, we believe that we can rely upon the information in the EDGAR system as it pertains to information security.

**Judgmental Sampling.** We reviewed a sample of 41 Form D filings that were filed electronically between September 15, 2008 and December 16, 2008. We selected this time period because September 15, 2008 was the first date when filers were allowed to file Form D electronically. Further, the SEC established a new Form D, which was available to filers on September 15, 2008. Between September 15, 2008 and March 16, 2009, issuers were permitted to file the new or prior Form D. As of March 16, 2009, all filers were required to file the new Form D. As a result, we limited our analysis to only the new Form D filings. We performed our analysis in mid-December and, therefore, looked at Form D filings submitted as of December 16, 2008.

Using EDGAR, on December 16, 2008, we printed out a list of all the Form Ds filed between the time period selected (September 15, 2008 to December 16, 2008). EDGAR listed a total of 322 Form D filings. We judgmentally selected the first filing, and every eighth filing thereafter, for a total of 41 filings. The purpose of the review was to determine the accuracy and timeliness of the filings.

### **OIG Estimate of Capital Intended to be Raised Pursuant to Regulation D.**

Neither the Commission nor any other private entity of which we are aware aggregates information on the total amount of capital raised or intended to be raised through the Commission's Regulation D exemption process. Because all Form Ds were filed in paper form until September 15, 2008, aggregating this information would have had to have been done manually, which would have been very time consuming.

Therefore, the OIG analyzed a sample of filings and estimated the amount of capital that may have been raised in calendar year 2008. We did this by

analyzing all of the electronic Form D filings filed between September 15, 2008 and December 31, 2008. We selected this time period because September 15, 2008 was the first date when filers were able to file Form D electronically. We performed our analysis in January 2009, and determined that data collected as of December 31, 2008, was sufficient for the purposes of our estimate. We only examined the electronically filed Form Ds because these Forms were easily accessible, through EDGAR, unlike the paper Form Ds.

According to EDGAR, between September 15, 2008 and December 31, 2008, 373 electronic Form Ds were filed with SEC. We printed out each filing and recorded the amount of capital each issuer intended to raise through a Regulation D offering. This figure was identified as "Total Offering Amount" in item 13 of Form D. The actual amount of capital raised by each filer is often not known at the time of a Form D filing and, therefore, is not recorded on the Form D.

In 321 out of 373 instances, filers included a dollar figure in item number 13 of Form D, "Total Offering Amount," and, in 52 instances, filers indicated that the offering amount was "indefinite." Therefore, we removed these 52 "indefinite" filings from our analysis since they did not contain a dollar figure. Our sample consisted of the remaining 321 Form D filings.

According to EDGAR, issuers filed 20,021 Form D filings with the SEC in calendar year 2008. This figure does not include Form D amendments. We did not include amendments in our analysis to avoid double counting any information. According to our sample of 321 filings:

- The aggregate "Total Offering Amount" was \$9,764,844,494.
- The average "Total Offering Amount" per filing was \$30,420,076 (\$9,764,844,494 / 321).
- This average, multiplied by the total number of filings in calendar year 2008, resulted in an estimate of \$609,040,347,708 (\$30,420,076 \* 20,021).

Thus, the OIG estimated the total amount of capital intended to be raised through the Regulation D process to be \$609,040,347,708 in calendar year 2008.

This figure is only an estimate and several factors could skew this estimate. For example:

- Many companies do not file a Form D when raising capital in reliance on a Regulation D exemption. The number of non-filers is unknown and therefore could not be included in our analysis.
- The OIG only reviewed Form D filings that were filed electronically between September 15, 2008 and December 31, 2008. The economy

was suffering during this period and, as a result, it is possible that fewer issuers raised capital pursuant to Regulation D during this period, compared to other times during 2008 or in prior years.

- CF informed us that perhaps more sophisticated, larger companies that generally raise larger amounts of capital chose to file Form D electronically instead of using a paper filing. Thus, a similar sample of paper filings could have resulted in a lower average capital amount per filing.
- CF management told us that they presume the actual amount of capital raised in a given year, using Regulation D, is over a trillion dollars; however, CF management was not able to provide us with a definitive source of this information. According to the prior OIG report on the Regulation D process, the Commission recorded that the nation's small businesses reported unregistered offerings of \$1.2 trillion in securities from January 2000 to March 2001.

**Prior Audit Coverage.** From June 2003 to January 2004, the OIG audited the Commission's Regulation D Filing Process and issued a related report, *Small Business Regulation D Exemption Process*, Report No. 371, March 29, 2004. The report contained 5 recommendations for improvement.

## Criteria

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### **SEC Proposed and Final Rules Relevant to Regulation D, including:**

- Commission final rule: Electronic Filing and Revision of Form D, Release No., 33-8891, 73 FR 10592, February 27, 2008.
- Commission proposed rule: Electronic Filing and Simplification of Form D, Release No. 33-8814, 72 FR 37376, July 9, 2007.
- Commission proposed rule: Revisions of Limited Offering Exemptions in Regulation D, Release No. 33-8828, 72 FR 45116, August 10, 2007.
- Commission final rules: Regulation D; Accredited Investor and Filing Requirements, Release No. 33-6825, 54 FR 11369, March 20, 1989.

**The National Securities Market Improvement Act of 1996, Public Law No. 104-290, October 11, 1996** - Amended various provisions of several Acts, including the Securities Act of 1933 and preempted the states from enforcing provisions related to Rule 506 of Regulation D, in favor of federal regulation.

**SEC Form D (revised as of September 15, 2008) and the prior SEC Form D** - The official notice of an offering of securities made without registration under the Securities Act, in reliance on an exemption provided by Regulation D.

**Rules 501 through 508 of Regulation D, 17 C.F.R. §§ 230.501-508** – The rules governing the limited offer and sale of securities without registration under the Securities Act of 1933.

**Securities Act Rules: Division of Corporation Finance Compliance and Disclosure Interpretations** – Comprise CF's interpretations of the rules adopted under the Securities Act.

**Information Memorandum to the Commission from the Divisions of Corporation Finance and Enforcement on Waiver of the Disqualification Provisions of Rule 252 in Connection with Settlement Offers, July 16, 1987** – the Commission's internal procedures for the Rule 505 waiver process.

## List of Recommendations

### Recommendation 1

The Division of Corporation Finance (CF) should develop a process to assess and better ensure issuers' compliance with Regulation D. CF should include in this process a periodic review of the Form D filings, an assessment of the accuracy and timeliness of the filings, and the identification of problems or "red flags" with the filings. When CF believes that companies have materially misused the Regulation D exemptions, CF should take appropriate action such as contacting the offenders, and/or referring the matter(s) to the Division of Enforcement, the appropriate state regulator or other regulatory authority.

### Recommendation 2

The Division of Corporation Finance (CF) should establish a procedure to review Form D information in the aggregate and develop meaningful management reports that provide information about the filings, such as:

- The aggregate amount of capital intended to be raised on an annual basis;
- The average amount of capital intended to be raised per filing;
- The number of filings that were filed timely;
- The number of filings made by hedge funds and the aggregate net asset value of those funds;
- The number of filings made pursuant to Rules 504, 505, 506;
- The types of companies that use the Regulation D filing process; and
- The extent to which small businesses use the Regulation D process to raise capital.

CF should use the information in the management reports to further understand the size and nature of the companies that raise capital through the Regulation D process and to assist CF in developing future policies, procedures and rule changes.

### Recommendation 3

The Division of Corporation Finance (CF), in consultation with the Division of Enforcement, should take appropriate action when issuers fail to file Form D in accordance with Rule 503. For example, CF could establish general criteria or guidance describing when it believes it is appropriate for the Commission to initiate an Enforcement action against an issuer that fails to file a Form D and request that a court enjoin an entity from violating Rule 503.

#### **Recommendation 4**

The Division of Corporation Finance should reintroduce its Early Intervention Program and utilize this program to assist in the enforcement of Regulation D and other securities laws and regulations.

#### **Recommendation 5**

The Division of Corporation Finance (CF) should develop criteria describing when it is appropriate to refer potential Regulation D abuses to its Office of Enforcement Liaison and when such referrals should subsequently be forwarded to the Division of Enforcement (Enforcement) for appropriate action. Additionally, CF and Enforcement should improve the communication and coordination between staff in CF's Office of Small Business Policy and Enforcement staff. Specifically, staff in CF's Office of Small Business Policy should periodically remind Enforcement about the expertise that they could provide to Enforcement staff regarding Regulation D issues, assist Enforcement with specific aspects of referrals pertaining to Regulation D issues, and/or offer training sessions to Enforcement staff.

#### **Recommendation 6**

The Division of Corporation Finance (CF) should take further efforts to finalize the Commission's proposed rule, "Revisions of Limited Offering Exemptions in Regulation D" (Release No. 33-8828, August 10, 2007, 72 FR 45116). For example, CF could discuss the merits of this proposed rule with the SEC's new Chairman, the Commissioners and Commission senior staff.

#### **Recommendation 7**

The Division of Corporation Finance should raise with the Commission, the option of making the filing of Form D a required condition for issuers to claim the Regulation D exemptions contained in Rules 504, 505 and 506.

#### **Recommendation 8**

The Division of Corporation Finance (CF) should issue additional guidance to issuers on the Form D filing requirements. This could be accomplished by reiterating the Form D filing requirements at relevant meetings and symposiums and by adding information to CF's public website about the filing process. CF could also enhance compliance with the Form D filing requirement by developing and sending a "form" letter to issuers that failed to file a Form D or did not timely file a Form D.

### Recommendation 9

The Division of Corporation Finance should discuss the following enhancements to Form D with the Office of Information Technology (OIT) and work with OIT to make the following revisions to Form D:

- Form D should include a statement conveying that the Commission has not necessarily reviewed the Form and has not determined if the information contained in the Form is truthful or complete and that any representation to the contrary is a criminal offense. The statement should also convey that the reader should not assume that the information in the Form is accurate or complete;
- Item 1 of Form D (Issuer's Identity) should be revised so to ensure that each issuer's state of incorporation or organization appears as a valid entry on Form D;
- Item 5 of Form D (Issuer's Size) should be revised to ensure that the electronic version of the Form contains headings in the text of the electronic Form stating that issuers need to fill in information related either to the "Revenue Range" or the "Aggregate Net Asset Value Range" of the offering; and
- Item 11 of Form D (Minimum Investment Amount) should be revised to allow issuers to select a choice indicating that an offering does not have a minimum investment amount. This could be accomplished by replacing the current choice of "zero" with "no minimum investment."

### Recommendation 10

The Division of Corporation Finance's (CF) Office of Small Business Policy staff should coordinate with CF staff who review Commission registration statements, 10-Ks and 8-Ks to determine if issuers also filed Form Ds when the registration statements, 10-Ks and 8-Ks indicated the existence of private placement offerings. CF should also follow up with delinquent Form D filers, as appropriate.

### Recommendation 11

The Office of Compliance Inspections and Examinations (OCIE) should further coordinate with the Division of Corporation Finance (CF) to ensure that CF timely receives copies of all OCIE examination reports that disclose misuses of the Regulation D exemption process and potential violations or abuses of the rules contained in Regulation D. OCIE should also provide CF with copies of all related Enforcement referrals. CF should follow up with and offer assistance to the Division of Enforcement and OCIE, as appropriate.

**Recommendation 12**

The Division of Corporation Finance (CF) should issue formal, written, publicly-available guidance describing how to request a waiver of disqualification under Rule 505 of Regulation D and under what circumstances a waiver request may be appropriate.

**Recommendation 13**

The Office of Information Technology (OIT), in consultation with the Division of Corporation Finance (CF), should evaluate the Commission's current EDGAR authentication process, and OIT should make necessary changes to further simplify or streamline the authentication process, as appropriate. To facilitate this process, CF should communicate related problems and proposed changes to OIT as soon as they become apparent and OIT should respond accordingly.

**Recommendation 14**

The Office of Information Technology (OIT) should analyze how other agencies (federal and/or non-federal) have implemented authentication processes to enable new users to file documents electronically, and determine if the SEC should implement any of the processes used by other agencies. OIT should implement any appropriate procedures to further streamline and simplify its own EDGAR authentication process.

**Recommendation 15**

The Division of Corporation Finance (CF) should work with the North American Securities Administrators' Association (NASAA) to finalize the Commission's Memorandum of Understanding with NASAA and recommend that the Commission approve it.

**Recommendation 16**

The Division of Corporation Finance should timely and appropriately coordinate with staff at the North American Securities Administrators' Association to develop a system that can be linked to the Commission's Electronic Data Gathering and Retrieval system, enabling issuers to file Form D electronically with the states.

**Recommendation 17**

The Division of Corporation Finance (CF) should take into account all of the comments and suggestions described above and implement appropriate action. In particular CF should:

- Determine to what extent CF can further coordinate with staff at the North American Securities Administrators' Association (NASAA), as in the manner described by Commissioner Aguilar, and take appropriate action; and
- Contact appropriate staff at state regulatory organizations, such as NASAA, when CF staff are discussing and drafting proposed rule changes pertaining to Regulation D.

## Comments from CF

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

March 30, 2009

H. David Kotz  
Inspector General  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549

Dear Mr. Kotz:

Thank you for the opportunity to respond to the recommendations in your March 24, 2009 draft report *Regulation D Exemption Process* (Audit Report No. 459). While our written response to each of the recommendations in the draft report is included in the attached document, we would like to present a few general points about the report.

As you explain in the report, the Division of Corporation Finance has a team of professionals dedicated to issues related to Regulation D compliance. These professionals handle questions from the public regarding Regulation D compliance, provide advice to the Commission and the Commission staff on matters—including enforcement matters—related to Regulation D rules and Form D, prepare and issue public guidance for issuers seeking to rely on Regulation D, and communicate with filers, state securities regulators and members of the bar about key compliance issues in this area. We welcome your recommendations on how we can improve these activities.

We feel that it is important to note that when the Commission originally proposed Form D, it stated that a primary purpose of the notice was:

to collect empirical data which will provide a basis for further action by the Commission either in terms of amending existing rules and regulations or proposing new ones. Further, the proposed Form will allow the Commission to elicit information necessary in assessing the effectiveness of Regulation D as a capital raising device for small businesses.

The current information requirements of Form D are consistent with the original data collection purposes the Commission set forth. It does not appear that the Commission intended for the Form D notice to be a vehicle for detecting Regulation D violations or fraud or abuse in the sale of securities, nor that it intended for Form D to be a vehicle to provide disclosure to investors. Form D does not require the type of information that could allow us to evaluate compliance with Regulation D on a case-by-case basis. While a review of a Form D could lead us to identify an issuer's failure to meet Form D filing requirements as they relate to timing, to evaluate compliance we would have to

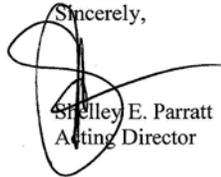
H. David Kotz  
March 30, 2009  
Page 2

review and analyze a much broader set of information than an issuer provides in a Form D filing. We will, however, weigh the potential benefits of your recommendation that we review Form D filings against the costs of such a review.

Finally, with regard to your suggestion that a review of a Form D may lead us to identify misuse of a Regulation D exemption, in many cases, an issuer relying on Regulation D may also be relying on other Securities Act exemptions from registration. While an issuer's failure to file a Form D is not, in and of itself, an indication of either a violation of the registration or antifraud provisions of the federal securities laws and a failure to meet the requirements of Regulation D is not, in and of itself, an indication of a violation of Section 5 of the Securities Act, we will work with the Division of Enforcement to develop an appropriate program to respond to issuers' failures to comply with the filing requirements of Rule 503.

Thank you for the courtesy your staff extended to us during the course of your audit and thank you for the opportunity you have given us to present the Division's views on your findings.

Sincerely,



Shelley E. Parratt  
Acting Director

**Recommendation 1**

The Division of Corporation Finance (CF) should develop a process to assess and better ensure issuers' compliance with Regulation D. CF should include in this process a periodic review of the Form D filings, an assessment of the accuracy and timeliness of the filings, and the identification of problems or "red flags" with the filings. When CF believes that companies have materially misused the Regulation D exemptions, CF should take appropriate action such as contacting the offenders, and/or referring the matter(s) to the Division of Enforcement, the appropriate state regulator or other regulatory authority.

**Division Response to Recommendation 1**

We will assess the accuracy and timeliness of the Form D filings we identify for review. However, while this review could help us identify a failure to comply timely with the filing requirements, we do not believe our review of the empirical data issuers provide in it will lead us to identify a misuse of an exemption available under Regulation D.

When we believe companies have materially misused the Regulation D exemptions, we will continue our practice of taking appropriate action, such as contacting the possible offenders, and/or referring the matter to the Division of Enforcement, the appropriate state regulator or other regulatory authority.

**Recommendation 2**

The Division of Corporation Finance (CF) should establish a procedure to review Form D information in the aggregate and develop meaningful management reports that provide information about the filings, such as:

- The aggregate amount of capital intended to be raised on an annual basis;
- The average amount of capital intended to be raised per filing;
- The number of filings that were filed timely;
- The number of filings made by hedge funds and the aggregate net asset value of those funds;
- The number of filings made pursuant to Rules 504, 505, 506;
- The types of companies that use the Regulation D filing process; and
- The extent to which small businesses use the Regulation D process to raise capital.

CF should use the information in the management reports to further understand the size and nature of the companies that raise capital through the Regulation D process and to assist CF in developing future policies, procedures and rule changes.

**Division Response to Recommendation 2**

We will collect the aggregate information you suggest and use it to understand the size and nature of companies that raise capital through the Regulation D process.

**Recommendation 3**

The Division of Corporation Finance (CF), in consultation with the Division of Enforcement, should take appropriate action when issuers fail to file Form D in accordance with Rule 503. For example, CF could establish general criteria or guidance describing when it believes it is appropriate for the Commission to initiate an Enforcement action against an issuer that fails to file a Form D and request that a court enjoin an entity from violating Rule 503.

**Division Response to Recommendation 3**

We will consult with the Division of Enforcement and take appropriate action.

**Recommendation 4**

The Division of Corporation Finance should reintroduce its Early Intervention Program and utilize this program to assist in the enforcement of Regulation D and other securities laws and regulations.

**Division Response to Recommendation 4**

Reintroducing our Early Intervention Program is dependent upon resources.

**Recommendation 5**

The Division of Corporation Finance (CF) should develop criteria describing when it is appropriate to refer potential Regulation D abuses to its Office of Enforcement Liaison and when such referrals should subsequently be forwarded to the Division of Enforcement (Enforcement) for appropriate action. Additionally, CF and Enforcement should improve the communication and coordination between staff in CF's Office of Small Business Policy and Enforcement staff. Specifically, staff in CF's Office of Small Business Policy should periodically remind Enforcement about the expertise that they could provide to Enforcement staff regarding Regulation D issues, assist Enforcement with specific aspects of referrals pertaining to Regulation D issues, and/or offer training sessions to Enforcement staff.

**Division Response to Recommendation 5**

We will develop criteria for Division staff to apply when evaluating whether to refer potential Regulation D abuses to our Office of Enforcement Liaison. We already have an appropriate policy in place to evaluate when the Division will refer matters to the Division of Enforcement.

**Recommendation 6**

The Division of Corporation Finance (CF) should take further efforts to finalize the Commission's proposed rule, "Revisions of Limited Offering Exemptions in Regulation D" (Release No. 33-8828, August 10, 2007, 72 FR 45116). For example, CF could discuss the merits of this proposed rule with the SEC's new Chairman, the Commissioners and Commission senior staff.

**Division Response to Recommendation 6**

We will discuss the pending rule proposal rule with the Chairman and Commissioners and the Commission senior staff.

**Recommendation 7**

The Division of Corporation Finance should raise with the Commission, the option of making the filing of Form D a required condition for issuers to claim the Regulation D exemptions contained in Rules 504, 505 and 506.

**Division Response to Recommendation 7**

We will consider your recommendation and take appropriate action.

**Recommendation 8**

The Division of Corporation Finance (CF) should issue additional guidance to issuers on the Form D filing requirements. This could be accomplished by reiterating the Form D filing requirements at relevant meetings and symposiums and by adding information to CF's public website about the filing process. CF could also enhance compliance with the Form D filing requirement by developing and sending a "form" letter to issuers that failed to file a Form D or did not timely file a Form D.

**Division Response to Recommendation 8**

We will reiterate the Form D filing requirements at relevant meetings and symposiums. We do not agree that it is necessary for us to issue additional guidance on the Form D filing requirements or add information to the Division's website about the Form D filing process at this time because the publicly available guidance is current and accurate.

We do not have a means to identify all issuers who failed to file a Form D notice. We will, however, consider whether notifying all late filers is an efficient use of our resources.

**Recommendation 9**

The Division of Corporation Finance should discuss the following enhancements to Form D with the Office of Information Technology (OIT) and work with OIT to make the following revisions to Form D:

- Form D should include a statement conveying that the Commission has not necessarily reviewed the Form and has not determined if the information contained in the Form is truthful or complete and that any representation to the contrary is a criminal offense. The statement should also convey that the reader should not assume that the information in the Form is accurate or complete;
- Item 1 of Form D (Issuer's Identity) should be revised so to ensure that each issuer's state of incorporation or organization appears as a valid entry on Form D;
- Item 5 of Form D (Issuer's Size) should be revised to ensure that the electronic version of the Form contains headings in the text of the electronic Form stating that issuers need to fill in information related either to the "Revenue Range" or the "Aggregate Net Asset Value Range" of the offering; and
- Item 11 of Form D (Minimum Investment Amount) should be revised to allow issuers to select a choice indicating that an offering does not have a minimum investment amount. This could be accomplished by replacing the current choice of "zero" with "no minimum investment."

**Division Response to Recommendation 9**

We will undertake the necessary research to evaluate your recommendation that we include the suggested legend on Form D.

We have already taken action to implement your recommendations regarding Item 1 and Item 5. We will consider your suggestion about reporting of minimum investment amount in any future recommendation for Form D rulemaking.

**Recommendation 10**

The Division of Corporation Finance's (CF) Office of Small Business Policy staff should coordinate with CF staff who review Commission registration statements, 10-Ks and 8-Ks to determine if issuers also filed Form Ds when the registration statements, 10-Ks and

8-Ks indicated the existence of private placement offerings. CF should also follow up with delinquent Form D filers, as appropriate.

**Division Response to Recommendation 10**

We will review electronically filed Forms D with a view towards evaluating the disclosure in the registration statements, 10-Ks and 8-Ks we select for full review.

**Recommendation 11**

The Office of Compliance Inspections and Examinations (OCIE) should further coordinate with the Division of Corporation Finance (CF) to ensure that CF timely receives copies of all OCIE examination reports that disclose misuses of the Regulation D exemption process and potential violations or abuses of the rules contained in Regulation D. OCIE should also provide CF with copies of all related Enforcement referrals. CF should follow up with and offer assistance to the Division of Enforcement and OCIE, as appropriate.

**Division Response to Recommendation 11**

The Division of Corporation Finance will follow-up with, and offer assistance to, the Division of Enforcement and OCIE.

**Recommendation 12**

The Division of Corporation Finance (CF) should issue formal, written, publicly-available guidance describing how to request a waiver of disqualification under Rule 505 of Regulation D and under what circumstances a waiver request may be appropriate.

**Division Response to Recommendation 12**

We will issue the guidance you recommend.

**Recommendation 15**

The Division of Corporation Finance (CF) should recommend that the Commission finalize its Memorandum of Understanding (MOU) with the North American Securities Administrators' Association (NASAA).

**Division Response to Recommendation 15**

We will recommend that the Commission finalize the MOU.

**Recommendation 16**

The Division of Corporation Finance should timely and appropriately coordinate with staff at the North American Securities Administrators' Association to develop a system that can be linked to the Commission's Electronic Data Gathering and Retrieval system, enabling issuers to file Form D electronically with the states.

**Division Response to Recommendation 16**

We will continue to work with NASAA on this.

**Recommendation 17**

The Division of Corporation Finance (CF) should take into account all of the comments and suggestions described above and implement appropriate action. In particular CF should:

- Determine to what extent CF can further coordinate with staff at the North American Securities Administrators' Association (NASAA), as in the manner described by Commissioner Aguilar, and take appropriate action; and
- Contact appropriate staff at state regulatory organizations, such as NASAA, when CF staff are discussing and drafting proposed rule changes pertaining to Regulation D.

**Division Response to Recommendation 17**

We will continue to work with NASAA and state regulatory organizations.

## Comments from OCIE

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### MEMORANDUM

TO: Jacqueline Wilson, Assistant Inspector General of Audits  
Office of Inspector General (“OIG”)

FROM: Lori A. Richards, Director  
Office of Compliance Inspections and Examinations (“OCIE”)

SUBJECT: OIG Draft Report, Regulation D Exemption Process

DATE: March 25, 2009

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Thank you for the opportunity to review and comment on the OIG’s draft report entitled Draft Report - Regulation D Exemption Process (“Draft Report”). In the draft report, the OIG makes one finding and recommendation that directly involves OCIE:

#### **Recommendation 11**

The Office of Compliance Inspections and Examinations (OCIE) should further coordinate with the Division of Corporation Finance (CF) to ensure that CF timely receives copies of all OCIE examination reports that disclose misuses of the Regulation D exemption process and potential violations or abuses of the rules contained in Regulation D. OCIE should also provide CF with copies of all related Enforcement referrals. CF should follow up with and offer assistance to the Division of Enforcement and OCIE, as appropriate.

We would be pleased to further coordinate with CF staff on Regulation D issues. We note that OCIE and CF have enhanced coordination recently. For example, in January 2008, CF staff and staff from the Division of Investment Management provided a training class to OCIE examiners addressing proposed changes to Regulation D and abuses noted in Regulation D offerings. We continue to look for additional ways to improve coordination with CF and other divisions and believe that such coordination improves the Commission’s ability to oversee the Regulation D exemption process.

The Draft Report notes that OCIE forwards some but not all of our examination reports dealing with Regulation D issues to CF. (Draft Report, page 24.) The Draft Report also notes that “According to CF staff, OCIE does not routinely send CF staff copies of pertinent broker-dealer examinations but does routinely forward its pertinent examinations of investment advisers to CF.” (Draft Report, page 24.) We agree that we inadvertently did not forward all broker-dealer examinations with Regulation D findings to CF staff and have already taken steps to improve our processes for identifying and forwarding pertinent broker-dealer examinations. We rely on our examination tracking technology to identify examinations with Regulation D findings and have discovered that limitations in this technology prevented us from identifying all such relevant examinations. We have already begun working on technological improvements to our examination tracking database. We further plan to expand our search efforts to other databases in order to enhance our ability to identify and share relevant examination reports with CF.

## Comments from OCIE

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OCIE Response to OIG Draft Report  
March 25, 2009  
Page 2

The Draft Report further states that OCIE should provide CF with copies of Enforcement referrals of Regulation D issues going forward. (Draft Report, page 25.) We respectfully request that the OIG consider modifying this to provide that OCIE should notify CF of instances where an examination results in a referral of Regulation D issues to the Division of Enforcement. We agree that CF staff could provide assistance to the Division of Enforcement during their consideration of how to pursue Regulation D issues. We believe, however, that we can facilitate coordination between CF and Enforcement staff by providing CF with copies of our examination reports, which generally provide a detailed discussion of Regulation D findings and issues,<sup>1</sup> and noting which of the identified examinations, if any, resulted in an Enforcement referral.

The OIG also made a finding and recommendation in the Draft Report that, while not directly related to OCIE, impacts the examination program. In particular, the OIG notes that filing a Form D should be a prerequisite to reliance on a Regulation D exemption. We agree. We believe that the requirement that issuers file a Form D in order to rely on the exemption processes in Regulation D would add transparency to the process that would, in turn, help us to identify potential firms and issues for examination.

Thank you again for the opportunity to comment on the Report. We also would like to express our appreciation for the courtesy you and your staff extended to us during this review. If you would like to discuss any of our comments, please do not hesitate to contact Kris Easter at extension 16253.

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<sup>1</sup> We note that our enforcement referrals often occur by forwarding a copy of the relevant examination report to enforcement staff and through telephone calls with enforcement staff.

## Comments from OIT and Enforcement

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### **Comments from the Office of Information Technology:**

OIT did not provide a formal comment letter but stated in an e-mail dated March 12, 2009, that OIT concurred without comment to recommendations 13 and 14, which are specific to OIT. OIT further stated that it would work with the Division of Corporation Finance on other recommendations in the report as appropriate.

Recommendations 13 and 14 stated that OIT and CF should work together to further simplify the EDGAR authentication process and that OIT should analyze how other agencies have implemented similar authentication processes and determine if any of those processes could be used to further simplify the SEC's EDGAR authentication process.

### **Comments from the Division of Enforcement:**

Enforcement did not provide a formal comment letter but stated the following in an e-mail dated March 25, 2009:

While the Division of Enforcement has limited resources in general, if the Commission informs us that this is an area in which they want us to focus, we will do so. We will review the referrals regarding Regulation D and recommend actions to the Commission where appropriate. There are two recommendations in this report where the Division of Enforcement is mentioned. In Recommendation 3 the report recommends that the Division of Corporation Finance, in consultation with the Division of Enforcement, should take appropriate action when issuers fail to file Form D. We concur in this recommendation and will work with the Division of Corporation Finance on general criteria in this area.

The other recommendation where the Division of Enforcement is referenced is Recommendation 5. We concur in the recommendation and will work to improve communication between the Divisions of Corporation Finance and Enforcement in this area.

## OIG's Response to Management's Comments

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We are pleased that OCIE, OIT and Enforcement concurred with, and committed to address the OIG report's recommendations that pertained to these units. We are also pleased that CF fully concurred with 10 out of the 15 recommendations that pertained to them and partially concurred with the remaining five recommendations.

On March 16, 2009, it became mandatory for all entities to file Form Ds electronically with the Commission. Now, anyone with an Internet connection can view the electronic Form D filings online and investors may rely upon this information. The OIG's analysis and review of OCIE examinations identified several instances where the Regulation D exemptions were abused and illegal activities such as "pump and dump" schemes were perpetuated through offerings that relied upon Regulation D exemptions. As a result, we believe that the Commission's commitment to analyzing Form D filings in the aggregate and taking further action to address entities that abuse the Regulation D exemptions is warranted and will further protect investors.

We also believe these actions will support the two primary purposes of the Form D filing process, as stated in a recent Commission rulemaking:

- Collection of data for use in the Commission's rulemaking efforts; and
- Enforcement of the federal securities laws, including the Regulation D exemptions.<sup>68</sup>

In light of the above, we hope that the Commission takes the appropriate action to implement these recommendations as soon as possible, to improve the Regulation D exemption process.

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<sup>68</sup> SEC final rule: Electronic Filing and Revision of Form D, Release No. 33-8891, 73 FR 10592, February 27, 2008, page 7.

# Audit Requests and Ideas

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The Office of Inspector General welcomes your input. If you would like to request an audit in the future or have an audit idea, please contact us at:

U.S. Securities and Exchange Commission  
Office of Inspector General  
Attn: Assistant Inspector General, Audits (Audit Requests/Ideas)  
100 F Street, N.E.  
Washington D.C. 20549-2736

Tel. #: 202-551-6061  
Fax #: 202-772-9265  
Email: [oig@sec.gov](mailto:oig@sec.gov)

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