

Small Business Regulation D Exemption Process

EXECUTIVE SUMMARY

The Office of Inspector General (OIG) reviewed the Division of Corporation Finance's (Division) process for assessing whether companies appropriately use Regulation D exemptions from the Securities Act of 1933 (1933 Act) registration requirements. We found that the Division's Office of Small Business Policy (Small Business) provides guidance to industry on Regulation D questions and conducts annual conferences to discuss matters affecting small businesses. Also, Small Business has proposed revising and requiring electronic filing of the Form D notice to make it more useful.

The Division can further assess whether companies appropriately use Regulation D exemptions by comparing information in Form D notices to companies' disclosures of unregistered sales of equity securities (required in filings to register offerings of other securities). Also, the Form D needs to include additional information to show compliance with Regulation D. In addition, the Division should collect and analyze information on Regulation D offerings and issues identified by the Office of Compliance Inspections and Examinations (OCIE).

Scope and Objectives

Our audit objective was to evaluate the Division's process for assessing whether companies appropriately use the Regulation D exemptions. We interviewed Division staff and reviewed relevant laws, regulations and other documentation.

We conducted the fieldwork between June 2003 and January 2004, in accordance with generally accepted government auditing standards.

Background

The Commission recorded that the nation's small businesses reported unregistered offerings of \$1.2 trillion in securities from January 2000 to March 2001 (statistics for other periods have not been collected).

Regulation D gives companies specific requirements to meet in order to exempt a sale of securities from registration under the 1933 Act. Companies that do not comply with Regulation D may still make unregistered sales of securities. Compliance with Regulation D, however, provides assurance that the company has met the 1933 Act requirements.

Regulation D includes three offering exemptions. Rule 504 exempts offerings up to \$1 million, Rule 505 up to \$5 million and Rule 506 an unlimited amount.

Investment companies, “blank check” companies (development stage companies without specific business plans) and companies that must file periodic reports under the Exchange Act of 1934 may not use Rule 504. Also, investment companies may not use Rule 505. On the other hand, any business may use Rule 506 to raise capital.

Regulation D requires companies to file a Form D, notice of the sale of unregistered securities, within 15 days after the first sale. Form D is a short form that identifies the issuer and any promoters, beneficial owners, officers and directors, and partners. Also, it provides information about the exemption claimed (Rule 504, 505, or 506) and information on the type and amount of the securities offered and the use of proceeds.

Also, Item 701 of Regulation S-K requires public companies to disclose in registration statements and periodic reports unregistered sales of equity securities within the past three years. This information includes the securities sold, underwriters and other purchasers, offering price, exemption claimed, terms of converting securities, and use of proceeds.

The Division does not systematically review Form Ds that are filed. However, the Office of Compliance Inspections and Examinations (OCIE) reviews Form Ds in connection with its examination of private placement activities of broker-dealers and investment advisers involving Regulation D issues.

Approximately 17,000 Form Ds were filed with the Commission in Fiscal Year (FY) 2003. The Commission’s Public Reference Room (Public Reference) in the Office of Filings and Information Services (OFIS) maintains Form Ds in paper for 30 days, and then discards them. A Commission contractor makes these forms available as document images.

The Office of Small Business Policy, consisting of five permanent and two rotating staff, is responsible for administering the Regulation D program. Small Business provides guidance to the industry by answering Regulation D questions submitted by telephone, e-mail, or regular mail. Also, it presents the annual SEC Government-Business Forum on Small Business Capital Formation attended by industry and state small business representatives.

Audit Results

The Division of Corporation Finance can improve its controls that ensure companies’ compliance with Regulation D. For example, the Division could use the Form D notice in reviewing the companies’ disclosures of unregistered sales of securities included in filings of public companies. Also, the Form D could be improved to

include certain information needed to show compliance with Regulation D and the Division could coordinate with OCIE on Regulation D issues. In addition, the Division could track data on Regulation D offerings or Regulation D compliance problems found by OCIE.

Form D and Registration Statements

We sampled 18 of approximately 320 Form S-1 1933 Act securities registration statements (registrations) filed between November 2002 and October 2003 on a judgment basis. We compared the disclosure of unregistered sales of securities in the registrations to the Form Ds filed by those companies during the same period. In 16 of the 18 registrations, we found at least one Regulation D transaction that appeared to lack a corresponding Form D. Also, for 12 of these 18 companies, we found at least one Form D transaction that we could not find disclosed in the registration.

Companies must file Form D for securities offerings for which they claim a Regulation D exemption. Also, Item 701 of Regulation S-K requires registration statement disclosure of unregistered sales of equity securities.

The Division's filing review staff relies on the Regulation D disclosures in the registration statement, and does not check them against the Form D.

Recommendation A

The Division should consider, in light of its priorities and resources, whether to require examiners to review the corresponding Form D information in connection with their review of subsequent registration statements.

Consult With OCIE

OCIE has identified deficiencies in Regulation D compliance during its examinations of registered entities' private placement activities. These deficiencies included insufficiently qualified accredited investors and potentially public securities offerings. The Division does not periodically consult with OCIE about Regulation D issues noted during exams. The Division could use this information to help guide its Regulation D policies.

Recommendation B

The Division should consult with OCIE to develop a process to obtain information regarding Regulation D compliance issues noted during OCIE examinations.

Track Form D Data

Small Business maintains an automated log of Regulation D telephone inquiries. Also, it created a database of information from approximately 9,400 paper Form Ds filed during 2000 and 2001.

The Division does not maintain current data regarding Regulation D offerings. This data would allow the Division to identify trends in the use of Regulation D (*e.g.*,

types of exemptions claimed, types of securities offered, offering amounts, use of proceeds).

Recommendation C

As its resources allow, the Division should track data on Regulation D offerings.

Revise Form D

The current Form D does not include certain information needed to determine compliance with Regulation D. For example, it does not show the date of the first sale of securities, although companies must file Form D within 15 days after the first sale.

Small Business proposed revising and requiring electronic filing of the Form D. It plans to coordinate with the states' securities authorities to identify information to add, change, or delete from the form.

The Commission must approve changes regarding Form D, including electronic filing. Also, the Office of Information Technology (OIT) has overall responsibility for system changes related to electronic filing. In addition, the Office of General Counsel might need to participate in addressing any related legal issues.

Recommendation D

The Division should recommend revising Form D to include the information described above, as well as any other information it deems necessary to include.

Recommendation E

The Division, in coordination with OIT and OGC, should make an appropriate recommendation to the Commission about electronic filing of Form Ds.